ADMINISTRATIVE LETTERS

An Administrative Letter is the method by which the Commissioner of Financial Institutions formally communicates with entities regulated by the Bureau of Financial Institutions. Administrative Letters are not regulations or law, but are positions that the Bureau of Financial Institutions has taken on issues affecting financial institutions. Administrative Letters are often issued after the Bureau of Financial Institutions identifies or receives a number of questions or concerns about a particular issue, regulation or law. Administrative Letters provide helpful direction, guidance, instructions, interpretations, or general information.

REGISTER OF ADMINISTRATIVE LETTERS
Issued by

Bureau of Financial Institutions
Virginia State Corporation Commission

FINANCIAL INSTITUTIONS AND SERVICES
Title 6.2

Banks
Chapter 8

Letter Number

Savings Institutions
Chapter 11

Payday Lenders
Chapter 18

ADMINISTRATIVE LETTER BFI-AL-0201
APPLICATION FOR A BRANCH OFFICE

1. Any bank or savings institution may apply to the State Corporation Commission for authority to establish a branch office.

2. Authority granted to any bank or savings institution to establish a branch will expire at the end of one year, unless a request for an extension of time is received not less than 45 days nor more than 60 days prior to expiration of the time stated in the certificate of authority to establish the branch. A request for an extension of time must specify the reason(s) for the delay.

3. For good cause, the time within which a branch must be opened for business may be extended for a period not to exceed six months beyond the expiration of the initial one year period authorized for the branch to be opened. Except in unusual circumstances and for good cause shown, a second extension of time will not be granted unless construction of the branch has been started.

4. Where a bank or savings institution has been granted an extension of time for the opening of an approved branch, the State Corporation Commission may elect not to act on an application for an additional branch office until construction of such previously approved branch has been started.

Revised and Reissued July 1, 1999 and June 1, 2011. Original effective date: September 10, 1979.

Reference: §§ 6.2-831 (Banks) and 6.2-1133 (Savings Institutions) of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0202
INVESTMENT BY BANKS IN SHARES OF INVESTMENT COMPANIES

Chapter 297 of the 1987 Acts of Assembly amended § 6.1-60.1 (recodified as § 6.2-874) of the Code of Virginia to provide (among other things) that the general prohibition against a bank's investing in corporate stock shall not prevent any bank "from acquiring, owning and holding, subject to such conditions as the Commissioner may prescribe, shares of investment companies." This circular prescribes the conditions governing investment in shares of investment companies (or, mutual funds) by state banks.

1. The investment portfolio of the investment company must consist solely and exclusively of instruments and obligations in which the bank could invest directly for its own portfolio.

2. Purchases of such shares are limited to the same extent that direct investment in any particular asset in the investment company's portfolio would be limited by applicable law or regulation.

3. The bank as shareholder must have legally enforceable, undivided interest in the underlying assets of the investment company, which interest is proportionate to the bank's ownership in the company.

4. The bank as shareholder must be shielded absolutely from direct or indirect liability for any act or obligation of the investment company.

5. The investment company must be registered with the Securities and Exchange Commission under the Investment Company Act of 1940 and the Securities Act of 1933.

6. Where the investment company engages in such activities as transactions in options, futures, puts or calls, etc., shares purchased by the bank must be treated as if the bank were engaging in such transactions directly and such transactions must be reported and accounted for accordingly.

7. The bank's board of directors must have established and formally approved an investment policy that specifically provides for investment in investment companies, and that requires specific prior approval by the board of each initial investment in the shares of any company. Thereafter, each additional investment in the shares of that investment company must be reviewed and approved by the board, and such review and approval must be reflected in official board minutes. It is the board's sole responsibility to determine, with the advice of counsel if necessary, whether the shares of any particular investment company meet all established criteria, legal and otherwise, before authorizing

BFI-AL- 0202

investment in those shares. The Bureau will not provide a prior determination of the eligibility of the shares of any specific company for investment.

8. Prior to any investment in investment companies, adequately detailed procedures, standards and controls for managing such investments must be established.

9. Not less frequently than quarterly, a detailed review of all holdings of investment companies' shares must be conducted by the board, and the board must further review the extent to which the board's policies and procedures are effective.

The board of directors must specifically consider and make adequate provision for the effect of investment in investment companies' shares upon the bank's present and future liquidity needs. The marketability of such shares and their acceptability as security for public deposits and for other purposes requires the full understanding and careful attention of the board. Careful attention to sales fees and accounting for such fees when shares are bought and sold is also necessary.

It is strongly emphasized that the decision to invest in shares of one or more investment companies is the absolute and sole responsibility of each bank's board of directors. Considerations of safety and soundness of an institution must not be subordinated to perceived opportunities for income.

Compliance with the foregoing conditions and requirements will be reviewed during examinations.

Issued by the Commissioner of Financial Institutions, August 10, 1987, as Circular 1-87.

Reference: § 6.2-874 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0203
LOANS SECURED BY STOCK OF
FINANCIAL INSTITUTION HOLDING COMPANIES

Section 6.2-874 of the Code of Virginia provides, in part, that a bank may not make loans secured by its own stock. This prohibition does not extend expressly to loans secured by shares of a bank's holding company. Where no substantial market for a holding company's stock exists, however, risks similar to those which underlie the statutory prohibition may be involved. It appears that such instances are less prevalent now than in 1987, when this issue was last addressed.

