VENDOR RISK MANAGEMENT

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Financial institutions are increasingly relying on third-party vendors to perform vital functions. While beneficial in many ways, outsourcing presents various risks. This article discusses these risks and best practices to mitigate them. The article first reviews the types of services and arrangements a financial institution can obtain from a vendor and the risks presented, while the balance of the article discusses best practices for managing outsourcing arrangements.

VENDOR ARRANGEMENTS AND THE ASSOCIATED RISKS

Financial institutions frequently use third-party vendors to reduce costs, enhance performance, and obtain access to specific expertise. Examples include outsourcing audits, compliance reviews, disclosure preparation, data processing, and website development. Financial institutions also use third-party vendors to offer products directly to customers. It is important to emphasize, however, that while day-to-day management of a product or service can be transferred to a third party, ultimate responsibility for all compliance requirements cannot be delegated and remains with the financial institution. Thus, institutions should recognize that using vendors involves significant compliance risk.

The use of third-party vendors presents several other risks, the most prominent of which are legal, operational, and reputational.

Legal Risk: The primary legal risk is that a vendor’s operation does not comply with consumer protection laws and regulations. Because of the number of complex laws and regulations, the risk of noncompliance has increased significantly. Consequently, financial institutions should be especially vigilant in identifying, assessing, monitoring, and mitigating this risk. For example, in 2010 a regulator filed separate enforcement actions against three banks, charging them with violating the Federal Trade Commission Act by engaging in deceptive practices in connection with credit card offers for the transfer and payment of charged-off consumer debt. The banks retained

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Mortgage Disclosure Improvement Act: Corrected Disclosure for an Overstated APR

By Ken Shim, Senior Examiner, Federal Reserve Bank of New York

Imagine for a moment that you have provided a consumer with a Truth in Lending Act (TILA) disclosure statement for a residential mortgage transaction that contains an overstated annual percentage rate (APR). Are you required to provide a corrected disclosure to the consumer and wait three business days before closing the loan, or can you proceed to close the loan because you believe that an overstated APR is always considered accurate under Regulation Z? To redisclose or not to redisclose, that is the question.

During the comment period for the December 2008 proposed implementing regulations for the Mortgage Disclosure Improvement Act (MDIA), the Board of Governors of the Federal Reserve System received comments from many financial institutions and financial services trade associations stating that a three-business-day waiting period before consummation is not warranted if the early TILA disclosure shows an overstated APR because the error benefits the consumer. This is a very common assumption among lenders, which is causing confusion regarding the MDIA’s redisclosure requirements.

In the Third Quarter 2010 issue of Outlook, Micah Spector of the Federal Reserve Bank of Philadelphia discussed the timing requirements of the MDIA in an article titled “Mortgage Disclosure Improvement Act (MDIA): Examples and Explanations.” This article clarifies the confusion surrounding the MDIA’s redisclosure requirement for overstated APRs.

CORRECTED DISCLOSURE REQUIREMENTS

To implement the MDIA’s redisclosure requirements, §226.19(a)(2)(ii) of Regulation Z requires lenders to provide a corrected TILA disclosure to the consumer if at the time of loan consummation the disclosed APR is outside the accuracy tolerance in §226.22. Lenders must make corrected disclosures of all changed terms, such as the finance charges and monthly payments, as a result of an APR change and must wait three business days before consummation. Lenders have the option of providing a complete set of new disclosures or redisclosing only the changed terms.

It is important to note that the three-business-day waiting period for corrected TILA disclosures applies only if the changes occurred as a result of an APR error. Otherwise, only the corrected disclosure is required, and lenders do not have to wait three business days before consummation.

Let’s take a closer look at §226.22 of Regulation Z, since this section deter-
mines whether a lender must provide the corrected TILA disclosure for overstated APRs.

**ACCURACY OF APR**

Section 226.22(a)(2) states that if a disclosed APR for a regular loan transaction does not exceed the actual APR by more than 0.125 percentage point above or below, then the disclosed APR is considered accurate. For irregular transactions, such as loans with multiple advances, irregular payment periods, or irregular payment amounts, the disclosed APR is considered accurate under §226.22(a)(3) if it does not exceed the actual APR by more than 0.25 percentage point above or below.

Regulation Z also states that for loans secured by real property or a dwelling, a disclosed APR will also be deemed accurate if the error resulted from the disclosed finance charge and the disclosed finance charge is not understated by more than $100 or if it is overstated. For example, assume that the actual total finance charge was $1,000 for a transaction secured by real property, but the disclosed APR was calculated based on a finance charge of $925 because the lender failed to include a $75 origination fee in the finance charge, which corresponds to an APR of 12 percent. The actual APR using the $1,000 finance charge would yield 13 percent. Even though the disclosed APR exceeds the legal tolerance by more than 0.125 percentage point (assuming this is not an irregular transaction), the disclosed APR is still considered accurate because the error was caused by the finance charge error, and the finance charge was not understated by more than $100. Therefore, in this example, lenders do not need to provide a corrected TILA disclosure and wait three business days before consummation.

Using the same example above, instead of disclosing a 12 percent APR based on a total finance charge of $925, the lender accidently disclosed a 12.5 percent APR because of an input error. The lender also has an understated finance charge of $75, which corresponds to a 12 percent APR. The actual APR is 13 percent based on a total finance charge of $1,000. (See Figure 1 below.)

