Chapter 8

Lending Audit

Introduction

Auditing the lending functions of the bank for compliance with federal regulations can be an intimidating job. In general, the laws and regulations that deal with the lending function of banks are aimed primarily at loans made to individual consumers. However, this is not a rule that can be relied upon in auditing the lending functions. So-called consumer regulations are generally much broader in scope than most bankers believe. A few of the federal regulations, such as Truth in Lending, are limited to consumer purpose loans, but others, such as the Equal Credit Opportunity Act, are not.

Even consumer loans directly affected by federal regulations are not just made in the consumer or installment loan department. Historically, the consumer loan departments have specialized in consumer purpose, installment-type loans. Today, however, consumer loans are often found in most other areas of the bank as well.

An executive and professional banking department generally has a great percentage of its loans covered by federal consumer credit regulations. Also, commercial lending portfolios inevitably have a few (and sometimes many) loans that are subject to the various regulations of the federal government. The indirect lending departments are also an area greatly affected by these regulations. Therefore, the compliance auditor must check every lending department for loans that are covered by one or more of the federal credit laws or regulations.

This chapter covers the auditing of all lending functions other than real estate lending and open-end credit (credit cards and the like). If the audit is to cover credit cards, revolving loans, or overdraft protection plans, Chapter 9 on open-end credit applies. If the purpose of the loan is to purchase real estate or if the loan is secured by real estate, the auditor should refer to Chapter 10 on the real estate lending audit. All other types of loans made by the bank that are covered by federal regulations are covered in this chapter.

Laws and Regulations Covered by the Audit

The laws and regulations covered in this audit program are surveyed in this section. A more complete description of each of these regulations is included in the book A Review of Consumer Laws and Regulations that accompanies this manual.
Truth in Lending/Regulation Z (12 CFR 1026)

In 1968, as a part of the Consumer Credit Protection Act, Congress enacted the Truth in Lending Act. Truth in Lending had one major purpose: to require creditors to disclose certain terms of consumer credit in a uniform manner. Congress believed that consumers were impeded in their ability to “credit shop” because credit terms were so varied that they were difficult to compare. Thus, Truth in Lending is primarily a disclosure law. It covers open-end and closed-end credit. Generally speaking, open end credit is revolving-type credit that is self-replenishing and contemplates repeat transactions during the life of the credit. Closed-end credit is any type of credit that is not open ended. Truth in Lending primarily covers small (originally $25,000 or less) consumer loans, as well as consumer loans that are secured by real estate.

On September 30, 1995, the President signed into law the Truth in Lending Amendments Act of 1995. Most of the act provides significant statutory relief to creditors; for example, changes have been made to the tolerance of the finance charge and the creditor's liability for certain transactions.

In 1969, Truth in Lending was implemented by the Federal Reserve Board's Regulation Z. Due to the great number of interpretive letters that were necessary to explain Regulation Z and because of the large number of Truth in Lending cases in the federal court system, Congress enacted a simplified version of Truth in Lending in 1980. To implement the Truth in Lending Simplification and Reform Act, the Federal Reserve Board revised Regulation Z in 1981 and published an Official Staff Commentary to Regulation Z to organize the information formerly contained in the many staff interpretation letters.

Regulation Z requires that a disclosure statement be given in all consumer loans secured by real estate or that are for $25,000 or less. In certain transactions, Regulation Z requires that a right to cancel notice be given to the borrower. Regulation Z was amended effective October 21, 1996, to implement changes resulting from the Truth in Lending Amendments Act of 1995. In addition to the new tolerance levels, the amendments clarify disclosure of certain mortgage loan fees and debt cancellation agreement fees. The Commentary was amended effective February 28, 1997, to provide more clarification in this area. The Commentary was again amended effective March 31, 1999, to clarify disclosure of the downpayment and the total sales price in credit sales transactions when a trade-in is involved or where negative equity exists on property presented as a trade-in. The Commentary was revised March 24, 2000, with compliance optional until October 1, 2000, to address the manner in which “payday loans” are to be disclosed. These transactions may also be referred to as “payday advances” or “deferred presentment loans.” Regulation Z was further amended effective September 27, 2000, to enhance consumers’ ability to notice and understand cost information provided in the table disclosures for credit and charge card solicitations and applications. These amendments address content of the table, size of the print, and location of the table. The commentary was also amended to correspond to these changes and to provide guidance on disclosure of introductory rates and penalty rates. To provide sufficient time to implement these changes, compliance with the new credit and charge card requirements was not mandatory until October 1, 2001. On April 2, 2002, the Commentary was revised to clarify three areas: (1) how credit contracts, which contain both the credit agreement and the disclosures, may satisfy the requirement for providing the disclosures in a form the consumer may keep, before consummation;
(2) to provide guidance on disclosing costs for certain credit insurance policies if the bank chooses to disclose based on an initial term of one year; and (3) to further define “business days” for purposes of the right to rescind and for purposes of delivery of disclosures for certain high-cost mortgages. On March 28, 2003, the Commentary was further revised to clarify that certain credit card fees are not considered finance charges, rules for replacing an accepted credit card with one or more cards, disclosure of private mortgage insurance premiums, and the selection of Treasury security yields for determining whether a mortgage loan is covered by provisions that implement the Home Ownership and Equity Protection Act.