Accordingly, the Bureau of Financial Institutions deems it an unsafe and unsound practice for a bank that has been in existence for less than five years to make a loan on the security of shares of its own holding company without prior written approval by the Bureau. Otherwise, lending on the security of shares of a bank's holding company will not be considered an unsound practice. This ruling does not affect the ability of a bank to take such holding company shares to prevent or reduce loss on a debt previously contracted.

Sections 6.2-1186 and 6.2-1187 of the Code of Virginia do not permit state savings institutions to make loans secured by shares of such institutions or their holding companies. Moreover, no such authority has been granted pursuant to subsection 22 of § 6.2-1186. Therefore, instances of such lending will be cited as violations.

Revised and reissued January 22, 1996 and June 1, 2011.

Reference: §§ 6.2-874, 6.2-1186, and 6.2-1187 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0204
INVESTMENT IN
COMMUNITY DEVELOPMENT CORPORATIONS

Chapter 464 of the 1988 Acts of Assembly amended § 6.1-60.1 (recodified as § 6.2-874) of the Code of Virginia to provide that the general prohibition against investment by a State bank in corporate stock shall not prevent any bank "...from acquiring, owning and holding, subject to such conditions as the Commissioner may prescribe, shares of stock in a community development corporation."

Under that authority, a State bank may invest in a community development corporation (CDC), provided:[1]

1. The CDC is, or is to be, organized and operated for predominately civic, community or public purposes, including (but not necessarily limited to) development or rehabilitation of housing or other property in low-income or moderate-income areas in designated Community Development Areas or in Urban Development Action Grant designated communities;

2. A bank's total investment in all CDC's may not exceed ten percent of its capital and surplus (as defined in § 6.2- 875 of the Code of Virginia) ;

3. Investments in CDC's are to be carried on a bank's books as "other assets";

4. As a matter of policy, the Board of Directors of a CDC should include representatives of the residential, business and government sectors of the community to be affected by the CDC;

5. Each bank investing in a CDC must have on file an investment proposal containing:

[1] These conditions apply only to investment in the stock (equity) of community development corporations. State banks have authority to donate funds to community organizations (§ 13.1-627 A 13 of the Code of Virginia), or to lend to such organizations subject to the provisions of § 6.2-875 of the Code of Virginia. However, it is noted particularly that, unlike general business corporations in Virginia, State banks are not empowered by law to enter into partnerships, joint ventures, or other associations, regardless of the purpose of such an organization (§ 13.1-627 B of the Code of Virginia).

(a) A description of the CDC, including name, state of incorporation, registered agent, total capitalizations, etc.

(b) A statement of the purpose of the CDC, including a description of how the purpose conforms to the requirement that it be predominately civic, community or public in nature;

(c) A list of the Board of Directors of the CDC, showing principal occupation and how the individual will satisfy the requirement for representation of the residential, business or government sectors of the community;

(d) A list of advisory committee members (if any) and their involvement or participation in the community;

(e) The nature and extent of the banks investment, contribution and other participation;

(f) A description of the CDC's target areas, projects and beneficiaries.

6. No bank may invest in a CDC if the activity of or transaction by the CDC will result in improvement or enhancement of the value of property in which a bank insider (officer, director, employee or a member of such individual's immediate family) has an interest.

Every investment in a CDC by a bank will be reviewed by the Bureau's examiners for asset quality, risk characteristics and adherence to the provisions of § 6.2-874 (15) of the Code of Virginia and this Circular. The management and Board of Directors of the bank are responsible for compliance with applicable laws and regulations.

Issued by the Commissioner of Financial Institutions September 8, 1988 as Circular 1-88.

Revised and reissued August 19, 2015, and April 20, 2016.

Reference: § 6.2-874 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0205
SECURITIES RATING SERVICES

Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act directed the federal banking agencies to remove from their regulations all references to, and requirements to rely on, nationally recognized statistical rating organizations (Moody's, Standard & Poor's, Fitch's, etc.) and to establish appropriate standards for evaluating the creditworthiness of securities and money market instruments.

Accordingly, every bank must, as a matter of prudence and as a basis for investment decisions, have available for analysis sufficient credit information to enable an informed appraisal of any security.

Banks are now required to identify credit risk in investment securities by fully assessing the issuer's repayment ability. While the process may be more intensive than reliance on external credit ratings, management has several existing tools at its disposal to identify and monitor credit risk. A bank's existing loan underwriting processes provide a basic starting point for identifying credit risk. As with underwriting credits, the degree of due diligence needed for any specific investment is dependent on the security's credit quality, the complexity of the structure, and the size of the bank's investment. So, for example, while a small investment in a straightforward general obligation bond of a local municipality should still receive an appropriate assessment of credit risk, such an investment would likely require less intensive review than a large investment in a corporate bond or a private label mortgage-backed security.[1]

For additional guidance, banks may refer to the Federal Reserve Board's Supervision and Regulation Letter SR 12-15 (Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings), which is available at the following website: http://www.federalreserve.gov/bankinforeg/srletters/sr1215.htm.

Revised and reissued February 26, 2014. Originally issued by the Commissioner of Financial Institutions June 21, 1978, as Circular 1-78.