Figure 1 helps us to understand §226.22(a)(5). Since the disclosed 12.5 percent APR is closer to the actual APR of 13 percent, compared with the 12 percent APR that corresponds to the $75 understated finance charge, the disclosed 12.5 percent APR is considered accurate, even though its computation was not the direct result of the finance charge error. (See Figure 2 on page 4.)

So far, the examples have dealt with understated APRs to help illustrate §226.22(a)(5). Now, let’s shift gears toward overstated APRs. The general rule for determining the accuracy of an APR for transactions secured by real property is that if the finance charge is overstated, and as a result, the corresponding APR is overstated, that APR would be considered accurate. Therefore, it is tempting to presume that any overstatement of an APR for transactions secured by real property would never trigger the three-business-day waiting period in addition to redisclosure. However, this presumption is not always correct. Overstatements of APRs can trigger redisclosure along with the three-business-day waiting period, as illustrated in the example below.

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*Figure 1: APR Tolerance for Mortgages*

### Figure 1: APR Tolerance for Mortgages

- **Closer to the Actual APR**
- 12% APR (finance charge understated by $75)
- 12.5% Disclosed APR (unrelated to finance charge error)
- 13% Actual APR

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2. §226.18(d)(1)
Assume an $8,000 loan secured by real property with an annual interest rate of 13 percent with no prepaid finance charges, and 60 monthly payments of $182.02. However, the lender included a $300 title search fee as a finance charge. The title search fee is not a finance charge. With no other charges except interest, the actual APR in this example would be 13 percent. The APR that corresponds to the $300 overstated finance charge would be 14.71 percent. The lender disclosed a 14.85 percent APR, which is unrelated to the overstated finance charge.

As shown in Figure 3, a disclosed APR that is not the direct result of an overstated finance charge can be subject to redisclosure even if the APR is overstated. Under §226.22(a)(5), if the disclosed APR is overstated beyond the APR that corresponds to the overstated finance charge, 14.71 percent in this example, the disclosed APR is not considered accurate, which triggers the MDIA rules of redisclosure, including an additional three-business-day waiting period.

**CONCLUSION**

Lenders must be very careful in assuming that overstated APRs do not trigger redisclosure and a three-business-day waiting period. Make sure your system is not automatically set up to generate corrected TILA disclosures only if the disclosed APR is understated. To apply the MDIA rules correctly and avoid violations of Regulation Z, lenders must determine the cause of the overstatement. An overstated APR that corresponds directly with an overstated finance charge is within tolerance and redisclosure is not required. However, not every overstatement of an APR is caused by an overstated finance charge. If there is no finance charge overstatement and the disclosed APR exceeds the 1/8 of a percent tolerance (1/4 of a percent for irregular transactions), or if the disclosed APR exceeds the APR corresponding to an overstated finance charge, redisclosure with a three-business-day waiting period is required. Specific issues and questions should be raised with the consumer compliance contact at your Reserve Bank or with your primary regulator.
Federal Reserve Board’s Compliance Guide to Small Entities

Regulation Z: Loan Originator Compensation and Steering

This guide was prepared by the staff of the Board of Governors of the Federal Reserve System as a “small entity compliance guide” under Section 212 of the Small Business Regulatory Enforcement Fairness Act of 1996, as amended. The guide summarizes and explains rules adopted by the Board but is not a substitute for any rule itself. Only the rule itself can provide complete and definitive information regarding its requirements. The complete rule, including the Official Staff Commentary, which is published as Supplement I to Regulation Z, is available on the Government Printing Office website.

The Truth in Lending Act
The Truth in Lending Act (TILA) is implemented by the Board’s Regulation Z (12 CFR Part 226). A principal purpose of TILA is to promote the informed use of consumer credit by requiring disclosures about its terms and cost. TILA also includes substantive protections. For example, the act and regulation give consumers the right to cancel certain credit transactions that involve a lien on a consumer’s principal dwelling. Regulation Z also prohibits specific acts and practices in connection with an extension of credit secured by a consumer’s dwelling.

Prohibitions Related to Mortgage Originator Compensation and Steering
Regulation Z prohibits certain practices relating to payments made to compensate mortgage brokers and other loan originators. The goal of the amendments is to protect consumers in the mortgage market from unfair practices involving compensation paid to loan originators.

The prohibitions related to mortgage originator compensation and steering apply to closed-end consumer loans secured by a dwelling or real property that includes a dwelling. The rule does not apply to open-end home equity lines of credit (HELOCs) or time-share transactions. It also does not apply to loans secured by real property if the property does not include a dwelling.

For purposes of these rules, loan originators are defined to include mortgage brokers, who may be natural persons or mortgage broker companies. This includes companies that close loans in their own names but use table funding from a third party. The term loan originator also includes employees of creditors and employees of mortgage brokers that originate loans (i.e., loan officers).

Creditors are excluded from the definition of a loan originator when they do not use table funding, whether they are a depository institution or a nondepository mortgage company, but employees of such entities are loan originators.

