The Compliance Connection

by Jean M. Hopeman

Compliance is too important to take a back seat to other loan officer responsibilities. For a variety of reasons, however, this may be the case, especially in smaller banks, and improper documentation can have painful results. Loan operations and compliance officers can help steer the course for the lenders. This article offers a few ideas for loan managers to consider and share with their lending groups: training, internal review, record keeping of problems (as similar problems may appear in the future), developing sample documents for each loan type, matching each deal with documents, and tracking progress.

Boredom is not a problem faced by lending management teams. Profitability, return on shareholder value, safety and soundness, and customer service all clamor for attention. Lending management appreciates the importance of regulatory compliance, but feels less comfortable with something that's not as easily measured or seen as a daily ledger and past due report. Compliance weaknesses, therefore, often are not detected internally. Rather, external compliance auditors or, worse, the bank's regulators discover them.

 Hopeman is senior vice president, credit administrator, and compliance manager for Sonoma Valley Bank, Sonoma, California. She also serves as a member of the Editorial Advisory Board of The RMA Journal.

This article is written primarily for those banks whose loan officers and loan operations personnel wear several hats and handle commercial, construction, and consumer loans alike. A banker in a smaller institution typically is assigned to handling a customer's various banking needs. If a loan officer seldom deals with real-estate-secured consumer loans, it is likely that he or she has not "nailed down" consumer loan documentation. If documents are missing, the bank can be "nailed" with violations of regulations and, in turn, be instructed to refund money to the borrower.

What regulations are typically involved?

- RESPA (Real Estate Settlement Procedures).
- Regulation Z (Truth in Lending).
- Regulation C (HMDA) Home Mortgage Disclosure Act.
- Regulation B (Equal Credit Opportunity Act).
- Fair Credit Reporting Act.
- Community Reinvestment Act (CRA) as regards data gathering on small businesses.

The Cost of Inattention to Compliance

Any bank can make a mistake once or twice. There are costs attached to "repeat violations," however, and the first can be in hard cash. Inadequate procedures or lack of action to correct problems not only embarrasses the audit committee, senior management, and the board, but the resulting repeat violations also invite civil money penalties.

—REGULATORY COMPLIANCE KNOWLEDGE—
A LITTLE KNOWLEDGE MAY NOT BE ENOUGH.
LOGIC IS NO SUBSTITUTE FOR KNOWLEDGE.

Another cost is the effect on employee relationships. Continuing errors can easily lead to defensive attitudes. Customer service personnel may think that the back-office personnel should be the experts in compliance. But while not as distracted as the platform officers who deal with customers all day, the back office takes direction from loan officers, who should understand which documentation goes with which type of loan. Compliance regulations, which prescribe the documents necessary, are often confusing and defy logic—one reason why compliance consultants are a rapidly growing service to banks.

Accountability

Within the streamlined structure prevalent in banks today, employees are called on to know more about banking, not less. Loan officers and loan operations personnel deal with all kinds of loans in a smaller bank and do not have the luxury of developing a single area of expertise. Since there are experts (auditors, consultants, compliance officers) who can answer their questions concerning compliance, each loan department employee must accept the challenge of self-accountability to ensure that the appropriate documentation is generated. Self-accountability includes asking for help when there are doubts, referring to resource materials, and knowing what transactions pertain to what regulations.

Everyone is accountable for compliance in the loan process. The process starts with the loan officers, who interview the applicants. Once the loan type is identified, loan operations prepares and reviews the documents; before signatures are gathered, loan officers need to review the documents yet again. Each set of eyes to view the loan documentation should check for what is appropriate for compliance, rather than checking just the loan amount, borrower name, interest rate, repayment schedule, and collateral description.

A discussion of some of the regulations shows what can lead to incorrect documentation due to limited knowledge about regulations.

HMDA

HMDA requires banks larger than $32 million in assets to report to the federal government by March 1 of each year detailed information on home purchases, refinances, and home improvements on dwellings. Officers need to know the definitions of a refinance, home improvement, and dwelling.

A *refinance* is a situation in which the loan is paid off and the deed is reconveyed. When this occurs, data is supposed to be collected about applicant race and gender. If this information is collected on a non-HMDA reporting loan, such as a modified loan

WHEN THE LOAN TEAM ANALYZES A PROBLEM, IT WILL LIKELY SHARE WHAT IT DID NOT KNOW ABOUT A REGULATION OR ITS MISUNDERSTANDING OF A PROCESS. IN THIS WAY, "THE BLAME GAME" CHANGES TO A SUPPORTIVE PROBLEM-SOLVING FORUM.

secured by a dwelling, a "violation" of this regulation has just occurred.