On August 14, 2009, the Federal Reserve Board published in the Federal Register final amendments to Regulation Z that revise the disclosure requirements for private education loans. The mandatory effective date for the amendments is February 14, 2010.

On June 20, 2011, amendments were published in the Federal Register resulting from the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), including amendments to the Truth in Lending Act to expand consumer protections by increasing the thresholds for exempt consumer loan transactions from $25,000 to $50,000 (adjusted annually). The increase to $50,000 became effective July 21, 2011. Annual adjustments will be based on the Consumer Price Index for Urban Wage Earners and Clerical Workers. On June 13, 2011, the Federal Reserve announced the first increase to that amount that will be effective January 1, 2012, increasing the threshold to $51,800. On June 13, 2011, the Federal Reserve announced the first increase and annual adjustments as shown below:

- Effective 1/1/2012 $51,800
- Effective 1/1/2013 $53,000
- Effective 1/1/2014 $53,500
- Effective 1/1/2015 $54,600

**Equal Credit Opportunity Act/Regulation B (12 CFR 1002)**

The Equal Credit Opportunity Act (ECOA) was passed in 1975 primarily to prevent discrimination in all credit transactions based upon sex and marital status. In 1977 this law was changed to add several more “prohibited bases” including race, color, national origin, age, religion, the receipt of public assistance income, and the exercise of rights under the Consumer Credit Protection Act. Regulation B was issued by the Federal Reserve Board to implement the requirements of ECOA. The Regulation and Commentary were revised effective April 1, 2004, with compliance required by October 1, 2004. The revisions amended the rules of construction to clarify that where the Regulation requires the lender to disclose an amount, the amount must be given in numerical terms unless otherwise stated in the Regulation. The Commentary was revised to address circumstances where a creditor fails to disclose on the right of rescission form an address where a consumer is to send the rescission notice. Standard forms usually refer to this address as the “creditor’s address.” The Commentary now states that if a consumer chooses to exercise the right of rescission and the creditor’s address (the address to which the consumer is to send the rescission form) has not been disclosed, the creditor must accept the notice if a consumer sends it to whom or where the creditor has directed the consumer to send payments.

Generally, Regulation B requires that a creditor refrain from any activity that would have the effect of discriminating against an applicant or borrower based upon the prohibited bases. It also requires creditors to send certain notices when denying credit or adversely changing credit terms when dealing with a consumer.
Regulation B was revised in 1985, and an Official Staff Commentary to Regulation B was published. Compliance with revised Regulation B became mandatory on October 1, 1986. The Official Staff Commentary, most recently revised to address credit scoring and spousal signature rules, became effective October 31, 1996. The regulation was last amended effective April 30, 1998, to provide sample adverse action notices that address amendments that were made to the Fair Credit Reporting Act.

Regulation B was amended effective April 15, 2003, with mandatory compliance required by April 15, 2004. The changes in the most recent amendments include authority for banks to request information about applicants’ characteristics for nonmortgage credit transactions for the purpose of conducting a self-test. The definitions of and criteria for performing a self-test have been expanded, as have the disclosure requirements that banks are to use if they choose to perform such tests by using information about personal characteristics of the applicants. The amendments also added a 25-month record retention requirement related to prescreened solicitations and clarified the rules for evaluating married and unmarried applicants and the rules concerning documentation of joint applications. The Official Staff Commentary was also revised as a part of these amendments to include clarification that the definition of an application includes certain preapproval requests; an exception from the requirement to provide a notice of incompleteness for preapprovals that constitute applications; and guidance as to when an inquiry about credit becomes an application. Finally, citations within the regulation were rearranged and renumbered.

On July 15, 2011, the Federal Reserve Board and the FTC published in the Federal Register final rules to implement the credit score disclosure requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). If a credit score is used in setting material terms of credit or in taking adverse action, the statute requires creditors to disclose credit scores and related information to consumers in notices under the FCRA.

The final rules also amend the FCRA portions of the model notices in Regulation B. The model notices combine the adverse action notice requirements for Regulation B and the FCRA, to reflect the new credit score disclosure requirements.

The rules are effective August 15, 2011.