Reference: § 6.2-875 of the Code of Virginia

[1] Christopher McBride, *Investing in Securities Without Relying on External Credit Ratings*, Community Banking Connections, Second Quarter 2013, at 7. Paragraph reproduced with permission from the Federal Reserve System.

ADMINISTRATIVE LETTER BFI-AL-0206
LOANS IN VIOLATION OF SECTION 6.2-875

The entire amount of a loan or other transaction which, at the time such loan or transaction is made, results in an aggregate obligation in excess of the bank's lending limit, is to be extended, rather than only that portion in excess of the legal limit. The lending limit on the date when the violation occurred is to be calculated and shown in the examination report as well as the lending limit and the balance of the obligation on the date of examination.

The foregoing procedure recognizes that a transaction which results in violation of the law is illegal in its entirety, rather than only to some lesser degree related to the amount by which the legal lending limit may have been exceeded. The emphasis here should not be, and is not, placed upon some concept of degree of violation of law, since violations are not believed to occur by degrees. If a transaction violates the law, the amount of the transaction is of no consequence.

Revised and reissued June 1, 2011. Originally issued by the Commissioner of Financial Institutions December 16, 1977, as Circular 3-77.

Reference: § 6.2-875 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0207
OBLIGATIONS SUBJECT TO THE LIMITS SPECIFIED

For legal lending limit purposes, § 6.2-875 of the Code of Virginia defines “obligations” as the direct liability of the maker or acceptor of paper discounted with or sold to a bank and the liability of an endorser, drawer or guarantor who obtains a loan from or discounts paper with or sells paper under his guarantee to a bank. With respect to endorsers, the effect of this section is to define the obligation of an endorser or guarantor subject to the bank’s lending limit as those instances in which the endorser or guarantor obtains as loan from, discounts paper with or sells paper under his guarantee to the bank. Stated differently, the bank’s lending limit applies to the obligation of an endorser or guarantor only when the endorser or guarantor obtains the proceeds of a loan, directly or indirectly. The statute provides further that the obligations of a corporation must be combined with the obligations of subsidiaries in which it owns or controls a majority interest.

The foregoing incorporates amendments to § 6.1-61 (recodified as § 6.2-875) of the Code of Virginia made by the 1978 Session of the legislature. Of particular interest is the definition of obligations of endorsers or guarantors, for purposes of the bank’s lending limit. Please be guided accordingly.

Revised and reissued June 1, 2011. Originally issued by the Commissioner of Financial Institutions November 1, 1978, as Circular 2-78.

Reference: § 6.2-875 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0208
EXCEPTIONS TO LENDING LIMITS FOR STATE-CHARTERED BANKS

Obligations as endorser or guarantor of installment consumer paper are not subject to lending limits, provided all conditions and requirements of § 6.2-875 D 20 of the Code of Virginia are met. For purposes of this Section, an unconditional repurchase agreement is considered to create a liability of the seller or discountor of installment consumer paper to the same degree as an endorsement without recourse or guarantee. A condition reasonably within the power of the bank to perform, such as repossession of a consumer product covered by a defaulted obligation, will not be considered to make conditional an otherwise unconditional agreement.

Certification pursuant to the foregoing section is necessary in all cases of paper purchased under endorsement, guarantee or repurchase agreement, if the obligation of the seller of the paper is to be excepted from the lending limit.

Section 6.2-875 D 2 can be applied only to obligations arising out of the discount of commercial or business paper. Installment consumer paper may not be sold or discounted without limit under the provisions of this exception.

Revised and reissued June 1, 2011. Originally issued by the Commissioner of Financial Institutions December 16, 1977, as Circular 2-77.

Reference: § 6.2-875 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0209
RIGHT OF OFFSET BY HOLDERS OF SUBORDINATED BANK DEBT

A ruling by a United States District Court has allowed the holder of a subordinated note, issued by a bank which subsequently had failed, to offset against that note funds of the closed bank which the lending bank was holding in a correspondent account.

In the specific instance cited, the subordinated capital note contained the usual subordination language and stated that payments on the note were subject to the provisions of Section 18(i) of the FDI Act. However, the note agreement also contained a clause stating: "Nothing in this agreement shall be deemed any wavier or prohibition of Bank's right of Banker's lien or offset." This clause was deemed to supersede the subordination provisions and allow the lending bank to offset, or apply, the deposit funds held against the outstanding note of the failed bank.

It is the Bureau's position that subordinated debt instruments which contain language permitting the holder to offset funds on deposit against the obligation do not qualify as capital for purposes of § 6.2-875 of the Code of Virginia and, further, may result in violation of § 6.2-890 of the Code of Virginia.

If a subordinated debt instrument is held by a bank which does not hold a deposit account against which the obligation could be offset, care should be taken in establishing subsequent deposit relationship.

The Bureau's examiners have been instructed to cite the existence of subordinated debt with this characteristic held in conjunction with deposit accounts of the issuing bank as violations of law.

Revised and reissued June 1, 2011. Originally issued by the Commissioner of Financial Institutions November 9, 1981, as Circular 3-81.

Reference: §§ 6.2-875 and 6.2-890 of the Code of Virginia

ADMINISTRATIVE LETTER
BFI-AL-0210
LOANS SECURED BY REAL ESTATE

1. Amount of Loan Requiring Appraisal

When a bank makes a loan secured by real estate within the meaning of § 6.2-878 of the Code of Virginia ("Code"), the bank is required by law to have a written appraisal if the amount of the loan is equal to or exceeds the amount to be established by the Commissioner of Financial Institutions ("Commissioner") as provided in subsection C of § 6.2-878 of the Code.

