Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

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Active, Engaged Boards Secret to Banking Success, Fed Says

Despite dismal loan growth, the FDIC reports that community banks earned $4.4 billion in the first quarter of 2014, and that more than half of all community institutions had higher earnings during the quarter than a year earlier. What is the secret to their success?

A top regulator offers some clues – and a few cautionary tales – in a recent article in *Community Banking Connections*. She compiled what she described as "telling stylized examples" of how banks are responding to the current environment. Those meeting with success, she says, have stayed true to three key themes of good strategic planning: casting a vision with the right people and careful execution; attracting and developing expertise at the board level; and sticking to a well-thought-out plan, evaluating and revising as needed.

"Given today's difficult operating environment, many banks are understandably reevaluating their strategies to remain competitive and profitable," Cathy Lemieux, executive vice president,

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FDIC to Focus on Continuous Overdraft Fees

CFPB has indicated it may launch a highly anticipated rule-making on bank overdraft policies later this year. But at least one prudential regulator is stepping up its scrutiny of overdrafts now.

The focus: continuous-overdraft or negative-balance fees where consumers are charged as often as every day when an account is overdrawn.

The practice raises potential UDAAP and safety and soundness issues, officials say, and some banks have already been cited under Section 5 of the FTC Act for engaging in the practice.

The latest guidance, from the Kansas City Regional Office of the FDIC, shows how the industry has continued to push for overdraft income even as regulators have sought ways to limit it. FDIC has issued multiple types of overdraft guidance over the years. Regulation E and Regulation DD were amended to require additional overdraft-related disclosures and affirmative opt-out opportunities. But that has not stopped banks from finding ways around the guidance. Regulators are now responding once again.

"As a result of these changes and in a desire to preserve noninterest income, bank products and services have changed," the FDIC said in its latest guidance. "Compliance examiners are seeing a number of

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Learn New Mortgage Disclosure Forms Now, Experts Say

There is good and bad news about new mortgage disclosure forms from the CFPB. The forms – which must be used starting August 1, 2015 -- should simplify things for consumers and even lenders. But it may take the better part of the next year to fully understand and get used to them. Best to start paying attention now. And for small banks in particular: make sure your vendor is on track to supply them in time so you can fully train personnel.

The new forms – a Loan Estimate due three days after a newly standardized loan application is completed, and a Closing Disclosure due three days before closing – replace Truth in Lending and RESPA documents that have been used for more than 30 years.

The strict time limits are aimed at getting information to consumers

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Overdraft

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institutions adopt or increase continuous (or extended) overdraft or negative balance fees. These fees are sometimes charged every day the account is overdrawn or once every few days the account stays overdrawn depending on how the program is set up."

Experts said banks from all parts of the country would do well to heed the guidance, even though they may be outside the strict purview of the FDIC or its Kansas City district. All banks are subject to UDAAP, and to the extent they run afoul of it, they could face trouble from examiners on safety and soundness grounds. To the extent that guidance raises common sense fairness concerns, bankers ought to heed it regardless of source.

"You have to look at what the guidance says. Is it logical? Does it have merit?" says Steven Arnold, partner with Manatt, Phelps & Phillips in Orange County CA.

"I think it is worth noting, even if you are not an FDIC regulated bank within the Kansas City area," Arnold said. "You have to ask yourself, 'Is this a significant vulnerability? Is this something that plaintiff's counsel or bank examiners could legitimately claim we are doing wrong?'"

The guidance urges banks to take the consumer's perspective.

"Bankers are encouraged to review the information provided to consumers concerning overdraft services, particularly any extended overdraft and negative balance fees, and conduct transactional testing to ensure that the bank is charging these fees as disclosed from a reasonable consumer's perspectives," the guidance stated.

The guidance also questioned whether banks are being clear enough about the time they give consumers to cure an overdraft before charging a fee, especially on days the bank is not open for business.

"If a bank charges a continuous overdraft fee after three days, and an overdraft occurs on Thursday, the third calendar day 'after' the overdraft is Sunday. Because Sunday is likely a non-processing day, if the bank charges the fee the prior Friday, this will provide the consumer only one day to cure the overdraft, not three," the FDIC observed. "Such practices have been cited as unfair, in violation of Section 5. In order to avoid such issues, banks should review how these types of fees are assessed in light of the claims made in the bank's disclosures."

The Kansas City FDIC officials said banks should do more than just focus on the required disclosures under Regulation E and Regulation DD. They should ask themselves this question: "As a customer, would I know enough about how the fee is assessed to prevent myself from incurring it, should I accidentally overdraw my account?"

