Module: Compliance
Section: Introduction
EM-605

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General

The FCA has a legal or accepted examination responsibility for enforcing compliance by Farm Credit System (System) institutions with certain consumer protection regulations, the Farm Credit Act, FCA Regulations, and other laws and regulations. While compliance with regulations is only one aspect of a System institution's operations, the presence of violations and the absence of an effective compliance program reflect adversely on management and the board of directors and may be indicative of inadequacies in other areas of management responsibility. Failure to comply with regulations or to possess an adequate internal control process that promotes compliance can also expose a System institution, its directors, and officers to costly civil liability, litigation, and a loss of customer goodwill. Additionally, noncompliance with regulations may subject the institution to enforcement actions by FCA or another Federal agency responsible for enforcement.

Even though most areas of examination activity involve some aspects of compliance, this module is limited to those regulations which lend themselves to a stand-alone examination process. In other words, it is easier and more efficient to single out certain types of regulations and to focus on evaluating compliance with these regulations, than it is to determine adherence while examining some other aspect of a System institution's operations.

To accomplish a stand-alone examination process, samples are periodically drawn and tested to measure an institution's compliance with regulations. The degree and depth of sampling should ordinarily be based on risk determined to be present. This risk may be minimal if policies, procedures, and internal controls are adequate and previous examinations or internal reviews have not disclosed substantive violations. In that case, it may be possible to exclude the evaluation of compliance with any or all regulations in this module from the scope of examination during a particular examination cycle. However, if policies, procedures and internal controls are inadequate and/or substantive violations were previously detected, the examiner-in-charge (EIC) must ensure that sufficient testing is conducted to adequately conclude on the compliance area being tested. If material violations are identified in areas with limited examination samples, additional sampling may be necessary to determine the cause of the problem (e.g., a pattern or practice, or an isolated error). In addition, testing should include a review of the extent and types of noncompliance disclosed in previous examination activity and the adequacy of corrective action taken by the institution since the previous examination. More specific sampling techniques are described elsewhere in this section.

Consumer Protection

Consumer protection legislation focuses on consumer credit and fair lending practices. However, not all consumer protection legislation is applicable to System institutions, and FCA does not have specific enforcement authority for some of the consumer regulations, including some regulations for which FCA examines an institution's compliance. Nevertheless, in some instances, the agencies charged with primary enforcement authority have generally delegated administrative enforcement authority to FCA. For example, FCA has been delegated responsibility by the Federal Reserve Board (FRB) for examining and enforcing compliance by System institutions with the Equal Credit Opportunity Act (FRB Regulation B), the Consumer Leasing Act (FRB Regulation M), and the Truth in Lending Act (FRB Regulation Z). As a result of the delegation, FCA is obligated to report, on an annual basis, the extent of System institutions' compliance with these regulations to the FRB.

While FCA has no specific enforcement authority for other consumer-related statutes, the agency has undertaken examination responsibility under its general authority to protect the safety and soundness of

System institutions. Other consumer-related statutes include FRB Regulation U (margin securities), the Fair Credit Reporting Act, the Real Estate Settlement Procedures Act, the Fair Housing Act, and the Home Mortgage Disclosure Act.

The Federal Reserve Board (FRB) has published the *Consumer Compliance Handbook*, which provides examiners with background on consumer compliance regulations and statutes as well as guidelines for conducting consumer compliance examinations. The Handbook is updated periodically to reflect changes in the regulations. In addition, the FRB website provides a brief description of each of the Board's regulations, with a link to the full text of the regulation (including interpretations or staff commentary) as it appears on the Electronic Code of Federal Regulations (e-CFR) web site authorized and maintained by the National Archives and Records Administration's Office of the Federal Register and the Government Printing Office (GPO). Links to all pending proposed amendments to regulations are also provided.The Handbook and the regulations can be accessed at http://www.federalreserve.gov/bankinforeg/default.htm. Because the consumer compliance regulations are amended frequently, FCA has determined that it is more effective to use the FRB's guidance for examination of the consumer compliance regulations.

Borrower Rights

An important aspect of the examination process is the evaluation of compliance with borrower rights regulations. The Farm Credit Act Amendments of 1985 extended certain protections to System loans exempted from the Truth in Lending Act. The Agricultural Credit Act of 1987 amended and expanded these borrower protection regulations for System loans. Some of these borrower protection regulations are summarized below:

- Disclosure of Loan Information--System institutions must provide borrowers with interest rate disclosures.

- Notice of Action and Review--All applicants are entitled to prompt written notice of action taken on applications, including the reason(s) for the action and the applicant's right to a review of an adverse action. Borrowers whose stock is to be retired must also be notified before the action is taken. All System institutions must establish review committees to review, at the applicant's request, adverse credit decisions. The committee must promptly notify applicants in writing of its decision and the reasons for the decision.

- Protection of Borrowers--Borrowers are protected from qualified lenders taking action on loans for which the borrowers have met all loan obligations.

- Restructuring--System institutions must provide distressed borrowers an opportunity to have their loans considered for restructure.

- Right of First Refusal--System institutions must provide previous owners of other property owned first refusal rights to repurchase the property.

- Access to Information--System institutions must provide a borrower or the borrower's representative copies of all documents signed by the borrower when the loan is executed or upon written request by the borrower at any time thereafter. Borrowers may also request copies of the institution's articles of incorporation, charter, and bylaws at any time.

- Retirement of Equities--System institutions must provide written notice to borrowers regarding the retirement of equities.