Therefore, pursuant subsection C of § 6.2-878 of the Code, and having considered appraisal requirements imposed on state banks under applicable federal regulations, the Commissioner hereby establishes this real estate loan amount:

- $400,000 –Loans secured by real estate for this amount and more are required to be supported by an appraisal.[1]

2. Date of Appraisal

While Chapter 8 of Title 6.2 of the Code sets no requirement for the date of an appraisal in relation to the date of making the loan secured by real estate, it is reasonable to expect that an appraisal be current and that it support the value of the real estate security upon which the bank relies in making the loan. Therefore, while no arbitrary time limit is set, an appraisal in support of loan secured by real estate should be made within a reasonable time prior to the date of the loan, and the appraisal should be related specifically to the loan rather than to another transaction.

3. Interests Excluded from the Term "Real Estate"

For purposes of the requirement of an appraisal in connection with loan secured by real estate, the Bureau of Financial Institutions will not construe the term "real estate" to include mineral rights, timber rights, or growing crops.

4. Appraisal According to Industry Standards

Chapter 8 of Title 6.2 of the Code requires, among other things, that real estate appraisals be in writing and that they be done by experienced persons competent to

[1] Sections 6.2-878, 6.2-879, and 6.2-880 of the Code set forth a series of instances where appraisals may or may not be required in support of various loans and categories of loans that are secured by real estate.

BFI-AL-0210

appraise real estate in the place where it is located, Chapter 8 of Title 6.2 of the Code does not prescribe a standard or establish an approved class of appraisers. Therefore, it appears there will be no conflict between this Administrative Letter and the appraisal standards of various industries.

Revised and reissued March 21, 1994, August 8, 2005, June 1, 2011, and May 4, 2021.

Reference: §§ 6.2-878, 6.2-879, and 6.2-880 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0212
OUTSIDE AUDITOR ACCESS TO VIRGINIA
EXAMINATION REPORTS

COPIES OF EXAMINATION REPORTS

Sections 6.2-904 and 6.2-1195 of the Code of Virginia provide, in pertinent part, that Boards of Directors of banks and savings institutions may, by resolution, permit reports of examination made by the Bureau of Financial Institutions to be inspected in the institution by such persons as are specified in the resolution. (Emphasis added). In addition, Section 931 of FIRREA requires an insured depository institution to furnish copies of examination reports to its outside auditors. Although the provision in Virginia law for such inspections might be construed as more restrictive, no actual conflict exists, since FIRREA does not require that outside auditors be permitted to remove copies of examination reports from the institutions' premises. Confining review of Bureau examination reports to the premises of the institution is not likely to obstruct or impair the completion of an audit.

EXIT INTERVIEWS AND MEETINGS

The federal bank and thrift regulatory agencies issued a policy statement on July 23, 1992, providing guidelines to depository institutions for furnishing information to external auditors and for meetings between external auditors and examiners. While the Bureau is not bound by these guidelines, their application to banks and savings institutions under examination must be recognized and examiners should respect arrangements made for the attendance of outside auditors at meetings where the results of an examination by a federal agency are to be discussed. However, in the case of independent examinations by the Bureau, attendance by outside auditors at exit interviews or meetings with management may be restricted if the examiner concludes that communication might be impaired by the presence of auditors or other persons.

The absolute necessity for preserving the confidentiality of information in examination reports is strongly emphasized. It may be useful to remind outside auditors that the unauthorized disclosure of confidential supervisory information may be grounds for civil and criminal charges under both State and federal law.

Revised and reissued August 20, 1992, September 30, 2002, and June 1, 2011. Originally issued by the Commissioner of Financial Institutions December 19, 1990.

This Administrative Ruling was previously identified as BFI-AL-0212.1.

Reference: §§ 6.2-904 and 6.2-1195 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0214
RESPONSIBILITY OF DIRECTORS
FOR LEGAL LENDING LIMIT VIOLATIONS

Section 6.2-875 H provides:

> All loans made by a bank in excess of 15 percent of its capital and surplus shall be approved by the board of directors or the executive committee of the bank by resolution recorded in the bank's minute book.

Except in instances where a director records a negative vote on the approval of a loan creating a legal lending limit violation, the board, jointly and severally, may be held responsible for any loss the bank may suffer on any loan made to a borrower creating a violation of the bank’s legal lending limit.

In some instances, lending limits reduced by operating losses may cause existing loans, which were legal when made, to exceed the current limit. Such loans will be reviewed on a case-by-case basis during examinations. Directors of a new institution should anticipate a reduced legal lending limit based on projected initial losses.

Revised and reissued June 1, 2011. Originally issued by the Commissioner of Financial Institutions May 7, 1991.