On June 1, 2011, the Federal Reserve Board published in the Federal Register notice of the agency address change for the FDIC. The new address for the FDIC should be reflected on adverse action notices and on banks’ FHA posters. Note that this change impacts only banks regulated by the FDIC. This change had been announced previously by the FDIC. The change is effective July 1, 2011; however, compliance is optional until May 31, 2012.

On June 25, 2014, the CFPB issued a memorandum to provide consistency with the Supreme Court decision in United States v. Windsor. The CFPB’s memorandum states that a person who is married under the laws of any jurisdiction is considered married nationwide for purposes of the federal statutes and regulations under the CFPB’s jurisdiction, regardless of the person’s place of residency. Under this interpretation, a person is not married by virtue of being in a domestic partnership, civil union, or other relationship not denominated by law as a marriage.

Fair Credit Reporting Act (15 USC 1681)

Congress enacted the Fair Credit Reporting Act (FCRA) in 1971 to regulate the consumer reporting process. It was most recently amended effective September 30, 1997. The purpose of the law was to ensure that consumer information is accurately and fairly reported. The law places several responsibilities and restrictions upon consumer reporting agencies, which are defined as
agencies that assemble or evaluate consumer credit information or other information on consumers for the purpose of furnishing consumer reports to third parties.

The requirements imposed upon a consumer reporting agency do not apply to banks as long as the bank does not report any credit information other than its own experience. However, there are other requirements of the FCRA that are placed on users of credit information. Banks and other financial institutions generally fall into the user category. Users of credit information must give the consumer applicant certain disclosures upon denying or adversely acting upon the application. The most recent amendments to the act added disclosures that are to be provided if the bank solicits credit using a prescreened list and increased the retention period for all information related to the solicited offer. The amendments also added a provision allowing banks to more easily share information among affiliates, stipulated rules regarding accuracy and completeness of information reported to consumer reporting agencies, and added procedures that must be followed if a consumer notifies a consumer reporting agency of a dispute regarding information in their consumer report.

The Fair Credit Reporting Act does not have an accompanying regulation. However, the regulatory agency that governs the bank examines it for compliance with the provisions of this act.

On December 4, 2003, President Bush signed into law the Fair and Accurate Credit Transactions Act of 2003. This Act amends the Fair Credit Reporting Act (FCRA). The intent of the new law is to help ensure the accuracy of consumer reports and to confront the problem of identity theft. Upon enactment, the FACT Act made permanent federal preemption provisions of the Fair Credit Reporting Act that otherwise would have expired on January 1, 2004. In addition, the FACT Act created new requirements that will significantly affect banks as they become applicable. The federal preemption also applies to many of those provisions.

Effective December 1, 2004, as a result of the FACT Act, all banks that report negative information to a nationwide consumer reporting agency must notify the consumer that the information will be or has been reported. The Federal Reserve Board issued two model notices that may be used by all financial institutions. The model notices can be found in 12 CFR 1022, Regulation V and in exhibit 3.2 in *A Review of Consumer Laws and Regulations*, the companion binder to *ABA’s Compliance Audit Manual*. The bank should use the appropriate notice depending on whether the bank has already reported negative information or may later report negative information to a nationwide consumer reporting agency.

In addition, December 1, 2004 was also the effective date for implementation of several provisions of the FACT Act that became effective without implementing regulations. While many of the provisions apply to credit reporting agencies, with which banks must comply to the degree that they fall within the definition of a “consumer reporting agency,” there were also requirements for which the banks, as users of consumer reports and as furnishers of information to consumer reporting agencies, must comply. The provisions applicable to banks include:

1. requirements to block the reporting of information claimed to be the result of identity theft and the re-reporting of information the consumer reporting agency has found to be inaccurate, incomplete, or unverifiable;
2. requirements to prevent the sale, transfer, or collection of a debt for which the bank has received notice from a credit reporting agency indicating that the debt was a result of identity theft;
3. requirements to provide credit scores and related information to consumer applicants for loans that are secured by 1–4 family dwellings;
4. requirements to respond to active duty and fraud “alerts” on consumer reports to ensure that the person applying for the transaction is in fact the person he or she is claiming to be;
5. requirements to respond to requests received from identity theft victims for documentation of transactions that may be related to identity theft; and
6. requirements for banks collecting debt for third parties to notify those third parties if the consumer claims the debt resulted from identity theft.

Other recent developments with the FACT Act include requirements to properly dispose of information derived from consumer reports, effective July 1, 2005, pursuant to Interagency Guidelines Establishing Standards for Information Security, as amended, and requirements to provide notice of right to opt-out from solicitations derived from prescreened lists, effective August 1, 2005, pursuant to regulations adopted by the FTC in January 2005.