The rule prohibits a creditor or any other person from paying, directly or indirectly, compensation to a mortgage broker or any other loan originator that is based on a mortgage transaction’s terms or conditions, except the amount of credit extended. The rule also prohibits any person from paying compensation to a loan originator for a particular transaction if the consumer pays the loan originator’s compensation directly.

The rule also prohibits a loan originator from steering a consumer to consummate a loan that provides the loan originator with greater compensation, as compared to other transactions the loan originator offered or could have offered to the consumer, unless the loan is in the consumer’s interest. The rule provides a safe harbor to facilitate compliance with the prohibition on steering.

Creditors who compensate loan originators must retain records to evidence compliance with Regulation Z for at least two years after a mortgage transaction is consummated.

Compliance with these rules is mandatory beginning on April 1, 2011. Accordingly, the rules on originator compensation apply to transactions for which the creditor receives an application on or after April 1, 2011.

Section-by-Section
Section 226.25 Record retention.
(a) General rule.
Requires, for each transaction subject to the loan originator compensation provisions in §226.36(d)(1), that the creditor maintain records of the compensation it provided to the loan originator for the transaction as well as the compensation agreement in effect on the date the interest rate was set for the transaction.

continued on page 12
The Board of Governors of the Federal Reserve System (Board) does not expect to finalize three pending mortgage loan rulemakings. On February 1, 2011, the Board announced that it does not expect to finalize three pending rulemakings for consumer mortgage loans under Regulation Z prior to the transfer of authority for such rulemakings under the Truth in Lending Act (TILA) to the Consumer Financial Protection Bureau (CFPB). In August 2009, the Board issued two significant rulemaking proposals for closed-end mortgage loans and home equity lines of credit (http://tinyurl.com/RegZ-mortgage). In September 2010, the Board announced the third proposal, which included changes to the disclosures consumers receive explaining their right to rescind certain loans and which would have clarified the creditor’s responsibilities if a consumer exercises this rescission right (http://tinyurl.com/reverse-rescind). The proposal also included changes to the disclosures for reverse mortgages, proposed new disclosures for loan modifications, restrictions on certain advertising and sales practices for reverse mortgages, and changes to the disclosure obligations of loan servicers. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), rulemaking authority for TILA will transfer to the CFPB. Because Dodd-Frank requires the CFPB to issue a rulemaking that combines the credit disclosures for mortgage loans required by TILA with the settlement cost disclosures for mortgage loans required by the Real Estate Settlement Procedures Act, the Board determined it would not be in the public interest to issue final rules for the three pending rulemakings. The Board’s announcement is available at: http://tinyurl.com/nofinalrule.

Agencies announce start of initial registration period under S.A.F.E. Act’s mortgage loan originator provisions. On January 31, 2011, the Board, the Farm Credit Administration, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision announced that the Nationwide Mortgage Licensing System and Registry had commenced accepting federal registrations. Under the Secure and Fair Enforcement for Mortgage Licensing Act and the agencies’ final rules, residential mortgage loan originators employed by banks, savings associations, credit unions, or Farm Credit System institutions must register with the registry, obtain a unique identifier from the registry, and maintain their registrations. After the 180-day initial registration period ends on July 29, 2011, any employee of an agency-regulated institution who is subject to the registration requirements will be prohibited from originating residential mortgage loans without first meeting these requirements. The rules include an exception for mortgage loan originators that originated five or fewer mortgage loans during the previous 12 months and who have never been registered; they would not be required to complete the federal registration process. Further information about the registry and registration process is available at the registry’s website: http://tinyurl.com/safe-registry1. The agencies’ joint announcement and the Federal Register notice are available at: http://tinyurl.com/safe-registry2.

Legislation extends enhanced protections for service members relating to mortgages and mortgage foreclosures. On December 29, 2010, President Obama signed into law the Helping Heroes Keep Their Homes Act of 2010. The act extends the protections against mortgage foreclosures and interest rates in excess of 6 percent for service members provided by the Housing and Economic Recovery Act of 2008. In the 2008 act, the protections were scheduled to expire on December 31, 2010. They are now extended until December 31, 2012. These protections include staying foreclosure proceedings against service members during military service and within nine months after their active duty ends. The act also reduces all mortgage interest rates to 6 percent during active duty and one year after their military service is concluded. The original time frames as laid out in the Servicemembers Civil Relief Act of 2003 were during active duty and 90 days after for mortgage foreclosure protection and only during active duty for the interest rate reduction.
The Board issues interim rules amending Regulation Z to clarify certain disclosures of the Mortgage Disclosure Improvement Act (MDIA). On December 22, 2010, the Board issued a clarification of its September 24, 2010, interim rule under MDIA for required disclosures of mortgage loans whose rates or payments can change. The clarification was made in response to public comments. The revised interim rule clarifies that creditors’ disclosures should reflect the first rate adjustment for a “5/1 ARM” loan because the new rate typically becomes effective within five years after the first regular payment due date. The revised interim rule also corrects the requirements for interest-only loans to clarify that creditors’ disclosures should show the earliest date the consumer’s interest rate can change rather than the due date for making the first payment under the new rate. The rule also clarifies which mortgage transactions are covered by the special disclosure requirements for loans that allow minimum payments that cause the loan balance to increase. The interim rule was effective on January 31, 2011, but compliance is optional until October 1, 2011. The Board’s announcement and Federal Register notice are available at: http://tinyurl.com/mdia-clarify.