The guidance also offered two best practices for banks in notifying consumers about an overdraft and providing time to cure it. Banks should include when the continuous overdraft fee will be assessed in messages notifying a customer that an overdraft has occurred. They should also give customers "a reasonable time" to cure the overdraft prior to assessing any fee.

According to the guidance, bank officials should also consider testing to see that fees are being assessed as intended, consistent with disclosures, after a system conversation or upgrade.

Michael Shumaker, a lawyer with Bryan Cave in Atlanta, notes that the Kansas City office of the FDIC has often played a significant role in initiating policy for the FDIC more generally. He sees the guidance as a potential response to continuing consumer complaints about overdraft charges, and efforts to reduce class-action lawsuits related to overdraft fees through clarifications to state usury laws. Regulators want it known that just because the class action lawsuits are on the wane, banks still need to consider their overdraft fees from a compliance risk and UDAAP perspective.

Shumaker said he interprets the guidance thusly: "Although many states have enacted a 'fix' on overdraft-related class actions, that does not mean that banks should relax on the content and form of their customer disclosures."

"There still are common sense compliance and disclosure responses that apply to banks and will be enforced by the regulators," Shumaker said. "Abusive disclosures will still be subject to scrutiny and enforcement by the bank's regulators despite the changes in state law to better accommodate an overdraft product."

The FDIC officials said banks should review overdraft products and transactions with the following questions in mind:

- Does the system use business or calendar days when calculating when a fee will be assessed, and is this distinction clearly disclosed to consumers?

• Are all relevant disclosures consistent through all communication methods? Is the number of days to cure the overdraft disclosed correctly?

• Where disclosures provide that fees may be charged "after" a certain number of days, does the system ensure that these fees will not be charged on or before the indicated day?

• If the fee is assessed on calendar days, how does the institution handle continuous overdraft situations that occur over a weekend or holiday period where the final day of the "cure" period falls on a non-business day?

• Does the bank have a policy addressing how weekend deposits are applied?

• Are fees assessed on days when the customer is not able to cure the overdraft?

• Are consumers clearly informed of the bank's policies regarding continuous overdraft and negative balance fees and how these fees are applied?

• Is the fee assessed before the decision to pay or return an item? If so, and the subsequent decision is to return the item, then no overdraft has occurred. Without an overdraft, it is improper to charge an overdraft fee.

• Can the assessment of bank service charges or fees cause an extended negative balance fee to be assessed? If so, is the consumer told that other fees can lead to a negative balance, which can lead to additional fees?

"If discrepancies are found between what the bank discloses and what fees are assessed, bank management should consider issuing new disclosures and making voluntary restitution to customers," the guidance concluded. "A review of depositor accounts for potential restitution should be conducted back to the date when customers were assessed fees in excess of what should have been charged. Correcting such issues, including making full restitution, will be considered by the FDIC in reviewing the bank's disclosures and practices."

CFPB Interest

Overdraft charges have been an area of intense interest for CFPB, which issued a white paper last year detailing what it felt were widespread problems. The agency has indicated in its rulemaking agenda that it expects to issue another white paper or an advance notice of proposed rulemaking this year.

CFPB is likely to draw on its own UDAAP authority in any rulemaking. The latest FDIC guidance provides a sort of sneak preview of the sorts of issues that CFPB is likely considering.

"I think that the traditional banking regulators are trying to be helpful to their banks, providing guidance and making sure that the industry is aware of the issues," Arnold said. "With respect to the CFPB, there seems to be a preference to regulate those areas based on the more subjective UDAAP standards instead of establishing specific rules or regulations."" ■

Mortgage Forms

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sooner than ever. But lenders are concerned about being locked into unrealistic cost estimates. Settlement agents also face intense new deadline pressures. Experts say there are procedures to work around these problems. But that

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Mortgage Forms

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is doing little to assuage industry concerns.

A big change is that the rules take away from lenders the flexibility to design their own loan applications and when to give loan estimates to consumers. The rules do not limit the factors that lenders may consider in taking applications and making estimates. But they require that once six specific items are obtained – name, income, Social Security number to obtain a credit report, property address, an estimate of the value of the property, and the mortgage loan amount sought -- an application is considered received, and the estimate must follow within three days.

Even CFPB acknowledges it will be a challenge just dealing with the paperwork, calculating the information required and correctly populating the new forms.

