

Client Alert

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A New Look At An Old Regulation

Getting ready for your next compliance examination? Well, it may be time to take a fresh look at your institution's Regulation B compliance. The Equal Credit Opportunity Act ("ECOA"), as implemented by Regulation B, is not a new concept. First adopted in 1974, Regulation B is understood by most institutions to include a focus on what information and what signatures can be obtained with respect to the family member of an applicant. However, examiners have used the heightened regulatory environment to take a new look at Regulation B and, in doing so, have found novel and aggressive ways to apply it to financial institutions.

We have represented dozens of financial institutions of various sizes over the last couple of years on Regulation B issues. What we have seen is that examiners are evaluating whether Regulation B should result in monetary penalties and referrals to the Department of Justice ("DOJ"). Even when we convince examiners not to pursue such actions, Regulation B violations increasingly are noted during compliance examinations. As a result, such issues are reducing institutions' compliance ratings and are the basis for informal administrative actions. Based in part on these representations and negotiations with examiners, we have compiled the following "red flag" areas to assist institutions in preparing for their next compliance examination. We recommend that institutions investigate and be ready to address these issues during their examinations, as the examiners certainly will be looking to do so.

Regulation B states, in relevant part, that "a creditor shall not require the signature of an applicant's spouse or other person, other than a joint applicant, on any credit instrument if the applicant qualifies under the creditor's standards of creditworthiness for the amount and terms of the credit requested. A creditor shall not deem the submission of a joint financial statement or other evidence of jointly held assets as an application for joint credit." 12 C.F.R. § 1002.7(d)(1). According to examiners, this means, in the most simplest of terms, that if an applicant is creditworthy, no additional signatures should be required by an institution. Period – end of inquiry. As such, the primary determination with respect to any application is the creditworthiness of the applicant before any discussion of a possible co- or joint applicant is allowed.

In practice, however, while many institutions' Regulation B policies comply, actual practices may be quite a different story. For instance, there is often a misunderstanding amongst loan officers in community property states as to which signatures they can require on notes versus pledge or security agreements. Loan officers, without considering the creditworthiness of the applicant, may automatically require that there be a co- or joint applicant on the note. The loan officer may believe that the additional signature on the note is necessary to secure community property. Yet, if the applicant was creditworthy, the requirement of an additional party on the note would be a Regulation B violation. In such case, no additional signatures should have been required. In contrast, an institution certainly can require other parties to execute pledge or security agreements in order to create a valid lien on the community property. We have seen this issue repeatedly arise in community property states, as well as in other settings. Examiners are approaching institutions with an appreciation of state law requirements to perfect liens on collateral, underscoring the importance of not only having good policies in place, but also appropriate training and monitoring mechanisms to see that those policies are applied correctly in practice.

If the applicant is not creditworthy, institutions should not suggest that the applicant bring in a spouse or other family member as a co-maker or guarantor. This too would violate Regulation B. Instead, the institution needs to communicate that the applicant does not have sufficient strength for approval without a co-maker, guarantor, or the pledge of additional collateral and allow the applicant to suggest how he/she will strengthen the credit. The end result may be the same as if the institution insisted on a spouse as a co-maker/guarantor, however, Regulation B demands that the applicant make the decision, not the institution.

Lack of documentation is also an increasing area of regulatory scrutiny under Regulation B. If there is a co-applicant or guarantor, then examiners require that the institution maintain proper documentation evidencing contemporaneous intent by that party to apply. We disagree with examiners on this point. The express language of the statute and the Regulation do not exclude oral proof of intent. Nonetheless, examiners have taken the position that Regulation B requires that such evidence of contemporaneous intent be in *writing*. In other words, it is not sufficient proof of compliance that two applicants walk into a bank and verbally express to the loan officer their intent to apply for joint credit if there is no written evidence of joint intent.

In essence, examiners want to see a separate written statement of joint intent, despite that there is currently no such requirement in the text of Regulation B. In the absence of such a statement, examiners have indicated that they will consider other written evidence of joint intent, such as notations in the loan file, but examiners have scrutinized such evidence and rejected, among other things, written powers-of-attorney whereby one spouse gave the other the express authority to enter into credit on his/her behalf as insufficient to establish joint intent. As such, it is important for an institution to review its loan files and determine whether it is maintaining the appropriate documentation. If not, there is no better time to change procedures than the present.

