

# Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

October 28, 2013

## HMDA Report Red Flags – What You Need to Know

What will land you in hot water with regulators when it comes to your HMDA reports?

Take Washington Federal, a \$13 billion Seattle-based bank: Regulators sampled the 5,785 mortgage applications the bank reported in 2011 and compared them to its actual loan files. In 38% of the cases at least some of the reported information was wrong.

CFPB ordered the bank to pay a civil penalty of \$34,000, correct and resubmit its 2011 HMDA data, and develop and implement an effective HMDA compliance management system.

Washington Federal has not been accused of mortgage lending discrimination, and the specific nature of the errors cited by the CFPB is not known. Nevertheless, the case has made the bank the latest poster child for HMDA abuse enforcement.

Managing HMDA data is not easy, but the risks of an inaccurate submission are rising.

In 2012, the FDIC imposed \$446,700 in civil money penalties on HMDA violators. Some 40 banks – from the \$52 million-asset Brimfield Bank of Brimfield, IL, to the \$2 billion German American Bancorp of Jasper, IN, were hit

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## CFPB Pushes Financial Institutions to Report Accurate HMDA Data, Threatens Enforcement Action

Community banks and other mortgage lenders have been urged for some time to take more seriously their reporting obligations under the Home Mortgage Disclosure Act. Now the data-centric Consumer Financial Protection Bureau (CFPB) is getting into the act, and the stakes are rising.

CFPB put the industry on notice in a big way earlier this month about the importance of accurate HMDA data reporting. It published a bulletin that discusses components of an effective HMDA compliance management system. It detailed factors the CFPB said it will consider when evaluating whether to pursue a public enforcement action for HMDA violations.

And it announced two HMDA-related enforcement actions – its first under the law -- where it said mortgage lending data reported to the agency had been “severely compromised” by inadequate compliance systems.

The moves add currency to what banking agencies have been saying for a long time: If you fail to take steps to ensure that your HMDA data is accurate, you are running a big risk. They also signal that HMDA reporting is on

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## Small New Jersey Bank Pays \$8.2 Million in BSA-Related Settlement

It was a feel-good story. A bunch of local investors, in a burst of civic pride, decide to launch a community bank. Prominent citizens agree to serve on the board. The bank opens for business. Deposits are taken. Loans are made. What could possibly go wrong?

For a time, that was the story of little Saddle River Valley Bank, of Montclair, N.J., which was chartered in 2006, and eventually grew to about \$120 million in assets, and two branches.

Today, however, the bank has been sold, and its investors are paying the price for taking their business plan far beyond the confines of Bergen County.

The bank agreed last month to pay an eye-popping \$8.2 million to settle federal claims that it violated U.S. anti-money laundering laws. The settlement comes after a federal investigation found that the bank processed more than \$1.5 billion in wire transfers for money service businesses

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## Accurate HMDA Data

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CFPB's radar, which is likely to lead to stepped-up enforcement by the prudential regulators examining their own banks for HMDA compliance.

"The lesson here may well be, 'Have another look at your HMDA reporting,' even if you are not subject to CFPB jurisdiction," said Don Lampe, partner at Morrison & Foerster in Washington. "It is something that one of the other regulators could very well surface. You could see the FDIC and the other regulators with examination authority giving this an even higher priority."

"If you are a HMDA reporter, and you are a smaller institution, this, to me, is a demonstration of an area of compliance that you may not have treated as a priority," Lampe added. "Compliance with Regulation C has basically been a backwater, something that is ordinarily relegated to the IT department. You have to have IT systems working well in order to report accurate HMDA data, and to the extent that community banks are not as well-resourced with respect to HMDA reporting, you could imagine that the issue could come up."

Community banks that are not supervised by the CFPB are starting to get requests from the agency for information about their HMDA and fair-lending activities. CFPB examiners also have the power to be included on exams conducted by prudential regulators of banks with under \$10 billion in assets, although the agency has said it has not yet exercised the authority.

"When financial institutions report inaccurate information, it obstructs

the purpose of the Home Mortgage Disclosure Act and makes it more difficult for the CFPB to discover and stop discriminatory lending," CFPB Director Richard Cordray said, in announcing consent agreements with Washington Federal of Seattle and Walpole, MA-based Mortgage Master. "Today we are sending a strong signal that no mortgage lending institution – whether bank or nonbank – should be able to mislead the public with erroneous data."

Under the 1975 law, banks and other lenders are required to gather and report detailed information about mortgage loan applications and rejections.