"It is very technical and heavy on detail and minutiae," CFPB lawyer Andy Arculin said at a June 17 Webinar where he gave an overview of the new ground rules. "We literally could dedicate an entire Webinar series to filling out the forms"

CFPB has published a "Guide to Completing TILA-RESPA Integrated Disclosure Forms" to provide instructions and to highlight common situations that may arise when completing the forms. The agency also has issued a "Small Entity Compliance Guide for the TILA-RESPA Integrated Disclosure" for "smaller businesses with limited legal and compliance staff." The "plain language" publication runs 86 pages.

Banks are already suffering some regulatory fatigue in the wake of sweeping changes from CFPB last year in the form of ability-to-repay and qualified-mortgage rules. And the long tail leading up to the effective date of the disclosure rules next year may be leading some banks to put off dealing with them. Experts say that would be a mistake.

"It's tempting to avoid focusing on something that doesn't take effect until August of next year," said Ben Olson, a lawyer at BuckleySandler in Washington, and a former CFPB official who was an early drafter of the new disclosure rules while at the agency. "However, there is a lot to do and every day counts so everyone should be starting now."

"Every day counts so everyone should be starting now."

The Loan Estimate form replaces the Good Faith Estimate designed by HUD under RESPA and the "early" Truth-in-Lending disclosure designed by the Federal Reserve under TILA. The Closing Disclosure form replaces the HUD-1 settlement form and the Federal Reserve's revised Truth in Lending disclosure.

The final rules and the official interpretations contain detailed instructions as to how each line on the forms should be completed. Both the Loan Estimate and the Closing Disclosure contain additional new disclosures required by Dodd-Frank. The Loan Estimate, for instance, requires new information on the cash that the borrower will need to close the transaction.

A key change is the definition of an application, and the consequences of when one is completed. The six factors are not new but the bureau eliminated a seventh "catch all" item covering other information deemed necessary by the lender to complete an application. That item effectively allowed a lender to delay disclosures until it had the information it deemed necessary. But the bureau was not comfortable leaving it that wide open because, in its view, that meant that the disclosure could be delayed indefinitely.

The trouble with existing law, Arculin said, is that every creditor has a different definition of an application, and that makes it hard for consumers to know when a good faith estimate of the cost of a loan will be generated.

At the same time, lenders believe they are losing some of their control over the process, and being forced to provide estimates earlier than they would like.

"The industry feels caught between the requirement to provide the estimate based on limited information and the requirement to provide a reliable estimate," Olson says. "They don't feel the six items that constitute an application are enough to provide an estimate they want to be bound by."

CFPB says creditors can collect information beyond the six items described under the rule. But they cannot require a consumer to submit documents verifying information related to the application before providing the loan estimate. A creditor, for instance, may not pre-condition a loan estimate on the consumer submitting verifying income information.

Creditors are also not allowed to charge a consumer for anything other than a "bona fide and reasonable fee" for a credit report. And they are prohibited from taking a check or credit card number from the consumer at the time of the loan estimate on the understanding that they would be cashed or charged after the consumer has indicated an intent to proceed with the transaction.

Olson sees the process as manageable, although with less flexibility, creditors will have to hold their people to more rigid standards and processes.

"You can create a form or check list where you get everything you need from the borrowers but one of the six items, such as their Social Security number. Once you get those other things, you tell the borrower you are ready to order the credit report and get the Social Security number. You control the process that way," Olson said. "It is about building a process and getting your staff comfortable with that process. It is going to change the way lenders do business."

As with existing law, the final rule restricts the circumstances in which consumers can be required to pay more for settlement services than the amount stated on the loan estimate. The general rule, Arculin said, is that a lender will have to credit back the difference between the estimated charges and the actual sums paid or charged the consumers, although there are some exceptions.

The rules also include limits on communications between creditors and borrowers before a formal loan estimate. Arculin made clear those limits do not apply to general advertising. But they do apply to cases where a lender attempts to pre-qualify a specific customer for a loan.

If consumer is provided with a written estimate of terms or costs before receiving the loan estimate, for example, the top of the first page must contain the statement "Your actual rate, payment and costs could be higher. Get an official loan estimate before choosing a loan." That document also cannot use the same fonts or headings as the loan estimate.

While lenders already face restrictions on charges that vary from the original estimates they provide borrowers, the CFPB is likely to be a much more formidable and vigorous enforcer of the law. In addition, borrowers will be able to sue lenders for increases in costs that do not fall within an exception.