Financial Reporting

System institutions are required to provide financial and other relevant disclosures to all shareholders and FCA. These disclosures include the Annual and Quarterly Reports to Shareholders, association Annual Meeting Information Statements, and Management's Discussion and Analysis. In addition, each System institution is required to provide FCA with quarterly Call Reports. FCA Regulations and Call Report instructions prescribe the content of each disclosure to shareholders and the quarterly Call Reports, respectively. Examiners are required to verify the accuracy of these disclosures and reports as part of the examination process. Any deficiencies noted are reported as violations of FCA Regulations.

Criminal Referrals

The Bank Fraud Working Group and FCA have established regulatory procedures for System institutions to report suspected criminal activity. While neither the System nor FCA has the authority to investigate crimes, the procedures provide a framework for defining violations, forwarding criminal referrals, distinguishing between those who allegedly commit crimes (i.e., System personnel, borrowers, or others), establishing accountability for making referrals, and setting deadlines for submitting criminal referrals. Finally, Supplement 1 contains the appropriate criminal referral form and instructions for its completion.

Examination Objectives

Determine if policies, procedures, and a system of internal controls provide adequate assurance that regulatory requirements will be met; System institution personnel are adhering to prescribed procedures; and deficiencies are brought to management's attention for appropriate corrective action.

Compliance Sampling Techniques

Basically, there are two accepted types of compliance sampling techniques--judgmental and statistical. Judgmental sampling is normally more efficient and effective than statistical sampling in uncovering whatever types of disclosure violations may exist in consumer loans and borrower rights areas. Because the volume of consumer loans is relatively small in most System institutions, and the nature of borrower rights regulations does not easily lend itself to statistical sampling, it is contemplated that judgmental sampling will generally be used. However, in addition to judgmental sampling, a brief discussion of statistical sampling is included below.

Judgmental Sampling

Judgmental sampling accommodates the risk-based approach to examining by allowing examiners to target areas for testing based on what is perceived as risk. As detailed in the Institutional Examination Planning section of the Planning and Monitoring module, the EIC develops focal points of risk based upon ongoing monitoring activities, prior examination findings, discussions with institution management, and any additional information discovered during survey activities. Targeted or judgmental samples typically consist of several smaller samples of specific loans tailored to fit the particular concerns being investigated. This type of sampling is generally more effective and efficient than random or statistical sampling since examiners are reviewing for only one or two pertinent factors on a smaller targeted sample instead of examining several generic items on every loan in a larger random sample. The depth of testing is continually reevaluated based on examination results. When sufficient work has been done to reach a conclusion, no further testing is required. If a conclusion cannot be reached, then the targeted sample should be expanded or refocused on those areas of significant risk.

> Consumer Protection Legislation (e.g., Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, etc.) The examiner should sample judgmentally, if necessary, by selecting from among the various loan categories a few of each type of consumer loan transaction with different characteristics. If disclosure or other violations are apparent in any type of transaction, the sample of that transaction type should be expanded to a level where the examiner is satisfied, after investigating the apparent cause or source of the violations, that a pattern or practice of such violations either does or does not exist.
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> In determining the transaction types to be sampled, loans with such characteristics as secured by personal property, secured by real estate (home improvement, purchase money mortgage, refinancing, etc.), unsecured loans, differing types of payment streams (single payment, installment payments, etc.), variable interest rates, credit life or accident and health insurance, or prepaid finance charges (real estate points, origination fees, etc.) should be sampled.

Loans to be tested for compliance should be selected from applications received and closed since the last examination. The identification of consumer loans might also be accomplished by reviewing loan committee minutes since the last examination and/or using criteria (such as loan purpose, loan size, collateral type, and other criteria extracted from the specific regulations being tested) that are indicative of consumer loans. Not all loans selected will be subject to the specific regulations; however, this should provide a basis for evaluating whether the institution is adequately complying with consumer protection regulations on loans covered by those regulations.

Discussions with management and loan officers will identify additional consumer loans that may have been overlooked in the review of the loan committee minutes. This approach can also identify the "population or universe" of consumer loans and, if such loans are numerous, statistical sampling techniques could be applied to facilitate the review for compliance with applicable regulations.

Borrower Rights Regulations (e.g., Disclosure of Loan Information, Notice of Action and Review, Right of First Refusal, etc.) Loan samples targeted for an examination of such factors as credit quality or credit administration may also provide an adequate sample from which to assess compliance with most borrower rights regulations, including disclosures to new borrowers, differential interest rate disclosures, and effective interest rate disclosures. In addition to loans, the institution's denied application log and/or file can be reviewed to evaluate compliance with adverse action regulations. Adversely classified and/or criticized loans as well as nonaccrual loans may fit distressed loan definitions, allowing evaluations of the distressed loan identification, loan restructuring, and nonaccrual loan notification processes. Additionally, the evaluation of other property owned (both existing and previously sold) may provide an opportunity to assess compliance with right of first refusal regulations.

Statistical Sampling

Statistical sampling may be desirable in certain circumstances. For example, when numerous, seemingly unrelated violations are noted, the examiner may wish to obtain a statistical sample to determine the probable extent of such violations throughout the consumer loan portfolio. A volume of such violations sufficient to indicate a breakdown in established procedures could be considered a pattern or practice warranting reimbursement or civil money penalties. Statistical sampling is also helpful in attaining a representative sample from a large universe of consumer loans. A larger volume of consumer credit is more likely to be encountered in a district bank or districtwide association. Given the potential for more efficient resource utilization, statistical sampling should be considered for these types of institutions depending on the volume of consumer loans.