CFPB says inaccurate HMDA data impedes its efforts to detect violations of the Equal Credit Opportunity Act and to stop discrimination in home mortgage lending. Other state and local agencies as well as community groups rely on HMDA reporting to evaluate compliance with such laws as the Community Reinvestment Act.

The data also serves as the foundation of the controversial disparate impact theories of discrimination currently being litigated in the federal courts.

The moves to improve the accuracy of HMDA data, which CFPB said was "an important element of its consumer protection mission," follow in the wake of CFPB last month launching a new Web site, complete with interactive maps and charts, which make it easier for consumers (and their lawyers) to access and analyze HMDA data.

And more rules are on the way. CFPB is currently preparing a rule-making on expanding the data it collects under HMDA including such information as points and fees, the

rate spread for loans, the value of the property, the channel through which the application was made, and the credit score of the applicant.

The new bulletin provides guidance on compliance with HMDA and Regulation C and highlights how mortgage lenders may structure HMDA compliance management systems to withstand regulatory scrutiny.

CFPB said, while effective HMDA compliance management systems should be calibrated according to the scope, complexity and size of the institution, such systems frequently include:

- Comprehensive policies, procedures, and internal controls to ensure ongoing compliance with the collection and reporting requirements set forth in HMDA and Regulation C;
- As appropriate to the size and complexity of the institution, comprehensive and regular internal, pre-submission HMDA audits, to test and evaluate data accuracy, and that include a reasonable amount of transactional analysis, written reports detailing findings, and recommendations for corrective actions;
- Reviews of any regulatory changes that may have occurred since the prior examination and/or data collection and reporting cycle;
- Reporting systems that are appropriate given the volume of the institution's lending operations;
- One or more individuals assigned responsibility for oversight, data entry, and data updates, including the timely and accurate reporting of the institution's data;

- Appropriate, sufficient, and periodic employee training to ensure that responsible personnel understand HMDA and Regulation C standards and reporting requirements;
- Effective corrective action in response to previously identified deficiencies; and
- As appropriate, board and management oversight.

The CFPB also established guidelines for when its examiners would ask institutions to correct and resubmit HMDA Loan Application Register data when the number of errors in a sample exceeds certain thresholds. It also encouraged institutions to use the same guidelines "to manage HMDA compliance and facilitate effective corrective action on self-identified errors."

Institutions reporting fewer than 100,000 HMDA LAR entries should correct and resubmit HMDA data when 10 percent or more of a sample of HMDA LAR entries contains errors. In certain cases, sample error rates below 10 percent — or below five percent in an individual data field — may call for resubmission if the errors prevent an accurate analysis of the institution's lending. Institutions reporting 100,000 or more HMDA LAR entries should correct and resubmit HMDA data when 4% or more of a sample of entries contains errors. CFPB said those guidelines would become effective as to HMDA reviews beginning on or after January 14, 2014.

CFPB said it would consider these factors in deciding whether to take public enforcement action for HMDA violations:

- The size of an institution's HMDA

LAR and the observed error rate;

- Whether an institution self-identified its HMDA errors outside the context of an active examination or examination-related activity, and independently took appropriate corrective action; and
- If the institution has previously been on notice regarding high HMDA LAR errors such that the institution should have known of on-going HMDA LAR error rates in excess of the resubmission threshold, whether error rates observed during the current exam are sufficiently lower such that they should be viewed as a sign of substantial progress in improving HMDA compliance management, or whether, despite notice, error rates have remained high or have increased.

CFPB also said it would consider these factors in determining civil money penalties and other corrective action:

- The size of financial resources and good faith of the person charged;
- The gravity of the violation or failure to pay;
- The severity of risks to or losses of the consumer, which may take into account the number of products or services sold or provided;
- The history of previous violations; and
- Such other matters as justice may require.

To some long-time practitioners, the new regime reflects a more aggressive and skeptical regulatory environment. Not too many years ago, for instance, banks could re-submit HMDA data

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## Accurate HMDA Data

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without fear of setting off a regulatory fire alarm. The goal was to ensure that the agency had the most accurate information, and so even multiple submissions did not necessarily turn heads. These days, the regulators may well question the strength of your compliance management program.

“The assumption is, something is wrong with you, that you cannot get it together,” says Mary Neil Price, a partner with Dickinson Wright in Nashville. ■

## Bank Pays \$8.2 Million

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known as casas de cambio located in Mexico and the Dominican Republic between 2009 and 2011.

How a tiny bank came to process hundreds of millions of dollars in international wire transfers is still being sorted out.