Interim rules implementing Section 411 of the FACT Act were published in a joint issuance in the Federal Register on June 10, 2005. The final rules were subsequently published in the Federal Register on November 22, 2005. The final rules are substantially similar to the interim rule. The rules create exceptions to the statutory prohibition against obtaining or using medical information in connection with credit eligibility determinations. The rules also address the sharing of medically related information among affiliates. For purposes of the new rules, medical information means information or data, whether oral or recorded, in any form or medium, created by or delivered from the health care provider or the consumer, that relates to the past, present, or future physical, mental, or behavioral health or condition of an individual, including the provision of health care to an individual or the payment for provision of health care to an individual. The rules became effective April 1, 2006, as delayed by the final rule. When performing an audit, it may be beneficial to refer to the examples of exceptions contained in the rules to better determine whether the bank’s practices of obtaining or using any medical information are consistent with the allowable exceptions.

On July 1, 2009, the federal financial regulatory agencies published final rules and guidelines to promote the accuracy and integrity of information furnished to credit bureaus and other consumer reporting agencies to be used to determine consumers’ eligibility for credit, employment, insurance, and rental housing. The new rules implement revisions to the Fair Credit Reporting Act resulting from section 312 of the Fair and Accurate Credit Transaction Act. The rule is effective July 1, 2010.

On January 15, 2010, the Federal Reserve Board and the Federal Trade Commission published in the Federal Register final rules that generally require the bank to provide a consumer with a notice when, based on the consumer’s credit report, the bank provides credit to the consumer on less favorable terms than it provides to other consumers. The final rules implement section 311 of the Fair and Accurate Credit Transactions Act of 2003, which amends the Fair Credit Reporting Act.

Risk-based pricing refers to the practice of setting or adjusting the price and other terms of credit provided to a particular consumer based on the consumer’s creditworthiness. The final rules provide creditors with several methods for determining which consumers must receive risk-based pricing notices. Consumers who receive this “risk-based pricing” notice will be able to obtain a free credit report to check the accuracy of the report.

As an alternative to providing risk-based pricing notices, the final rules permit creditors to provide consumers who apply for credit with a free credit score and information about their score.

The final rules are effective January 1, 2011.
On July 15, 2011, the Federal Reserve Board and the FTC published in the Federal Register final rules to implement the credit score disclosure requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). If a credit score is used in setting material terms of credit or in taking adverse action, the statute requires creditors to disclose credit scores and related information to consumers in notices under the FCRA.

The final rules amended the FCRA and Regulation V to revise the content requirements for risk-based pricing notices, and to add related model forms that reflect the new credit score disclosure requirements.

The final rules also amend the FCRA portions of the model notices in Regulation B. The model notices combine the adverse action notice requirements for Regulation B and the FCRA, to reflect the new credit score disclosure requirements.

The rules under Regulations V and B are effective August 15, 2011.

When the CFPB converted Regulation V, there were not significant changes made to the regulation. There was one revision made to revise references to other agencies contained within certain disclosures. These include the risk-based pricing notice and credit score notice where the bank is to disclose “How You Can Get More Information.” The disclosure is now required to include a website address for the CFPB as directed in the model disclosures of the Appendix. The revisions to these forms became effective January 1, 2013.

Credit Practices Rule

The Federal Reserve Board promulgated Regulation AA in 1985; the effective date was January 1, 1986. Regulation AA is substantially similar to the Federal Trade Commission’s (FTC) Trade Regulation Rule on Credit Practices, which became effective in 1985.

Both the FTC rule and Regulation AA primarily were issued to prevent certain practices in consumer credit contracts and to provide a disclosure notice to cosigners and guarantors of consumer loans. Regulation AA also requires that cosigners and guarantors be provided with a disclosure statement that explains their liability at the time of the loan. This is the only disclosure requirement of the regulation.

An important responsibility of a bank under Regulation AA is to make sure that it does not purchase consumer contracts that contain a prohibited provision. This requirement particularly affects the indirect lending function of the bank.

On August 22, 2014, the CFPB issued joint guidance with other Federal Regulators, entitled “Interagency Guidance Regarding Unfair or Deceptive Practices.” The guidance addresses the proposed repeal of Regulation AA for banks as a result of the Dodd-Frank Unfair Deceptive and Abusive Acts and Practices Rule (UDAAP). The FTC’s regulation will remain in place for entities it regulates. Note that banks may still need to comply with Regulation AA rules if they purchase contracts from entities under the FTC, as these rules mirror the content of the FTC’s credit practices rule—including, for example, rules related to dealer or retail paper. The guidance notes that while the regulation for banks is being repealed, regulators may still cite banks for unfair and abusive practices, including those described in the original Regulation AA. Regulating agencies expect that banks will continue complying with the current content of Regulation AA. For these reasons, the current Regulation AA rule summary is retained in this chapter, and is now referred to as the “Credit Practices Rule” rather than “Regulation AA.” Continued compliance with the content of
the original regulation may be a best practice, even if not required by regulation, given the broad subjectivity of determining unfair deceptive and abusive acts and practices. Audit questions referring to these prohibitions have been retained with removal of reference to Regulation AA.