The federal banking and thrift agencies release annual CRA asset-size threshold adjustments for small and intermediate small institutions. On December 21, 2010, the Office of the Comptroller of the Currency, the Board, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (agencies) announced that effective January 1, 2011, the definitions of small and intermediate small institutions for Community Reinvestment Act (CRA) examinations will change as follows: “Small bank” or “small savings association” means an institution that, as of December 31 of either of the prior two calendar years, had assets of less than $1.122 billion. “Intermediate small bank” or “intermediate small savings association” means a small institution with assets of at least $280 million as of December 31 of both of the prior two calendar years, and less than $1.122 billion as of December 31 of either of the prior two calendar years. The banking agencies’ joint press release and Federal Register notice are available at: http://tinyurl.com/cra-2011.

The agencies expand the scope of the CRA regulations to encourage support of the Neighborhood Stabilization Program (NSP). On December 15, 2010, the agencies announced changes to the CRA regulations to support stabilization of communities affected by high foreclosure rates. The term “community development” is being revised to include loans, investments, and services by financial institutions that support, enable, or facilitate projects or activities that meet the “eligible uses” criteria and are conducted in designated areas identified in plans approved by the Department of Housing and Urban Development under the NSP. Allowing banking institutions to receive CRA consideration for NSP-eligible activities in NSP-targeted areas serves the CRA’s purposes and creates an opportunity to build on government programs in areas with high rates of foreclosure and vacancy. This joint final rule was effective January 19, 2011. The banking agencies’ joint press release and Federal Register notice are available at: http://tinyurl.com/CRA-change. A webinar on this topic is scheduled for April 6, 2011, at 2:00 p.m. EST. You can register at: http://tinyurl.com/webinar-cra.

The Board proposes rules to expand consumer protection regulations to credit transactions and leases of higher dollar amounts. On December 13, 2010, the Board proposed two rules to amend Regulation Z and Regulation M to implement a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act increases the transaction coverage of TILA and the Consumer Leasing Act to apply to consumer credit transactions and consumer leases up to $50,000, compared with $25,000 currently. This amount will be adjusted annually to reflect any increase in the consumer price index. The changes under Dodd-Frank become effective on July 21, 2011. Comments on the proposals were due on February 1, 2011. The Board’s announcement and Federal Register notices are available at: http://tinyurl.com/tila-cla.
Spousal signature violation as a defense to enforcing spousal guaranty after statute of limitations has expired. *In re Westbrooks*, 440 B.R. 677 (Bankr. M.D.N.C. 2010). When a company applied for financing, the lender required a guaranty from the company’s owners and their wives. The loan was later modified and additional credit extended, and the lender required spousal signatures each time. Another lender later acquired the promissory notes and attempted to collect on the guaranties. One of the owners filed for bankruptcy and filed a lawsuit in bankruptcy court with his wife to void her guaranty. The lawsuit alleged that the lender violated §202.7(d)(1) and (d)(5) of Regulation B by requiring the wife’s guaranty of the loan without first determining the husband was not independently creditworthy for the amount and terms requested. The lender filed a motion to dismiss based on the ECOA’s two-year statute of limitations. The court denied the motion, noting that numerous cases have held that the statute of limitations does not bar ECOA violations asserted defensively in response to a debt collection lawsuit. The lender also argued that the husband and wife were guarantors, not “applicants,” and therefore lacked standing to sue under ECOA and Regulation B. The court rejected this argument because the definition of “applicant” in §202.2(e) was specifically broadened in 1985 to include guarantors for purposes of §202.7(d).