“It’s pretty remarkable that a small community bank in suburban New Jersey was attracting more than a billion dollars in transactions with customers in Mexico and the Dominican Republic, and nobody thought it was too good to be true,” Jennifer Shasky Calvery, director of the Treasury Department’s Financial Crimes Enforcement Network, said in a statement commenting on the settlement last month. “Banks of all sizes, in any part of the country, may be tempted by such lucrative ventures. However, banks must use common sense in evaluating customer risk or seemingly lucrative business could

become quite the opposite.”

While all the facts are not yet known – no one has been charged with a crime though the investigation is believed to be continuing – experts said the case seems to be a not so unusual convergence of two trends: the lack of banking experience among investors in small banks, and the dwindling ways that they can make some money.

“I represented a small community bank much like that bank. Do you know what they are thinking? They are being run by people who are not banking people. They do not understand what it is like to be working in a regulated environment. They are thinking, ‘Wow, here’s this bank. I can get involved in the community and it would be a great investment,’” said Beth Moskow-Schnoll, a partner at Ballard Spahr based in Wilmington, DE, and a former federal prosecutor.

Moskow-Schnoll said competitive pressures also likely played a role in the debacle. “It is hard for little banks or community banks to compete in this world. They’re more likely to put out riskier products and engage in riskier services because they need the money,” she said. “It is a recipe for disaster unless they have the proper controls in place.”

Federal regulators have been warning community banks about the risks of processing transactions for third parties, especially those based overseas, and the fact that unscrupulous operators have been increasingly targeting them. Law enforcement authorities have also been warning U.S. financial institutions that drug traffickers were believed to be using Mexican

banks and casas de cambio to launder proceeds from U.S. narcotics sales.

Saddle River was ordered by the OCC in October 2011 to correct deficiencies in its BSA and AML programs and to have its wire and account activities independently reviewed, which subsequently led to the late filing of more than 190 suspicious activity reports.

The regulator told the bank to not restart its international wire transfer business until it had an automated system for detecting suspicious transactions. The bank was also prohibited from accepting remote deposit capture transactions from money service businesses until it had systems to conduct due diligence on its customers, their lines of business and the clients of the bank’s customers.

By that time, Saddle River had been acquired from its original investors by an investment firm controlled by J. Christopher Flowers, a former Goldman Sachs partner, in a deal that was seen as a rare bet by a major buyout firm on the world of community banking. The new owners said they learned of the compliance issues only after they had acquired control. They sold their stake last year to Center Bancorp of Union, NJ. The proceeds from that sale – about \$9.2 million – are being used to pay the government.

Federal authorities said the bank’s anti-money laundering program was deficient in several key areas. Besides failing to monitor at least \$1.5 billion in transactions, and properly detect and report suspicious activity, it was scored for not having conducted sufficiently enhanced due diligence on the casas de cambio

and for not having a BSA officer with sufficient experience to operate an AML program. The bank also failed to provide adequate AML training to employees and to retain qualified independent testers to periodically check its AML program.

Saddle River agreed to pay the Treasury Department a \$4.1 million civil money penalty assessed by the OCC and FinCEN. It also agreed to forfeit an additional \$4.1 million to resolve an investigation by the U.S. Attorney in New Jersey.

According to the Bergen Record, former shareholders of the bank, including a prominent local surgeon and a former Saddle River mayor, are now suing the Flowers firm and others in an attempt to recover millions in losses that they allege were caused by negligence and mismanagement. The defendants deny any wrong-doing, and are seeking to have the suit dismissed.

"You see it when there is an air of desperation," Mark Belongia, national community bank attorney and partner in charge of the Chicago office of Roetzel & Andress in Chicago, said of the disastrous plunge. "What are they going to do to make money and improve the bank's position? Instead of thoughtful analysis on this issue, they get panicky about the bank's precarious position. The board and management both say, 'Let's just do it,' without proper risk assessment. They do not take the time to talk to their lawyers, other outside professionals, and regulators before venturing into new business lines."

"It is a failure to have internal controls," Belongia adds. "If you don't have proper staff, properly trained, it will go off the rails in about a day." ■

## Red Flags

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with penalties ranging from \$1,500 to \$60,000.

Now, with the CFPB administering and interpreting HMDA, the enforcement environment is intensifying. CFPB set its expectations in a bulletin and guidelines issued earlier this month, punctuated by the announcement of its first enforcement actions under the law.

Besides Washington Federal, it hit Mortgage Master of Walpole, MA, with an even heftier \$425,000 civil penalty that apparently reflected the fact that the lender had been previously fined by state regulators in Massachusetts for excessively high HMDA error rates.