**Fair Debt Collection Practices Act (15 USC 1692)**

The Fair Debt Collection Practices Act was enacted in 1977 to regulate the collection of debts for third parties. This law was passed in response to complaints by consumer groups that debt collection agencies were using abusive techniques and harassment to collect debts.

The law places restrictions on who a debt collector may communicate with about an individual’s debt and how the information can be communicated. It also regulates when and how the collector may communicate with the debtor and makes illegal various abusive methods of collecting the debt.

The Fair Debt Collection Practices Act makes several practices illegal because they intentionally mislead a consumer. For instance, a collector may not make a consumer believe that a communication is service of legal process if it is not.

The act also gives consumers the right to call a halt to debt collection efforts and requires the collector to comply with the request.

The law is not applicable to a bank’s efforts to collect its own debts. However, if the bank provides a debt collection service for another lender, the provisions of the act apply. Also, if the bank collects its own debts using a name other than its own, the act applies.

The Fair Debt Collection Practices Act is not implemented by a regulation.

**Servicemembers Civil Relief Act**

The Servicemembers Civil Relief Act of 2003 (SCRA) was signed into law on December 19, 2003, amending and replacing the Soldiers’ and Sailor’s Civil Relief Act of 1940. The law protects members of the Army, Navy, Air Force, Marine Corps, and Coast Guard, including members of the National Guard, as they enter military service (active duty), as well as commissioned officers of the Public Health Service and the National Oceanic and Atmospheric Administration engaged in active service. Some of the benefits accorded servicemembers by the SCRA also extend to servicemembers’ spouses, dependents, and other persons subject to the obligations of servicemembers. Banks have several obligations when notified of a servicemember’s orders for active duty.

Amendments to the Housing and Economic Recovery Act of 2008 extended the time period for certain protections in the SCRA. In particular, the provision for an extended time period for protections affecting foreclosure, sale, or seizure of real or personal property remains effective through December 31, 2012.

On August 6, 2012, President Obama signed into law the Honoring America’s Veterans and Caring for Camp Lejeune Families Act of 2012. Section 710 of the act amended section 303 of the Servicemembers Civil Relief Act (SCRA), 50 USC app. 533.

SCRA section 303 addresses obligations secured by a mortgage, trust deed, or other security similar to a mortgage on real or personal property owned by a servicemember. The provision applies only to obligations that originated before the servicemember’s military service and for which the servicemember is still obligated. The recent amendment extended, on a temporary basis, the period during which certain SCRA protections apply as follows:
A sale, foreclosure, or seizure of property based on a breach of such a secured obligation is not valid if made during the period of military service or within one year thereafter, unless it is made pursuant to a court order or a waiver by the servicemember.

A court may, on its own motion, and shall, upon application by a servicemember whose ability to comply with the obligation is materially affected by military service, stay the proceedings or adjust the obligation to preserve the interests of all parties at any time during the period of military service or within one year thereafter.

This extension ends December 31, 2014. Beginning January 1, 2015, there will be a period of 90 days after the end of the servicemember’s military service during which a foreclosure, sale, or seizure of the servicemember’s property based on a breach of a mortgage, trust deed, or other security, without a court order or waiver, will not be valid. During this period, a court may also stay proceedings enforcing such obligations.

This change will impact the Servicemembers Civil Relief Act long form notice that is required to be sent to delinquent home loan borrowers. It is expected that HUD will revise the notice it recently issued to reflect this change. The notice should not be revised or implemented until the effective date of this change.

This act is effective February 2, 2013.

**Joint Guidance on Overdraft Protection Programs**

On February 18, 2005, the federal banking agencies issued guidance on certain overdraft protection programs. While the guidance is primarily directed toward “overdraft protection” programs being promoted by banks, it also addresses the safety and soundness risks associated with the traditional bank practice of paying overdrafts on a discretionary basis. Much of the guidance focuses on the manner in which banks market, disclose, and otherwise make these programs available to consumers. The marketed programs typically disclose to consumers an express overdraft limit that applies to their accounts. The specific features of the overdraft protection programs vary from bank to bank.

The guidance outlines concerns related to these programs and covers risks that should be evaluated including the legal, reputation, safety and soundness, and other risks. Within the legal risks the guidance discusses the application of the Federal Trade Commission Act/Advertising Rules, Truth in Lending Act, Equal Credit Opportunity Act, Truth in Savings Act, and Electronic Fund Transfer Act. The guidance also provides a list of Best Practices regarding overdraft programs and policies.
The audit should include review of the bank’s overdraft program(s) and policies to determine aspects of the interagency guidance that might be relevant and ensure that the program complies, as applicable.