Reference: § 6.2-875 H of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0215
BANK-OWNED LIFE INSURANCE

Pursuant to §§ 6.2-808, 6.2-814 A, 13.1-627 A 14, and 13.1-627 A 15 of the Code of Virginia, state-chartered banks are permitted to purchase bank-owned life insurance ("BOLI"). BOLI purchases must adhere to general principles of safety and soundness. A bank should complete a thorough analysis before purchasing material amounts of BOLI. The purchase of cash value life insurance is a long-term, illiquid, nonamortizing, and unsecured obligation of the insurance carrier. As such, it subjects the policyholder to credit, liquidity, and interest rate risks. Banks holding life insurance in a manner inconsistent with safe and sound banking practices may be subject to supervisory action.

Consistent with prudent risk management practices, a bank must limit its purchase of life insurance from any one issuer to 15 percent of its capital, surplus, and undivided profits less goodwill (do not include loan loss reserves or net unrealized FAS 115 gains or losses). Furthermore, the Bureau of Financial Institutions ("Bureau") will generally consider a concentration to exist when a bank's aggregate purchase exceeds 25 percent of its capital, surplus, and undivided profits. Banks should not automatically assume that a concentration level as high as 25 percent is always appropriate. The Bureau will consider exceptions to these purchase limitations on a case-by-case basis. Any exceptions to the applicable limitations require the prior written approval of the Bureau.

At a minimum, pre-purchase analysis should include consideration of the following: (1) determination of the need for insurance; (2) quantifying the amount of insurance needed; (3) vendor selection; (4) carrier selection; (5) review the characteristics of the available insurance products; (6) analyze the benefits of BOLI; (7) determine the reasonableness of compensation provided to the insured employee if the insurance results in additional compensation; (8) analyze the associated risks and the bank's ability to monitor and respond to those risks; (9) evaluate alternatives; and (10) document decision. The board may delegate decision-making authority related to purchases of life insurance to management; however, the board remains responsible for ensuring that such purchases are consistent with safe and sound banking practices. Bank management and the board of directors cannot rely solely on a third-party analysis of the benefits of BOLI such as the one that a vendor or carrier of the product may prepare. A review of third-party analyses should include a comparison of various products and purchase alternatives, be well-documented, and be approved by the board of directors prior to any BOLI purchase.

In addition to the foregoing, a bank must evaluate the financial condition of the insurance company before purchasing a life insurance policy. The bank should continue to monitor its condition while the policy is in force.

Purchases of life insurance policies entered into before the date of this ruling are provided a "safe harbor" if the following three conditions are met: (1) the policies are beneficial to the conduct of the bank's business; (2) the policies do not threaten the safety and soundness of the bank; and (3) the policies do not represent insider abuse or violate other laws, regulations, or rulings. If these conditions are met, no further action by the bank is needed. However, if any of the three conditions are not met, the Bureau may require corrective action at any time during the bank's ownership or while it has a beneficial interest in a policy. Such determinations will be made on a case-by-case basis.

Pursuant to § 38.2-302 A 3 of the Code of Virginia, any bank purchasing BOLI must provide the insured employee(s) with notice in writing that such insurance has been purchased, the amount of such coverage, and to whom benefits are payable in the event of the employee's death.

For additional detail and guidance on BOLI, you may generally refer to the interagency Statement on the Purchase and Risk Management of Life Insurance, which is available at http://www.federalreserve.gov/boarddocs/SRLETTERS/2004/SR0419a1.pdf. Notwithstanding the Interagency Statement's discussion of risk-based capital, given the Bureau's long-standing reliance on equity, the differences in risk weighting for general vs. separate account BOLI are not relevant to this Administrative Letter.

Revised and reissued April 1, 2004 and June 1, 2011. Originally issued by the Commissioner of Financial Institutions date August 30, 2002.

Reference: §§ 6.2-808, 6.2-814 A, 13.1-627 A 14, 13.1-627 A 15, and 38.2-302 A 3 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0216
PAYMENT OF DIVIDENDS

Section 6.2-869 A of the Code of Virginia provides that "the board of directors of any bank may declare a dividend . . . of the net undivided profits of the bank, after providing for all expenses, losses, interest and taxes accrued, or due by such bank. Before any such dividend is declared, any deficit in capital funds originally paid in shall have been restored by earnings to their initial level, and no dividend shall be declared or paid by any bank which would impair the paid-in capital of the bank."

It is the Bureau of Financial Institutions' view that funding a dividend by increasing a deficit in undivided profits would violate § 6.2-869 A and be an unsafe and unsound banking practice. A bank should not fund any dividend until it has recovered its initial losses, accumulated a reasonable undivided profits account, and can reasonably fund the payment of a cash dividend or fund a stock dividend at market value.

Likewise, holding companies are expected to serve as a source of strength to their subsidiary banks. Creating a larger deficit in undivided profits is not consistent with the source of strength doctrine and will be viewed by the Bureau as detrimental to a bank's safety and soundness.

As noted in subsection C of § 6.2-869, the Commission may limit or approve the payment of dividends by a bank when the Commission determines that doing so is warranted by a bank's financial condition. It is the Bureau's view that only in extraordinary circumstances should a bank or holding company fund a dividend by increasing a deficit in undivided profits.

Issued by the Commissioner of Financial Institutions March 27, 2012.

Reference: §§ 6.2-869 and 6.2-708 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0301
INVESTMENT IN CAPITAL STOCK OF USL SAVINGS INSTITUTIONS INSURANCE GROUP, LTD.