Servicer’s obligations in responding to a RESPA qualified written request (QWR). *Catalan v. GMAC Mortgage Corp.* 629 F.3d 676 (7th Cir. 2011). The Seventh Circuit issued an important decision concerning QWRs. Section 6(e) of RESPA requires servicers to acknowledge receipt of a QWR within 20 business days, take action within 60 business days, and not report negative information to the consumer reporting agencies during the 60-day period. The borrowers sued their loan servicers (original and assignee) for QWR violations after payments were not properly credited, late fees were improperly assessed, and a servicer tried to foreclose. Before filing suit, the borrowers sent several letters to the servicers to resolve these issues without success. The problems were corrected only after the borrowers contacted HUD, which insured the loan. The trial court dismissed one of the servicers because of RESPA’s safe harbor, which applies if a servicer discovers an error, corrects it, and sends notice to the borrower within 60 days and before receiving a QWR. The Seventh Circuit reversed the dismissal because the servicer had not sent the required notice to the borrowers. The court also clarified the legal test for a borrower communication to qualify as a QWR: “RESPA does not require any magic language before a servicer must construe a written communication from a borrower as a [QWR] and respond accordingly...*Any reasonably stated written request for account information can be a [QWR].*” The court remanded the case to the trial court for further proceedings. RESPA was amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act to shorten the QWR response deadlines. A servicer will have five business days to acknowledge receipt of a QWR, 30 business days to respond, and an optional 15-day extension if notice is provided to the borrower. These changes will become effective 12 months after final implementing regulations are issued.
RESPA does not apply to an undivided loan discount fee. *Freeman v. Quicken Loans, Inc.,* 626 F.3d 799 (5th Cir. 2010) and *Wooten v. Quicken Loans, Inc.,* 626 F.3d 1187 (11th Cir. 2010). In two separate cases, the Fifth and Eleventh Circuits affirmed the dismissal of class-action lawsuits alleging that Quicken Loans violated §8(b) of RESPA by charging a loan discount fee on mortgages without providing a rate reduction. Section 8(b) prohibits fee splitting of an unearned fee. The federal appeals courts are divided on how this should be interpreted. The Fourth, Seventh, and Eighth Circuits have determined that this section is exclusively an anti-kickback provision prohibiting the splitting or transfer of an unearned fee between two or more parties. The Second, Third, and Eleventh Circuits have determined that §8(b) prohibits any fee charged for unearned services, even if no splitting or transfer of fees occurs. In these two cases, the plaintiffs alleged an unearned fee (charging a loan discount fee without providing a rate reduction) but did not allege that the fee was split with another party. The Fifth Circuit in *Freeman* held the language of §8(b) stating “no person shall give and no person shall accept” requires two parties splitting a fee. Because Quicken Loans did not split the loan discount fee, RESPA did not apply. In *Wooten*, the Eleventh Circuit also dismissed the RESPA claim of charging an unearned loan discount fee but used a different analysis. The court noted that RESPA’s scope is limited to “settlement services.” Regulation X defines “settlement” as “the process of executing legally binding documents regarding a lien on property that is subject to a federally related mortgage loan.” The court noted that the “service” referred to in RESPA includes “any act undertaken to bring about the execution of a mortgage and note.” The court affirmed the dismissal of the case based on its conclusion that charging loan discount points did not constitute a “service” under this definition.

**FAIR CREDIT REPORTING ACT (FCRA)**

**FCRA preempts state law claim against furnisher of credit information.** *Ross v. FDIC,* 625 F.3d 808 (4th Cir. 2010). The plaintiff lived in a house that her ex-husband had purchased with a mortgage that was eventually assigned to Washington Mutual Bank (WaMu). She had obtained a court order naming her the sole owner of the property, although her ex-husband remained the sole obligor for the loan. The plaintiff notified WaMu of these changes, but WaMu inadvertently listed the plaintiff’s name on the mortgage as an obligor when it entered the information in its systems. When the loan later went into default, WaMu reported negative information about the plaintiff to the consumer reporting agencies (CRAs). The plaintiff notified WaMu about this issue, and it eventually corrected the reporting to the CRAs; however, the plaintiff later learned that WaMu was still providing negative reporting to one of the CRAs. The plaintiff sued WaMu in state court for violating the FCRA and the North Carolina Unfair and Deceptive Trade Practices Act (NCUDTPA), and the trial court dismissed the case. On appeal, the Fourth Circuit affirmed the dismissal of the FCRA claim because the lawsuit was outside the FCRA’s two-year statute of limitations. The court also affirmed the dismissal of the NCUDTPA claim because of the broad preemption provision in the FCRA for state law claims against furnishers: “No requirement or prohibition may be imposed under the laws of any State...with respect to any subject matter regulated under...section 1681s-2 of this title, relating to the responsibilities of persons who furnish information to consumer reporting agencies...”

* Links to the court opinions are available in the online version of *Outlook* at: http://www.consumercomplianceoutlook.org.
third-party vendors to help administer and market the balance transfer offer programs. The enforcement actions contained specific provisions requiring close oversight of third parties. Each bank was ordered to pay restitution and/or a civil money penalty, which collectively totaled over $4 million.

Another legal risk involves legally binding contracts of a fixed duration. If business needs change because of intervening events, “there is a risk that financial institutions may be locked into agreements that reflect outdated business realities. The contractual basis of outsourcing coupled with this intrinsic business uncertainty contributes to legal risk.”

Reputational Risk: A vendor’s noncompliance with consumer laws and regulations creates reputational risk for a financial institution, including the possibility of a public enforcement action by the institution’s regulators, class action lawsuits, and negative publicity.

Operational Risk: This is the risk that a vendor’s operational system does not perform properly and negatively affects customers. For example, if a financial institution retains a vendor to determine if the institution’s loans secured by a building or a mobile home are located in a special flood hazard area for purposes of complying with the flood insurance requirements of Regulation H, and the vendor fails to regularly update its database of special flood hazard areas, the institution could be cited by its regulator and subject to civil money penalties if this results in violations of Regulation H.

RISK MITIGATION
Financial institutions that outsource a service or product must adopt appropriate controls, policies and procedures, and oversight to mitigate outsourcing risks effectively. Institutions should focus on five key areas for effective risk mitigation: vendor selection, vendor contract, vendor management and monitoring, human resource management, and contingency planning.

Vendor Selection
Conducting proper due diligence in selecting a vendor is a critical aspect of vendor risk management. Important due diligence steps include:

- asking the vendor to provide references (particularly ones from other financial institutions) to determine satisfaction with the vendor’s performance;
- asking questions about the vendor’s data backup system, continuity and contingency plans, and management information systems;
- researching the background, qualifications, and reputations of the vendor’s principals;
- determining how long the vendor has been providing the service;
- assessing the vendor’s reputation, including lawsuits filed against it; and

- obtaining audited financial statements to check the vendor’s financial health.