On November 17, 2009, the Federal Reserve Board published final rules in the Federal Register that amend Regulation E. The amendments prohibit banks from charging consumers fees for paying overdrafts on ATM and one-time debit card transactions, unless a consumer opts in to the overdraft service for those types of transactions. The final rules are effective July 1, 2010 for new customers. Fees cannot be charged on existing customers that opened accounts prior to the effective date after August 15, 2010. The bank’s overdraft protection program must be in compliance with these rules as discussed elsewhere in the deposit section, Chapter 6 of this manual, in addition to the overdraft protection guidance.

Types of Loans to Audit

The coverage and scope of most of the laws and regulations discussed in the previous section are broad enough to encompass loans in nearly every part of the bank. The auditor should sample the loans in all departments where consumer loans are made, as well as the commercial loan department for loans that fall under the reach of the regulations. Such loans include those listed next (the list is not definitive and is meant only to provide examples). Remember that open-end credit loans and accounts and real estate loans are covered in Chapters 9 and 10. The types of loans to audit include:

- installment loans made to individuals;
- single payment loans made to individuals;
- loans to individuals for personal investments;
- indirect installment loans;
- personal loans made to professionals and executives; and
- commercial loans (for ECOA purposes).

Steps in the Lending Audit

In planning the audit of the lending function, the auditor should follow the procedures discussed in detail in Chapter 2, “Developing the Individual Audit.” The basic steps in the audit, as they specifically apply to the lending audit, are reviewed here.

The steps described in this chapter are designed for optimum flexibility. Because banks vary a great deal in size, lending products, and organizational structures, the possibility of designing a standard audit of this function is very slim. Therefore, the audit steps are organized around a loose functional model of a loan. The various steps are further broken into categories to allow the auditor to pinpoint relevant material. For instance, if a bank does not collect any debts other than its own, the auditor may omit the section on collection. The auditor must be familiar with the loan products offered by the bank and with bank operations in order to select the appropriate questionnaires and procedures.

The audit of the lending departments consists of several phases. The first step is to define the scope and objectives of the audit.
Second, the auditor should administer the internal control questionnaire to the bank personnel who take applications for loans covered by the various regulations and to those who prepare documentation and oversee the closing of loans in the various lending areas.

The third step in the audit process is to obtain a copy of the blank forms that are used in the lending transaction. Forms to be reviewed include all disclosures, applications, and promissory notes, as well as other forms used in the various lending transactions. Each blank form is checked to make sure all regulatory requirements are met.

The fourth phase of the audit is to obtain credit and loan documentation files and to review specific transactions for compliance. The person conducting the audit (either the auditor or compliance officer) should select samples of the various types of loans to be audited. Samples should be selected from each lending department.

Consumer purpose loans are the only type of loan subject to Truth in Lending, but other regulations have broader applicability; therefore, a sample of loans to individuals should be obtained, even though some of the loans in the sample are not for consumer purposes. A special effort should be made to locate the consumer loans made by other areas of the bank, even if only a few are in the portfolio. (Sampling techniques are discussed in Chapter 3.)

Once a sample is obtained, each transaction should be analyzed to determine what regulations apply and if the requirements of each were correctly followed. The credit files are audited for compliance with the Equal Credit Opportunity Act’s information gathering restrictions. Also, at this point, the auditor should review the denied loan applications and notifications sent to the applicants. This involves selecting a sample of the denied loan applications and then making sure that the proper notice was sent to the applicant.

When the loan files are reviewed, the auditor checks for compliance with Truth in Lending, the Equal Credit Opportunity Act, and Regulation AA. This portion of the audit is extremely important because many, if not most, of the dangerous violations are found at this point.

After the documents are reviewed, the auditor checks the various operational procedures within the lending areas to ensure that the bank is in compliance with all the applicable regulations. For example, the audit should test whether the record retention regulations are being adhered to after the loan is booked and after it pays off.

Another operational step in the audit process is to review the bank’s procedures in complying with the Fair Debt Collection Practices Act. This act is not applicable to all banks. In order to be governed by the Fair Debt Collection Practices Act, a bank must be in the business of collecting consumer debts for others or must use a different name when it collects its own debts.

The final responsibility of the person conducting the audit is to report the findings of the audit to bank management or the board of directors. The preparation of the audit report is discussed in Chapter 2.
Scope and Objectives of the Audit

Before defining the scope and objectives of the audit, many banks perform an analysis of the risks of noncompliance (discussed in Chapter 2). Generally, the scope of the audit should either be confined to one of the lending departments that makes consumer loans, or it should cover all loans that could be subject to federal regulations.

The objectives of the audit should be to determine if the lending policies, procedures, and loan documentation are in compliance with all federal credit regulations. State laws and regulations can also be covered in the audit and should be added to the scope and objectives accordingly. Specific objectives should be written that reflect the scope of the audit.