A *home improvement loan* is a loan used to repair, remodel, rehabilitate, or improve a dwelling or the real property on which it is located and that the institution classifies as a home improvement loan. A "little" knowledge about HMDA combined with intuition can lead the lender down the wrong path on documentation instructions. Lenders generally think that most consumer purpose term loans secured by a second trust are HMDA reportable. A home improvement loan can be unsecured. It would be an error to omit reporting an uncollateralized home improvement loan. Logic often misleads us in complying with these regulations. Home equity loans, where the purpose of the funds may be for debt consolidation or to buy a car, are not HMDA reportable. Loan officers need to understand the purpose of the funds and definitions. Do home improvements simply mean rehabilitation or addition to a structure? A swimming pool is considered a home improvement. The loan is HMDA reportable if loan funds are used for that purpose.

HMDA's definition of *dwelling* includes not only one's principal dwelling but residential rental income property as well. If the bank regularly lends on mixed-use property, the loan officer needs to describe in the credit analysis the square footage or income attributed to the residential rental income. If loan policy states that HMDA applies when either 50% or more square feet or 50% or more residential income is derived from the property, the loan is HMDA reportable. It is unlikely that loan operations will read the credit proposal to find out that information. So as not to overlook reporting such loans, the officers need to be aware of the nuances of the regulation and properly write documentation instructions

Similarly, if the loan is for bridge financing or temporary financing (less than 24 months) on a home purchase or refinance, the loan is not HMDA reportable. A modified loan and deed of trust to increase the loan amount is also not HMDA reportable. Logic would tell us that a change in the loan amount should trigger recording the change, but modified loans are not candidates for HMDA reporting.

When business and consumer clients come to the bank for debt consolidation loans or to finance equipment with a loan secured by their homes, it is not HMDA reportable. Again, this regulation is purpose driven, and a solid understanding of definitions will make the job easier for all areas of the loan department. Loan operations will follow the instructions given by the officer. If the loan officer and loan operations are not confident in their knowledge of these regulations, the wrong documents are likely to be generated.

RESPA

RESPA is also hard to understand. Unlike HMDA, RESPA always requires a recorded deed of trust. This regulation requires the "good faith estimate," settlement costs booklet, and HUD settlement statement and notice of transfer-of-service letter (first trust deed only). RESPA applies to any consumer-purpose loan, including debt consolidation, home purchase, home refinance, home improvement loans, and home equity credit lines and construction loans if permanent financing by the same lender is provided and if the construction loan extends longer than two years.

Loans collateralized by vacant land (unless within two years from the settlement date, a one- to four-family dwelling or manufactured home will be constructed or placed on the property using the loan proceeds), loans secured by 25 or more acres, and loans extended for primarily business, commercial, or agricultural use are exempt.

As mentioned, loan officers in smaller banks manage many types of loans for the business customer. Frequently, owner-occupied real-estate-secured property or rental property is offered as collateral for loans other than business credit lines, equipment term loans, and commercial construction or purchase. Consumer-purpose loans can creep in through the business relationship door. For example, say there is an opportunity to finance the down payment for your business customer's son's first home collateralized with the customer's rental residence. The loan falls under RESPA. The loan officer understands the deal and is the starting point to determine which documents will be signed by the borrower(s). The loan officer also needs to review the application to make sure the purpose written on it coincides with what is actually done. Although this would seem obvious, customers do not always pick the right "boxes" on the application or write down correctly what they actually want. Is the loan for home improvements, for refinancing, or for buying equipment for the business? If, upon review, the application request does not match the boarding instructions, auditors will seek to learn the real purpose of the loan and whether the correct documents were signed.

CRA

The Community Reinvestment Act requires banks to record data regarding small business loans and small agricultural loans. Gross business revenues are tracked to gauge banks' lending in designated census tract areas. Auditors will test parts of the portfolio by choosing files to see if the gross revenues recorded in the database match the application, tax returns, and the revenue figure the officer used for the credit decision.

Loan officers need to be familiar with what to record for all types of lending situations—for example, the special requirements of a start-up company. Loan operations needs to be familiar with the call code definitions, so that loans are properly categorized for CRA purposes.

THESE REGULATIONS ARE CONFUSING; TIME SPENT REVISITING THEM AND USING ACTUAL EXAMPLES HELPS STAFF REMEMBER HOW AND WHEN CERTAIN REGULATIONS APPLY.

Compliance is too important to take a back seat to other loan officer responsibilities. Loan operations and compliance officers are there to help steer the course for the lenders. With this in mind, a few ideas for loan managers to consider and to share with their lending groups are offered.

Recommendations

Learn together. Hire a compliance consulting group to provide in-house training for loan operations and loan officers together. If external auditors find exceptions to the loan files, use those customer files as examples for corrective action. The process that your bank follows can be examined very closely.