Some financial institutions prefer to use other financial institutions for outsourcing because they are already familiar with the business. Regardless, financial institutions should ensure that qualified vendors are chosen after the appropriate level of due diligence is conducted.

Vendor Contract
The contract between the financial institution and the vendor is another key factor in mitigating risk because it dictates legally binding terms and conditions. Financial institutions should engage experienced counsel to ensure that its interests are protected and potential contingencies are considered, such as the potential effect of regulatory changes on the vendor’s obligations and performance. The contract should also articulate the mutual expecta-
Articulating expectations in the contract is important because if expectations are not adequately communicated and problems arise, each side will typically blame the other.

Some of the issues to be addressed in the contract include:

- scope of outsourced services;
- terms of the agreement;
- written procedures;
- minimum service levels, including any ancillary services to be provided;
- payment schedules;
- incentives to align interests of the service provider and financial institution;
- right to retain other third parties;
- approval required for vendor’s use of subcontractors;
- right to conduct audits and/or accept third-party reviews of their operations;
- retained ownership and confidentiality of data shared with service provider;
- warranties, liability, and disclaimers;
- dispute resolution mechanisms, including service levels to be provided during the dispute, escalation procedures, and arbitration;
- human resource issues (e.g., whether vendor will hire staff whose function is being outsourced);
- contingency and business recovery plans;
- insurance coverage;
- default and termination — identifying what constitutes default, cure, remedies, and termination;
- customer complaints and who is responsible for responding to them; and
- force majeure, or “act of God” events.

Given their significance and length, outsourcing contracts must be drafted carefully. “[E]rrors or poor execution can have major implications by locking an institution into a contractual relationship that does not meet [its] needs.”

**Vendor Management and Monitoring**

After the vendor has been selected and the contract signed, it is important to manage and monitor the relationship. Senior management should be involved in approving policies and procedures to monitor the vendor’s performance and activities. Performance monitoring controls include:

- ensuring that the vendor is complying with consumer protection laws and regulations;
- periodically analyzing the vendor’s financial condition and performing on-site quality assurance reviews;
- regularly reviewing metrics for the vendor’s performance relative to service level agreements;
- reviewing customer complaints for services or products handled by the vendor and conducting anonymous testing if applicable (mystery shopper);
- assessing whether contract terms are being complied with;
- testing the vendor’s business contingency planning;
- evaluating adequacy of the vendor’s training to its employees; and
- periodically meeting with the vendor to review contract performance and operational issues.

**Human Resources Management**

A financial institution’s decision to outsource certain functions can create operational risk because of the effect of the announcement on the institution’s staff whose job functions will be affected: “These concerns impact staff in both the affected and unaffected business units and are, at the very least, a distraction that may result in errors and productivity losses. More seriously, they can wound employee morale and lead to loss of desirable or key employees. In extreme cases, institutions fear misconduct or retaliatory behavior.”

To mitigate this risk, the Human Resources Department should be consulted early in the process to ensure that appropriate outreach is made to affected employees. In addition, the vendor contract should specifically address whether the vendor is required to hire staff whose job functions are being outsourced and if so their compensation and term of employment. Timely communications are very important so that staff are kept apprised and their concerns addressed. In addition, if the financial institution does not want to transfer staff, it has to adopt contingency plans in the event its staff members are recruited by the third-party vendor.

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Contingency Planning
While outsourcing can be beneficial, it creates the risk that a vendor’s operations can be disrupted and might affect the financial institution for the services the vendor provides. To mitigate this risk, financial institutions must ensure that the vendor has a prudent business recovery plan in place that is reviewed on an ongoing basis.

A contingency plan must be established to address the risk that the vendor may not perform satisfactorily: “In the face of unsatisfactory responsiveness, an institution’s options include changing service providers, returning the activity to the institution, or sometimes even exiting the business.” These options are costly and problematic and are usually taken only as a last measure after the institution has first made reasonable efforts to resolve the issues with the vendor.

Another mitigant against the risk of unsatisfactory performance is to start the vendor with a small contract to test its performance before outsourcing the entire function. If the vendor performs satisfactorily during the test period, the contract can be expanded to outsource the entire function.

CONCLUSION
When an institution outsources a function subject to consumer compliance requirements, the ultimate responsibility for compliance cannot be delegated and remains with the institution. While vendor arrangements can provide valuable benefits to a financial institution, they require an active role to manage risk and achieve success. It starts with selecting a good vendor whose skills and competencies match up well with the bank’s needs. Financial institutions must exercise due diligence throughout the vendor-selection process. Signing a contract with a vendor is not the end of the process but the point at which risk mitigation begins. Specific issues and questions about consumer compliance matters should be raised with the appropriate contact at your Reserve Bank or with your primary regulator.

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Section 226.36 Prohibited acts or practices in connection with credit secured by a dwelling.

(a) Loan originator and mortgage broker defined.

States that the regulation applies to all persons who originate loans, including mortgage brokers and their employees, as well as mortgage loan officers employed by depository institutions and other lenders.

The rule does not apply to payments received by a creditor when selling the loan to a secondary market investor. When a mortgage brokerage firm originates a loan, it is not exempt under the final rule unless it is also a creditor that funds the loan from its own resources, such as its own line of credit.