As a general rule, the scope and objectives are dictated by the number of consumer-type loans made by the bank and the extent to which the bank has been audited for compliance in this area in the past. If past audits or compliance examinations have uncovered problems in particular areas, those areas should be specifically targeted in the audit scope and objectives. For example, one could audit just the consumer loans made by the professional lending area or by the commercial loan department if audits have been infrequent or if compliance examination reports have indicated that problems exist in those particular areas.

Internal Control Questionnaire

After the scope and objectives are set, the attention of the auditor should turn to administering the internal control questionnaires to the appropriate bank personnel. The questionnaires in this section are designed in a functional manner. Therefore, they should be administered to the person who is responsible for the particular lending function to which they pertain. For example, the receptionist, loan secretaries, and loan officers should be given the customer-contact questionnaire, and the loan officers should answer the evaluation questionnaire.

The following classifications of employees should be questioned:

- customer-contact personnel, including receptionists, secretaries, and tellers that work in the lending lobbies;
- application processors, including employees who prepare adverse action notices;
- loan closers, including employees who prepare documents for and conduct loan closings;
- loan review and operations personnel, including employees who review loan documents from time to time, those who review them immediately after consummation, and those who are responsible for maintenance of the loan during its term; and
- collectors—the questions in this category are divided into two categories: those that are applicable only if the bank collects its own debts, and those that apply if the bank collects debts for others or if the bank collects its own debts but uses another name to do so.

Internal control questionnaires are administered for the purpose of determining that proper procedures are utilized in each step of the lending process. Banks divide responsibilities in varying ways, so certain questions may not be applicable to someone who performs that function in a
particular bank. Therefore, it is important that the auditor review the questions in advance to
determine which ones apply to each individual.

Each of the questions in these internal control questionnaires is phrased so that the correct
response is yes. The auditor can pose the questions to the respondents as they are phrased here since
the accuracy of the responses will ordinarily be tested in subsequent steps of the audit. Depending
on the design of the audit, though, the auditor can rephrase the questions so that more substantive
answers are required of the respondents. This approach may more readily reveal deficiencies in the
bank’s procedures and routines. An example of rephrased internal control questions is presented in
Exhibit E in Chapter 2, “Developing the Individual Audit.”
Customer-Contact Personnel—
(Preapplication and Application Process)

The following internal control questionnaire should be administered to persons who interact with
the public, including those who greet applicants (including receptionists), screen applicants or
answer questions, quote interest rates, and accept applications. Include anyone who interacts with
the customer during the time an application or inquiry is being made.

The questions regarding use of a prescreened list should be administered to personnel involved
in developing credit solicitations, if applicable.

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<th>Yes</th>
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<tr>
<td>1. If simple interest rates are quoted in response to customer inquiries, are annual percentage rates (APRs) quoted also?</td>
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<tr>
<td>CFR 226.26(b)</td>
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<td>2. If an annual percentage rate cannot be quoted in response to a customer inquiry, are sample transactions used in order to quote an APR?</td>
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<tr>
<td>12 CFR 1002.4(a)</td>
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<td>3. Are customer-contact personnel who pre-screen applicants and take applications trained in the proper procedures for taking application information?</td>
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<td>12 CFR 1002.4(a)</td>
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<td>4. Are all applications taken without regard to race, color, age (except with regard to age of majority), sex, marital status, national origin, religion, the receipt of public assistance income, and the exercise of rights under the Consumer Credit Protection Act?</td>
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<td>12 CFR 1002.7(b)</td>
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<td>5. Are applications accepted in any birth-given name, surname, spouse's surname, or a combined surname of the applicant?</td>
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**Lending Audit**

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
<th>Comments</th>
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<tbody>
<tr>
<td>12 CFR 1002.5(c)(2)</td>
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<td>6. Do bank personnel refrain from requesting any information on the applicant’s spouse unless:</td>
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<td>▶ the spouse will be permitted to use the account;</td>
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<td>▶ the spouse will be contractually liable on the account;</td>
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<td>▶ the applicant is relying on the spouse’s income as a basis for repayment of the credit requested;</td>
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<td>▶ the applicant resides in a community property state, or the property that is the basis of repayment is located in a community property state; or</td>
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<td>▶ the applicant is relying on alimony, child support, or separate maintenance payments from a spouse or former spouse as a basis for repayment of the credit?</td>
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<td>12 CFR 1002.5(d)(1)</td>
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<tr>
<td>7. If an applicant requests individual unsecured credit, do bank personnel refrain from asking the applicant’s marital status unless the applicant resides in a community property state or is relying on property located in such a state as a basis for repayment of the credit?</td>
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<td>12 CFR 1002.5(d)(1)</td>
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<td>8. Are inquiries of marital status limited to the terms: married, unmarried, and separated?</td>
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<td>12 CFR 1002.5(d)(2)</td>
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<td>9. Are applications taken without asking whether income is derived from alimony, child support, or separate maintenance payments unless it is disclosed to the applicant that such income need not be revealed?</td>
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<td>12 CFR 1002.5(d)(3)</td>
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<td>10. Do bank personnel refrain from inquiring about birth control practices and intentions of bearing children?</td>
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<td>12 CFR 1002.5(d)(3)</td>
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<td>11. If bank personnel inquire about dependent-related financial obligations or expenditures, is it done without regard to sex, marital status, or any other prohibited basis?</td>
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12 CFR 1002.5(b)