USL Savings Institutions Insurance Group, Ltd., (the "Company") was formed for the primary purpose of owning and operating Savings Institutions Insurance Company (the "Subsidiary"), which expects to be licensed to operate as an insurance company under the provisions of the laws of Illinois and to begin operations by March 1, 1987. The Subsidiary proposes to provide reinsurance for certain directors and officers liability and blanket bond risks for institutions which hold shares in the Company. It is understood that the Subsidiary intends to enter into contractual arrangements with Virginia Surety Company, Inc., ("Virginia Surety"), pursuant to which the Subsidiary will reinsure portions of risks under directors and officers liability and blanket bond insurance policies issued by Virginia Surety.

Shares of common stock in the Company are offered to certain savings institutions which will thereupon become eligible to apply for the insurance coverage to be offered. The Bureau of Financial Institutions has been asked whether shares of stock issued by the Company may be purchased by Virginia savings institutions.

Section 6.2-1186 A 22 of the Code of Virginia authorizes state associations to invest in obligations, instruments or investments which are specifically approved by the Commissioner of Financial Institutions. Section 6.2-1110 of the Code of Virginia grants savings institutions the power to "...become a member of, deal with, maintain reserves or deposits with, or make reasonable payments...to any organization...to the extent that such organization...assists in furthering or facilitating the institution's purposes, powers, services or community responsibilities...".

There is ample evidence that directors and officers liability and blanket bond insurance coverage has become difficult and expensive for savings institutions to obtain. The program to be offered by the Company and its Subsidiary appears to be directed toward making such insurance coverage more readily available. It is clear that the absence of reasonably adequate insurance coverage has a potentially detrimental effect upon a savings institution's purposes and operation and its ability to provide services and meet its community responsibilities. The insurance program in question will tend to reduce the risks to which an institution might otherwise be exposed as a result of insufficient insurance coverage.

In view of these circumstances, shares of common stock in USL Savings Institutions Insurance Group, Ltd., are hereby approved for investment by Virginia savings institutions in accordance with the schedule of maximum investment requirements, based upon total asset size, incorporated in the January 7, 1987 Prospectus issued by the Company. This approval will

BFI-AL-0301

continue so long as the Company and its Subsidiary are engaged in the business of reinsuring directors and officers liability and blanket bond risks relating to savings institutions.

Each Virginia savings institution which invests in these shares is required to inform the Bureau of Financial Institutions promptly, in writing, of the number of shares purchased, the price paid and, upon issuance, the kinds and amounts of insurance coverage obtained.

Revised and reissued June 1, 2011. Originally issued by the Commissioner of Financial Institutions February 12, 1987, as Circular 1-87.

Reference: §§ 6.2-1110 and 6.2-1186 A 22 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0303
INVESTMENT BY VIRGINIA SAVINGS INSTITUTIONS IN
SHARES OF OPEN-END MANAGEMENT INVESTMENT COMPANIES

Section 6.2-1186 A 21 of the Code of Virginia provides that the assets of a State Association may be invested in shares in open-end management investment companies. In consideration of the potential risk characteristics which such shares may exhibit, careful attention to reasonable standards in their acquisition is warranted. During examinations, investment company shares will be reviewed to determine whether the following conditions are met:

1. The investment portfolio of the investment company must consist solely and exclusively of instruments and obligations in which the Association could invest directly for its own portfolio.

2. Purchases of such shares are limited to the same extent that direct investment in any particular asset in the investment company's portfolio would be limited by applicable law or regulation.

3. The Association as shareholders must have a legally enforceable, undivided interest in the underlying assets of the investment company, which interest is proportionate to the association's ownership in the company.

4. The Association as shareholder must be shielded absolutely from direct or indirect liability for any act or obligation of the investment company.

5. The investment company must be registered with the Securities and Exchange Commission under the Investment Company Act of 1940 and the Securities Act of 1933.

6. Where the investment company engages in such activities as transactions in options, futures, puts or calls, etc., shares purchased by the Association must be treated as if the Association were engaging in such transactions directly and such transactions must be reported and accounted for accordingly.

7. The Association's board of directors must have established and formally approved an investment policy that specifically provides for investment in investment companies, and that requires specific prior approval by the board of each initial investment in the shares of any company. Thereafter, each additional investment in the shares of that investment company must be reported to the board and

reflected in official board minutes. It is the board's sole responsibility to determine, with the advice of counsel if necessary, whether the shares of any particular investment company meet all established criteria, legal and otherwise, before authorizing investment in those shares. The Bureau will not provide a prior determination of the eligibility of the shares of any specific company for investment.

8. Prior to any investment in investment companies, adequately detailed procedures, standards and controls for managing such investments must be established.

9. Not less frequently than quarterly, a detailed review of all holdings of investment companies' shares must be conducted by the board, and the board must further review the extent to which the board's policies and procedures are effective.

The board of directors of an association must specifically consider and make adequate provision for the effect of investment in investment company shares upon the association's present and future liquidity needs. The marketability of such shares and their acceptability as security for public deposits and for other purposes requires the full understanding and careful attention of the board. Careful attention to sales fees and accounting for such fees when shares are bought and sold is also necessary.

It is emphasized strongly that the decision to invest in shares of one or more investment companies is the absolute and sole responsibility of each association's board of directors. Considerations of safety and soundness of an institution must take precedence over perceived opportunities for income.

Failure to meet the foregoing conditions may result in classification of the investment in whole or in part, as substandard, doubtful or loss and may be deemed to be an unsafe and unsound practice.