(d) Prohibited payments to loan originators.

For purposes of §226.36(d)(1) and (d)(2), affiliates are treated as a single “person.”

(d)(1) Payments based on transaction terms or conditions.

The rule prohibits a creditor or any other person from paying, directly or indirectly, compensation to a mortgage broker or any other loan originator that is based on a mortgage transaction’s terms or conditions, except the amount of credit extended.

A loan originator’s compensation can neither be increased nor decreased based on the loan terms or conditions. When the creditor offers to extend a loan with specified terms and conditions (such as rate and points), the amount of the originator’s compensation for that transaction is not subject to change, based on either an increase or a decrease in the consumer’s loan cost or any other change in the loan terms. Thus, if a consumer’s request for a lower interest rate is accepted by the creditor, the creditor is not permitted to reduce the amount it pays to the loan originator based on the change in loan terms. Similarly, any reduction in origination points paid by the consumer must be a cost borne by the creditor.
Under the rule, the amount of credit extended is deemed not to be a transaction term or condition of the loan for purposes of the prohibition, provided the compensation payments to loan originators are based on a fixed percentage of the amount of credit extended. However, such compensation may be subject to a minimum or maximum dollar amount. The minimum or maximum amount may not vary with each credit transaction.

Creditors may use other compensation methods to provide adequate compensation for smaller loans, such as basing compensation on an hourly rate, or on the number of loans originated in a given time period.

Example: A creditor may not pay a loan originator 1 percent of the amount of credit extended for amounts greater than $300,000, and 2 percent of the amount of credit extended for amounts that fall between $200,000 and $300,000. However, a creditor could choose to pay a loan originator 1 percent of the amount of credit extended for each loan, but no less than $1,000 and no more than $5,000. In this case, the originator is guaranteed payment of a minimum amount for each loan, regardless of the amount of credit extended to the consumer. Using this example, the creditor would pay a loan originator $3,000 on a $300,000 loan (i.e., 1 percent of the amount of credit extended), $1,000 on a $50,000 loan, and $5,000 on a $900,000 loan.

An originator that increases the consumer’s interest rate to generate a larger yield spread premium can apply the excess creditor payment to third-party closing costs and thereby reduce the amount of consumer funds needed to cover up-front fees. Thus, the rule does not prohibit creditors or loan originators from using the interest rate to cover up-front closing costs, as long as any creditor-paid compensation retained by the originator does not vary based on the transaction’s terms or conditions.

For example, suppose that for a loan with a 5 percent interest rate, the originator will receive a payment of $1,000 from the creditor as compensation, and for a loan with a 6 percent interest rate, a yield spread premium of $3,000 will be generated. The originator must apply the additional $2,000 to cover the consumer’s other closing costs.

(d)(2) Payments by persons other than consumer.

If any loan originator receives compensation directly from a consumer in a transaction, no other person may provide any compensation to a loan originator, directly or indirectly, in connection with that particular credit transaction. Thus, no person who knows or has reason to know of the consumer-paid compensation to the loan originator (other than the consumer) may pay any compensation to a loan originator, directly or indirectly, in connection with the transaction.

For purposes of this rule, payments made by creditors to loan originators are not payments made directly by the consumer, regardless of how they might be disclosed under HUD’s Regulation X, which implements the Real Estate Settlement Procedures Act (RESPA).

(e) Prohibition on steering.

Prohibits a loan originator from “steering” a consumer to a lender offering less favorable terms in order to increase the loan originator’s compensation.

Provides a safe harbor to facilitate compliance. The safe harbor is met if the consumer is presented with loan offers for each type of transaction in which the consumer expresses an interest (that is, a fixed rate loan, adjustable rate loan, or a reverse mortgage) and the loan options presented to the consumer include:

(A) the loan with the lowest interest rate for which the consumer qualifies; (B) the loan with the lowest total dollar amount for origination points or fees, and discount points, and (C) the loan with the lowest rate for which the consumer qualifies for a loan without negative amortization, a prepayment penalty, interest-only payments, a balloon payment in the first 7 years of the life of the loan, a demand feature, shared equity, or shared appreciation; or, in the case of a reverse mortgage, a loan without a prepayment penalty, or shared equity or shared appreciation.

To be within the safe harbor, the loan originator must obtain loan options from a significant number of the creditors with which the originator regularly does business. The loan originator can present fewer than three loans and satisfy the safe harbor, if the loan(s) presented to the consumer otherwise meet the criteria in the rule.

The loan originator must have a good faith belief that the options presented to the consumer are loans for which the consumer likely qualifies. For each type of transaction, if the originator presents to the consumer more than three loans, the originator must highlight the loans that satisfy the criteria specified in the rule.
As part of its outreach efforts, the Federal Reserve System regularly conducts *Outlook Live* webinars on consumer compliance topics. The table below lists the archive of past events. You can view the webinars and download the presentation slides at the links provided. If you subscribe to *Outlook*, you will automatically be notified of future *Outlook Live* events. You will also receive an e-mail notification when a new issue of *Outlook* is published.