"Even if the limitations have not changed dramatically, the consequences of getting this wrong are much more severe. You have a regulator more likely to hold lenders' feet to the fire and the possibility of being sued by your borrowers," Olson said, adding that creditors should be prepared to carefully document such variances. "Any time anything changes, be able to document why it has changed and that it fits within one of the rule's exceptions." ■

Success

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supervision and regulation, Federal Reserve Bank of Chicago, wrote. "While challenges to our nation's community banks are stiff, these examples demonstrate that success is possible if banks have involved boards of directors and well-planned strategies supported by the right staff, capital, and controls."

Lemieux indicated there are even prudent ways to approach business lines that have been growing points of concern for regulators – such as investing more and more deposits in securities or opening the window on C&I or CRE loans. For reasons of confidentiality, she says, the stories she offers are not based on the experience of a single bank, but rather are a composite of supervisory observations.

In one example, a community bank grappling with slow growth decides to buttress earnings until the local economy improves by investing more funds in structured investment products and larger loans syndicated by other banks. The bank's board was aware of the deep losses suffered by other institutions on these types of loans and investments during the financial crisis – and of warnings from the banking agencies showing high levels of criticized assets among Shared National Credits.

To counter the risks, the board authorized senior management to set prudent controls for underlying credit risk, growth rates, and balance sheet concentrations. It also budgeted funds for the bank to hire two senior staff members — one with experience evaluating and selecting large shared credits, and another with knowledge of structured and complex investment products. Lemieux said the bank knew well the importance of laying the risk management groundwork in staffing and capital when casting a new strategic direction.

A similar story she cited – without the planning – played out in a different way at a rural community bank looking to offset reduced income on variable-rate

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Success

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agriculture loans. Bank management decided to take advantage of opportunities in surrounding counties to fund higher-yielding loans for big-ticket construction equipment and vehicle purchases by businesses.

According to this example, the CEO decided to use existing staff to preserve cash. Trouble was, the staff did not have a thorough understanding of the risks. Asset quality issues arose within the portfolios, and the resulting losses soon put a strain on capital. Disposing of repossessed vehicles and machinery soon became agenda items at board meetings.

Lemieux said active and engaged board is central to any turnaround. She cited the case of a community bank serving an urban area with a mix of businesses and residential neighborhoods that was beginning to exit crisis mode after five years of triaging asset quality issues among small business loans. With capital restored and neighborhoods showing signs of improving economic conditions, the bank shifted its attention to loan growth within its CRE portfolio.

The board recruited two new directors with ties to local business sectors, adding the owner of a small but established manufacturing company, as well as a business attorney. Three specific types of local borrowers were targeted for new loans and related business services.

"The resulting three-year plan included allocating capital relative to distinct borrower risk profiles to ensure the bank's overall capital was managed prudently and to cushion against unexpected losses, as well as dedicating funds to hire a banking professional with experience in choosing and refining underwriting systems," Lemieux wrote. "Specific risk controls were established to limit the bank's concentration by loan type and industry. A patient approach to reaching the bank's goals for growth recognized that improved earnings may take more than a few quarters to achieve, allowing management sufficient time to roll out the new strategy."

Other experts have identified other attributes of banks succeeding in these hard times. Some institutions are attacking costs with a new vigor, biding their time until the current cycle of low rates and stagnant loan growth plays out. Merger fever has taken hold among others. Experts see an uptick in activity among small banks looking to spread the burden of a seemingly endless stream of new regulations.

"In this environment, where you are lacking growth, and you already have significant pressure on margins, cost control is absolutely critical," said Kevin Tweddle, president of Fiserv's Bank Intelligence Solutions group in Atlanta. "When you have a stagnant interest rate environment without growth you are going to get margin compression. On top of that, the added regulatory pressure from the CFPB is minimizing fee income growth opportunities for banks. By default, you have to lower your expenses."

A study the firm did recently of top performing banks over the last five years showed that those on the list were especially good at controlling costs.

"If you have a lower cost foundation you don't have to go out and take these risks," Tweddle said. "You don't have to buy mortgage servicing rights or do some risky investment bond purchase."

"The banks that made the list were pretty simple folks. They didn't do a lot of unique things. Some had really good markets. Some had pretty unique niches. But the general story was, these banks were simple," Tweddle said. "They kept costs down. They did not overreach for yields. They did not overreach for risk. They stayed the course, knowing this is the cycle."

His advice: Keep costs down and scrutinize future opportunities.

"It is a different environment today amid demographic changes and the improvements in technology and the movement of banking into mobile sources," Tweddle said. "You should be able to cover more territory with fewer branches. You don't need a Fort Knox branch location. You need smaller square footage, high technology, and fewer, but perhaps more experienced, universal employees that can handle a variety of responsibilities." ■