Revised and reissued June 1, 2011. Originally issued by the Commissioner of Financial Institutions August 12, 1987, as Circular 2-87.

Reference: § 6.2-1186 A 21 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0401
INVESTMENT OF FUNDS
BY CREDIT UNIONS

Section 6.2-1376 of the Code of Virginia lists the investments that are authorized by law for credit unions chartered under Chapter 13 of Title 6.2 of the Code of Virginia.[1]

1. <u>INVESTMENT IN GOVERNMENT-ISSUED SECURITIES</u>

Subsections 6 and 7 of § 6.2-1376 authorize investment in certain government issued securities; i.e., (1) obligations of, and securities fully guaranteed by, the United States, and (2) obligations of Virginia and its political subdivisions.

The Bureau will treat this authority as equivalent to that given to Virginia state chartered banks. For a description, see subdivisions D 5 through D 18 of § 6.2-875 of the Code of Virginia

2. **<u>OTHER INVESTMENTS – REGISTERED INVESTMENT COMPANIES, COLLECTIVE INVESTMENT FUNDS, COMMON TRUST FUNDS, and CHARITABLE DONATION ACCOUNTS</u>**

In addition to the investments authorized by Subsections 1 through 7 and 9 through 12 of § 6.2-1376 of the Code of Virginia, credit unions may invest in a registered investment company, collective investment fund, or common trust fund (as defined below), provided the registered investment company, collective investment fund or common trust fund itself is restricted to investments and investment transactions that are permissible for state credit unions.[2]

A registered investment company is an investment company that is registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (15 U.S.C. 80a). Examples of registered investment companies are mutual funds and unit investment trusts.

A collective investment fund is a fund maintained by a national bank under 12 CFR, Part 9.18. A common trust fund is a fund maintained by a state bank under § 6.2-1009 of the Code of Virginia.

---

[1] This investment authority is apart from, and in addition to, the authority to make loans (as given in Article 9, §§ 6.2-1370 through 6.2-1375 of the Code of Virginia).

[2] Subsection 8 of § 6.2-1376 of the Code of Virginia authorizes investment in "such stock," securities, obligations, or other investments as may be approved from time to time by the [State Corporation] Commission;". The Commission has delegated to the Commissioner of Financial Institutions the authority to approve other investments for credit unions. See 10 VAC 5-10-10.

A credit union may also invest in a charitable donation account to the same extent, and subject to the same terms and conditions, as is authorized for federal credit unions under 12 C.F.R § 721.3(b)(2). A charitable donation account is a hybrid charitable and investment vehicle that generates funds to donate to tax-exempt charities chosen by a credit union. The account is primarily charitable in nature and facilitates charitable activities for credit unions by allowing them to hold investments that would otherwise be prohibited.

3. <u>GENERAL STATEMENT-INVESTMENT POLICIES AND PROCEDURES</u>

A credit union will be required to carry out the investing of credit union funds in accordance with policies and procedures approved by the board of directors of the credit union. Such policies and procedures – as well as the investments and transactions themselves – are subject to review on examination by the Bureau. Inadequate policies and procedures, transaction errors and improper investments may result in examiner criticism, an investment's being classified substandard, doubtful or loss, and in other supervisory action.

Revised and reissued by the Commissioner of Financial Institutions December 15, 1990, May 17, 1999, June 1, 2011, and February 22, 2017. Originally issued by the Commissioner of Financial Institutions January 4, 1988.

Reference: § 6.2-1376 of the Code of Virginia

STATE CORPORATION COMMISSION
Bureau of Financial Institutions

ADMINISTRATIVE LETTER BFI-AL-0402
THIRD PARTIES THAT PROVIDE DATA PROCESSING
SERVICES TO CREDIT UNIONS

Section 6.2-1309 of the Code of Virginia provides that examiners shall be given free access to all books, papers, securities, and other sources of information regarding a credit union. For the purpose of conducting an examination, the Commission may subpoena and examine personally witnesses under oath, whether or not such witnesses are members of the credit union, and may require the production of any documents, whether or not such documents are documents of the credit union.

It is the position of the Bureau that information technology is an integral part of credit union operations that presents significant risk factors potentially impacting the safety and soundness of these institutions. Some credit unions retain data processing operations in-house, which permits examiners to evaluate the sufficiency of controls through direct physical access to operations, premises, records, and information. Other credit unions outsource data processing services to third parties or utilize a hybrid technology solution, which results in these institutions having less direct control over operations and the protection of data. Accordingly, the effectiveness of information technology examinations for credit unions that use outsourced or hybrid solutions are currently impacted by a lack of examiner visibility directly into data processing servicers' operations, premises, records, and information.

In order for the Bureau to evaluate the operations of third parties that provide data processing services to credit unions, it is imperative that credit unions' data processing contracts expressly require third parties to give the Bureau's examiners direct access to their operations, premises, records, and information. It is the Bureau's view that having such access facilitates its supervisory responsibilities under Chapter 13 (§ 6.2-1300 *et seq.*) of Title 6.2 of the Code of Virginia.

It should be noted that the Bureau will generally coordinate its on-site visits through the credit unions who have outsourced their data processing services.

Issued by the Commissioner of Financial Institutions February 13, 2018.