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<td>04/06/11</td>
<td><strong>CRA and HUD Neighborhood Stabilization Program</strong></td>
<td>Senior Project Manager Theresa Stark, Federal Reserve Board; Senior Vice President Mike Griffin, Key Bank; and Chief Lending Officer Matt Perrenod, Housing Partnership Network, discuss these new CRA opportunities.</td>
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<td>03/17/11</td>
<td><strong>Loan Originator Compensation</strong></td>
<td>Senior Attorney Paul Mondor and Senior Attorney Nikita Pastor, both of the Board of Governors, provide updated information and answer questions about the new regulatory requirements for loan originator compensation.</td>
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<td>02/16/11</td>
<td><strong>Risk-Based Pricing Notices</strong></td>
<td>Senior Attorney Mandie Aubrey, Board of Governors, and Supervisory Examiner Rebecca Reagan, Federal Reserve Bank of Richmond, discuss the new regulatory requirements for the RBP notices.</td>
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<td>11/17/10</td>
<td><strong>Tips for Reporting Accurate HMDA and CRA Data</strong></td>
<td>Senior Examiners Cindy Anderson, Federal Reserve Bank of Atlanta, and Karin Modjeski Bearss, Federal Reserve Bank of Minneapolis, discuss the current regulatory requirements for collecting and reporting CRA and HMDA data, common errors in reporting the data, and tips to help ensure that the data are right the first time, every time.</td>
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<td>08/19/10</td>
<td><strong>Consumer Regulatory Changes</strong></td>
<td>Assistant Director Jim Michaels, Managing Counsel Jane Gell, Senior Counsel Kathleen Ryan, and Senior Attorney Brent Lattin, Division of Consumer and Community Affairs, Board of Governors, provide up-to-date information on the following:</td>
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|            |                                                                         | • Status of current regulatory proposals  
• Upcoming final rules  
• Overview of new rules in the regulatory reform legislation |
| 05/20/10   | **Consumer Compliance “Top Ten” Lists**                                 | Senior Compliance Manager Ariane Smith and Senior Examiner Richele Brady, both of the Federal Reserve Bank of San Francisco, discuss a number of current or emerging topics in consumer compliance, including the: |
|            |                                                                         | • top 10 things found in well-run compliance programs;  
• top 10 issues identified on recent examinations; and  
• top 10 things to know about consumer complaints. |
| 11/10/09   | **New Overdraft Protection Program Rules**                              | Managing Counsel David Stein and Attorney Dana Miller, both of the Board of Governors, provide an overview of the final rules. |

**Outlook Live Webinars**
**Regulatory Calendar**

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<th>EFFECTIVE DATE</th>
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<td>SAFE Act</td>
<td>Deadline for mortgage loan originators employed by regulated institutions to register with SAFE Act registry</td>
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<td>Reg. CC</td>
<td>Proposal to amend Regulation CC regarding collection of checks and availability of funds</td>
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<td>Rulemaking proposal to regulate debit card interchange fees</td>
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<td>04/01/2011</td>
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<td>Restrictions on loan steering and loan originator compensation</td>
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<td>04/01/2011</td>
<td>Reg. Z</td>
<td>Interim final rule for appraisal independence for consumer credit transactions</td>
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<td>Reg. Z</td>
<td>Proposal to lengthen HPML escrow period and exempt certain creditors</td>
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<td>*</td>
<td>Reg. Z</td>
<td>Federal Reserve Board does not expect to finalize 3 pending mortgage rulemakings</td>
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<td>01/30/2011</td>
<td>Reg. Z</td>
<td>Revised MDIA interim rule for mortgage loans with variable rates or payments</td>
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<td>CRA credit for Neighborhood Stabilization Program activities</td>
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<td>01/01/2011</td>
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<td>Required notice to borrower when mortgage is sold or transferred</td>
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<td>Reg. Z</td>
<td>New disclosures for private education loans</td>
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*Rulemaking proposals generally do not have an effective date, except for the Dodd-Frank proposed regulations because Congress specified the effective date in the legislation.
Calendar of Events

April 7, 2011  Community Bankers Conference
              Federal Reserve Bank of New York
              New York, New York

April 28-29, 2011  2011 Federal Reserve Community Affairs
                  Research Conference
                  The Changing Landscape of Community
                  Development
                  Crystal Gateway Marriott
                  Arlington, Virginia

May 4-6, 2011  Implementing Dodd-Frank: Progress to
                  Date & Recommendations for the Future
                  47th Annual Conference on Bank
                  Structure and Competition
                  Hotel InterContinental Chicago
                  Chicago, IL

May 9-11, 2011  Exploring Innovation: A Conference on
                  Community Development Finance
                  Federal Reserve Banks of St. Louis,
                  Atlanta, Dallas, and Minneapolis
                  Chase Park Plaza Hotel
                  St. Louis, Missouri

May 19-20, 2011  The New Face of Retail Payments: Markets,
                  Strategies and Regulations
                  Eleventh Annual Payments
                  Conference
                  Federal Reserve Bank of Chicago
                  Chicago, IL

June 9-10, 2011  2011 Policy Summit
                  Housing, Human Capital, and
                  Inequality
                  Federal Reserve Bank of Cleveland
                  InterContinental Hotels Cleveland
                  Cleveland, Ohio

June 12-15, 2011  ABA Regulatory Compliance
                  Conference
                  Marriott Wardman Park Hotel
                  Washington, DC