12. Do bank personnel refrain from inquiring about the race, color, religion, or national origin of an applicant?

15 USC 1681m

13. If the bank uses a prescreened list to solicit credit, is each consumer provided with a clear and conspicuous disclosure statement of the following:

- information in the consumer’s credit report was used in connection with the transaction;
- the consumer received the offer because the consumer satisfied criteria for creditworthiness;
- if applicable, credit may not be extended, after the consumer responds, if the consumer does not meet the criteria used to select the consumer or does not furnish any required collateral;
- the consumer has the right to prohibit information contained in the consumer’s file, with any consumer reporting agency, from being used in connection with any credit transaction that is not initiated by the consumer;
- the consumer may exercise the right above by proper notification to the consumer reporting agency; and
- address and telephone number, toll-free if the agency is nationwide, of the credit reporting agency for notification?

14. Does the bank retain documentation of all information relative to the solicited offer until the expiration of the three-year period beginning on the date the offer was made to the consumer?

12 CFR 1002.12(b)(7)

15. Regarding a prescreened solicitation, does the bank retain the following specific information for 25 months after the date on which an offer of credit is made to potential customers (12 months for business credit)?

- the text of any of the solicitation;
- the list of criteria used to select recipients of the solicitation; and
- any correspondence related to complaints (formal or informal) about the solicitation.
12 CFR 41.30(b)(1); 222.30(b)(1); 232.1(b); 334.30(b)(1)

16. Does the bank refrain from obtaining or using medical information pertaining to a consumer in connection with the determination of the consumer’s eligibility, or continued eligibility, for credit, unless the manner of receiving the information or the manner in which the information is used is specifically exempt from this requirement?

12 CFR 41.30(c)(1); 222.30(c)(1); 232.2(a); 334.30(c)(1)

17. If the bank receives unsolicited medical information pertaining to a consumer, was it received in connection with a determination of the consumer’s eligibility, or continued eligibility, for credit without specifically requesting medical information?

12 CFR 41.30(d)(1); 222.30(d)(1); 232.3(a); 334.30(d)(1)

18. If the bank uses unsolicited medical information, does the bank ensure that:

- the information is of the type routinely used in making credit eligibility determinations, such as information relating to debts, expenses, income, benefits, assets, collateral, or the purpose of the loan, including the use of proceeds;  

- the bank uses the medical information in a manner and to an extent that is no less favorable than its use of comparable nonmedical information in a credit transaction; and

- the bank does not take the consumer’s physical, mental, or behavioral health, condition or history, type of treatment, or prognosis into account as part of any credit determination?

12 CFR 41(e); 222(e); 232.4(a); 334.30(e)

19. If the bank obtains and uses medical information, was the information obtained and used in accordance with one of the specific exceptions contained in the interim rules?

Note: When performing an audit, it may be beneficial to refer to the examples of exceptions contained in the rules to better determine whether the bank’s practices of obtaining or using any medical information are consistent with the allowable exceptions.
20. If the bank receives medical information about a consumer from a consumer reporting agency or its affiliate, does the bank refrain from disclosing that information to any other person, except as necessary to carry out the purpose for which the information was initially disclosed, or as otherwise permitted by statute, regulation, or order?

12 CFR 41.31(c); 222.31(c); 334.32(c)

21. If the bank has complied with section 603(d)(2) to share information with an affiliate, does the bank limit sharing to the following:

- in connection with the business of insurance or annuities;
- for any purpose permitted without authorization under the Health Insurance Portability and Accountability Act (HIPAA);
- for any purpose described in Section 502(e) of the Gramm-Leach-Bliley Act;
- in connection with a determination of the consumer's eligibility, or continued eligibility, for credit consistent with the allowable exceptions; or
- as otherwise permitted by order of the bank’s regulator?

12 CFR 1026.47(a)

22. If the bank makes a private education loan, are disclosures provided at the time of application or solicitation that address:

- interest rates;
- fees and default or late payment;
- repayment terms;
- cost estimates;
- eligibility;
- alternatives to private education loans;
- rights of the consumer; and
- self certification?

12 CFR 1026.47(d)(1)

23. Are the disclosures provided on or with the application or solicitation?