Find out what went awry with the documents for a particular loan. For example:

- Were incomplete or inaccurate documents generated because the officer misdirected?
- Did someone in loan operations conduct a second review before the documents were given to the loan officer for the customer to sign?

When the loan team analyzes a problem, it will likely share what it did not know about a regulation or its misunderstanding of a process. In this way, "the blame game" changes to a supportive problem-solving forum. A third-party compliance teacher is an effective conveyor of the message—to learn and to change procedures as required.

Internal review. Develop an ongoing internal review process for loans by the compliance officer or support staff. The compliance review should be given as much visibility in reports to management as is the safety and soundness review. Attention paid to these regulations through scheduled reviews will impress their importance upon the loan department team, senior management, the audit committee, the board, and regulators.

Monthly communication. Hold monthly loan department meetings, at which compliance is discussed and regulations are reviewed. Habitual review of the regulations keeps everyone cognizant of the need to ask questions or to consult an external compliance auditor for a particular loan situation.

These regulations are confusing; time spent revisiting them and using actual examples helps staff remember how and when certain regulations apply. With compliance as a regular part of the meeting, its importance is reinforced. The discussions should help reveal the "holes" in the procedures and result in fixes.

THE MEMO IS EVIDENCE THAT YOU HAVE STOPPED TO RESEARCH THE SITUATION. THE REGULATORS DON'T HAVE ALL OF THE RULES NAILED DOWN, EITHER. IT'S GRATIFYING TO HAVE A CHANCE TO PROVE YOUR KNOWLEDGE DURING AN AUDIT.

Teaching methods and tools. Find out which learning materials work best for your bank. Computer training modules are good for learning about regulations and for reference, but they are no substitute for group discussion. Prepare easy-to-use handouts or grids to share with the loan department. Create a compliance reference book for each loan officer and for the loan operations department. A change in training approaches will keep retraining fresh, rather than repetitive.

Memo to file. The compliance expert should be brought in to discuss any unclear situation, with the resolution documented in the credit file. Keep a copy of this memo in the compliance trainer's reference book, as there will probably be other loans like it in the future. The memo also will help during audits, as evidence that you have stopped to research the situation. The regulators don't have all of the rules nailed down, either. It's gratifying to have a chance to prove your knowledge during an audit.

Deal/document match. The loan officers and loan operations need to compare the deal with the documents. Does the loan purpose match the documents? Don't rely on a computer-generated document system for correctness. Review the "attention" warnings on the documentation checklist, although that will help only if you chose the right loan product. If you hit the wrong selection button—for example, *purchase real estate loan* rather than *refinance real estate*—the computer will create the right document for the wrong loan. A purchase selection will not generate a right of rescission, so if the deal is really a refinance of an existing mortgage, the lender is left hoping that the borrower continues to pay on time and does not become upset with the bank.

Sample documents. Create a sample book of additional documents needed—from the predisclosures to the flood insurance—for commonly used loan types. Some examples of loan types are:

- Owner-occupied purchase loans.
- Non-owner-occupied purchase loans.
- Refinance owner-occupied purchase loans.
- Refinance non-owner-occupied purchase loans.
- Home improvement loans.

The ability to view sample documents is particularly helpful if the lenders make these types of loans only occasionally. It can help keep the lenders from producing the wrong documents and from overdisclosing—providing more documents than are necessary. Sample documents take the guesswork and "logic trap" choices of documents out of the equation.

Track progress. Have management and the loan department jointly establish a compliance goal for the bank. This goal could be expressed as an absolute number or as a percentage of the loans that will fail a compliance audit. Track the number of failing loans against the target. Tracking can be done in the monthly internal audit review and reported in the department meetings. Setting a target and measuring progress before the auditors arrive reflect a proactive, in-charge kind of attitude that strengthens the compliance position of the institution.

Conclusion

The cost of repeated inattention and lack of accountability to compliance regulations can result in fines and embarrassment at all levels of the bank, from the loan officer and operations support on up to the audit committee, senior management, and the board. Errors will be minimal if knowledge of compliance regulations is a part of the institution's definition of a professional banker. Do not assume that others in the department are documentation experts. Be knowledgeable and accountable for customer loan documentation. Senior management should acknowledge and reward competency in compliance as much as they acknowledge and reward profit generation. ❒

Hopeman may be contacted by e-mail at jhopeman@sonomavlybnk.com

The Compliance Connection from AIB International ensures you stay in-the-know on upcoming compliance dates, requirements, and tips and tricks to maintain and track your food safety progress. Connect with the FSMA training solutions you need from the partner you trust! FSMA Freebies. Online Training.