The monetary sanctions certainly hurt. Worse, experts say, is the added regulatory scrutiny that violations can bring.

"If you fail HMDA then you fail CRA and if you have HMDA and CRA problems then you have got regulatory problems across the board," said Mary Neil Price, a partner with Nashville's Dickinson Wright law firm. "You are going to have a problem opening a branch. You are going to have a problem shutting down a branch. You are going to have a problem with anything that requires regulatory approval. Regulatory actions that would normally take place on a regional level are going straight to Washington."

Not every HMDA error is an indictable offense. Many reporting errors are unintentional. But to regulators, they can also be symptomatic of weaknesses in lending processes or internal controls.

Every regulatory compliance examination includes a review of your HMDA Loan Application Register (LAR) including an assessment of the quality and reliability of your compliance risk management system. That includes internal controls, policies and procedures, training, and audit and review functions for HMDA and Regulation C.

A complete HMDA LAR requires a comprehensive review of applications and loans. Under the law, lenders must collect data regarding applications for, and originations and purchases of, home purchase loans, home improvement loans, and refinancings for each calendar year.

Mortgage lending accounts for the bulk of HMDA data. But unsecured home improvement loans are reportable - if the loan is classified as home improvement. Business loans secured by residential property may or may not be HMDA reportable, depending on whether the new loan was made to pay off an existing lien secured by residential property.

And while most application outcomes are simple to identify, some don't fit neatly into a single category. An "incomplete" application can also be reported as "denied for incomplete information," for instance. Experts say the key is being consistent in how you report your data.

Submitting erroneous HMDA data can be grounds for administrative action, as a growing number of banks are finding out. According to federal guidelines, examiners generally consider civil money penalties whenever:

- The bank has been required to resubmit data based on findings at consecutive examinations;

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## Red Flags

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- Resubmitted data are still erroneous and have an error rate that exceeds the resubmission guidelines;
- The bank has greater than a 5% error rate in four or more key fields for loan application records sampled; or
- The bank has errors in at least one of the key fields for more than 40% of the loan application records sampled.

The good news: most banks have gotten better at managing their HMDA data in recent years. The bad news: regulators are also better and more sophisticated at testing the accuracy of your data.

Price and Loretta Kirkwood, a managing director at CrossCheck Compliance LLC, based in Chicago, say that HMDA data management is an on-going process, starting with data capture at the point of application, through the credit management process and ultimately submitted to the bank's primary federal regulator.

In a recent presentation to the Tennessee Bankers Association they identified these "Red Flags" in HMDA reports that are apt to attract regulatory scrutiny:

- Higher percentage of withdrawn applications when compared to approved not accepted and denied applications;
- Limited or no approved not

accepted and incomplete applications;

- Substantial majority of applications result in an origination;
- Inconsistent distribution of applications based on race and ethnicity as compared to market/assessment area; and
- Limited or no home improvement purposes applications reported.

Kirkwood and Price also found HMDA filers commonly making these errors:

- **Government Monitoring Information:** Applicant information (ethnicity, race, sex) "corrected" by bank; income understated
- **Action Code:** No documentation of withdrawal request by applicant or evidence of credit underwriting in file; Preapproval denials not reported
- **Preapproval:** Documentation in file that preapproval was requested, not flagged on LAR
- **Purpose:** Home Improvement purpose on application, reported as Refinance
- **Geocode:** May have to be corrected because vendor geocode programs are often modified during the year.

Kirkwood said that checking for omitted data is most effectively managed through systemic data integrity testing, a process that involves reconciling HMDA data to application and loan system data using classification codes and fields not

commonly considered HMDA fields.

Under such an approach, a narrative field on an application system could be used to isolated "home improvement" loans, while collateral codes on a loan system could be used to identify residential secured and multifamily loans.

"Developing a systemic validation process provides a less manual and more effective process," Kirkwood said. "Use your system coding to help make sure you haven't omitted data that might not ordinarily be considered part of your residential lending program. This is more efficient and effective than going through loan files."

Regulatory agencies have also begun questioning the independence of the method a bank chooses to test the accuracy of its HMDA data, suggesting that the same people who are charged with preparing your HMDA data should not be responsible for testing it.

According to Price and Kirkwood, examiners are now starting to consider whether the board of directors has established an independent review of the policies, procedures and HMDA data to ensure compliance and accuracy, and is advised each year of the accuracy and timeliness of the financial institutions' data submissions. Since the compliance officer or department in many banks is responsible for collecting, reviewing and submitting data, that could create conflicts with regulators down the road. ■