Examiners have also begun scrutinizing and seeking to narrow the business lending exception (the "Business Lending Exception") of Regulation B. The Business Lending Exception allows a creditor to require the personal guarantee of partners, directors, or officers of businesses and shareholders of closely-held corporations, even if the business is creditworthy. However, the requirement must be based on the guarantor's relationship with the business or corporation, not a prohibited basis; e.g., "a creditor may not require guarantees only of the married officers of a business or the married shareholders of a closely held corporation." Official Staff Interpretations of Regulation B, Supplement I to 12 C.F.R. Part 1002, Paragraph 1002.7(d)(6), Comment 1. This is easier said than done. What we have seen in practice is that demonstrating the existence of the guarantor's "relationship with the business or corporation" can be problematic, particularly with family-run farms and sole proprietorships where there is oftentimes little to no formal documentation supporting the guarantor's role in the operation. Institutions must make sure that loan officers are properly documenting the guarantor's relationship when applying the Business Lending Exception and be prepared for examiners to scrutinize such evidence during their next examination.

Moreover, examiners have recently interpreted the Business Lending Exception very narrowly. Specifically, one regulatory agency has said that the exception applies only to documents entitled "guarantees." In other words, a partner, director, or officer of a business can be required to execute a "guarantee," but an institution cannot require such individuals to serve as co-makers, co-signers, co-applicants, or joint borrowers even if such signatures have the same legal effect. We have seen institutions require co-signers or co-makers instead of guarantees on business loans, unwittingly thinking that these terms had the same legal effect and that the Business Lending Exception therefore applied. However, certain regulators have found such a practice to be a Regulation B violation.

We have also seen examiners scrutinize guarantees, requiring institutions to maintain documentation that the guarantor's decision was, in fact, voluntary. The FDIC issued a newsletter earlier this year cautioning

institutions that while voluntary guarantees are not prohibited by Regulation B, an institution accepting a voluntary guarantee should have contemporaneous documentation in the loan file demonstrating that it analyzed the creditworthiness of the applicant and determined whether a guarantor was necessary. If the guarantor was not necessary, the FDIC stated that an institution must show that the spouse's decision to offer the guarantee was, in fact, voluntary and a choice exercised after being fully informed of the options. In that same vein, the FDIC has advised that continuing or unlimited guarantees present "heightened fair lending risks." Accordingly, the FDIC recommends that institutions request guarantees that are limited in scope to the credit requested, and that such guarantees be revisited in the future if there is a request to extend or provide additional credit. If the guarantee is no longer needed in the future, the FDIC advises that the unlimited or continuing guarantor should be released.

We recognize that there are compelling reasons why a guarantor may be willing to enter into a continuing or unlimited guarantee. Oftentimes, for small businesses, only one spouse is participating in operations on a daily basis. The other spouse may be working full time for another employer and may lack the luxury of taking time off to sign loan documents once or twice a year. Accordingly, we recommend that the institution educate customers about the pros and cons of continuing or unlimited guarantees. In such case, the guarantor can then make a fully-informed decision that it prefers the broader guarantee in lieu of missing time from work, with the institution carefully documenting this voluntary decision. Obviously, the institution is not going to renew the loan without sufficient credit support.

It should be noted that Regulation B compliance "2.0" is a focus not just on the paperwork, but also on the numbers. We have seen examiners ask institutions what percentage of their loans involve a small business or small farm. Examiners have then asked institutions to review their loan portfolios to see what percentage of all such loans involve the husband and wife signing as co-makers or providing spousal guarantees. If the percentage approaches 100%, then regardless of the contemporaneous evidence, examiners are suggesting that the institutions must be mandating that there be a co-signer or guarantee in practice, even if the policy and the documentation for the application appear to be acceptable.

Given this heightened scrutiny, institutions might also consider obtaining waivers when restructuring loans. An acknowledgement that a spouse or family member "actively and with full understanding" participated in negotiating an agreement "after consultation and review with counsel" may help to insulate the institution from Regulation B claims.

In sum, while Regulation B is far from new, examiners are clearly taking novel and aggressive approaches to apply Regulation B to institutions during compliance examinations. Examiners have shifted the burden to institutions to affirmatively demonstrate that Regulation B has not been violated with respect to each loan. In doing so, examiners now require institutions to maintain significant documentation within the loan files to show Regulation B compliance. In this environment, it is crucial that institutions are prepared to address these "red flag" areas, as the regulators certainly will be.

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