ADMINISTRATIVE LETTER BFI-AL-0701
JUDGMENT RATE OF INTEREST

Section 6.2-302 of the Code of Virginia provides that the interest rate on an obligation upon which judgment has been obtained shall be an annual rate of six percent. A money judgment entered in an action arising from a contract shall carry interest at the rate lawfully charged on such contract, or at six percent annually, whichever is higher.

It is the position of the Bureau that interest may be charged only on the amount for which judgment is granted and that no other amount may be added, such as residual unearned interest, not included in the judgment. This prohibition applies to both direct loans and installment sales contracts purchased by licensees. Examiners will cite instances of duplication of interest charges on judgments as violations of law.

Originally issued by the Commissioner of Financial Institutions December 9, 1983. Revised and reissued September 30, 2002 and June 1, 2011.

Reference: § 6.2-302 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0702
CHARGES ON SUBORDINATE MORTGAGE LOANS
BY CERTAIN LENDERS

Section 6.2-327 of the Code of Virginia allows certain lenders making subordinate mortgage loans on which interest is charged on the basis of a simple annual rate to also charge a 5% "loan fee" (referred to as "points").

1. Such lenders may charge interest on a loan amount which includes points only if points charged are financed.

2. Points charged on such loans may not exceed 5% of the principal loan amount, which is an amount that does not itself include any points or fees.

3. Overcharges resulting from violation of this Ruling must be reimbursed to the borrower.

Issued by the Commissioner of Financial Institutions April 6, 1990, as Consumer Finance Circular 90-1 and revised and reissued January 20, 2004 and June 1, 2011.

Reference: § 6.2-327 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-0703
REBATE OF UNEARNED INSTALLMENT LOAN INTEREST BY BANKS
RULE OF 78

The following represents the Bureau's interpretation of § 6.2-403 of the Code of Virginia, as it relates to banks, and the effect of the term "scheduled payment date" in the last paragraph of that Section. This is an administrative interpretation only, made in response to questions, and may not be considered binding by a court of law.

1. (a) Section 6.2-423 of the Code of Virginia relates to rebates of unearned interest on installment loans secured by subordinate mortgages, but specifically exempts certain types of institutions, including banks, from its terms.

   (b) Section 6.2-401 of the Code of Virginia requires lenders to rebate unearned interest, calculated according to § 6.2-403 of the Code of Virginia, when payment of the balance of a <u>defaulted</u> installment loan is <u>accelerated</u>.

   (c) Section 6.2-403 of the Code of Virginia contains a formula for calculating rebates of unearned installment loan interest but does not say when it is to be used. I conclude, therefore, that banks are not required by law to use the definition in § 6.2-403, except upon acceleration of a defaulted debt.

2. Section 6.2-403 could govern the rights of parties under a bank's installment loan contract, if the contract recited the terms of the section or incorporated them by reference. Further, a court or other authority might find, based on evidence, that the parties intended to be bound by all terms of the section.

3. Whenever § 6.2-1409 of the Code of Virginia is applicable, the Bureau will interpret the term "scheduled payment dates" in the final paragraph as <u>monthly anniversary dates</u>, rather than literally. This is consistent with what is seen as mere legislative endorsement of the practice of "rounding off" any part of a month to a whole month, so as not to require calculation of odd days interest. The use of "anniversary dates" rather than literal "scheduled" payment dates is apparently now the prevalent practice among banks and will not be criticized by the Bureau so long as it is applied consistently by a bank, without resort to literal "scheduled" payment dates when doing so would result in a smaller rebate.

Revised and reissued by the Commissioner of Financial Institutions July 1, 1990 and June 1, 2011.. Original effective date: January 7, 1980, as Circular 1-80.

Reference: §§ 6.2-401, 6.2-403, 6.2-423, and 6.2-1409 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-1603
COMPENSATING, OR OFFERING TO COMPENSATE, UNLICENSED MORTGAGE BROKERS

Section 6.2-1600 of the Code of Virginia defines a "mortgage broker" as "…any person who directly or indirectly negotiates, places or finds mortgage loans for others, or offers to negotiate, place or find mortgage loans for others." Section 6.2-1601 of the Code of Virginia prohibits engaging in business without a license, and § 6.2-1625 of the Code of Virginia declares that any person not exempt from licensing who acts a mortgage broker without having obtained a license is guilty of a Class 6 felony.

It is the position of the Bureau of Financial Institutions that any "person" who, for compensation, refers individuals who are seeking a "mortgage loan" (as the terms "person" and "mortgage loan" are defined in Chapter 16) to a lender or lenders is engaged in business as mortgage broker, and must be licensed unless exempt under § 6.2-1602 of the Code of Virginia. The identity of the person compensating the mortgage broker, and the form of compensation, do not affect the licensing requirement. When the Bureau has evidence that an unlicensed person is acting as a mortgage broker, appropriate action will be taken.

As the Bureau understands the criminal laws of Virginia, a person who is an accessory to the commission of a felony, or who solicits the commission of a felony, is subject to criminal liability. Lenders compensating, or offering to compensate, unlicensed mortgage brokers may, in certain circumstances, face criminal prosecution. When the Bureau has evidence that a lender has engaged in such activity, appropriate action will be taken.

The Bureau will provide confirmation, upon inquiry, of the current licensed or unlicensed status of any specific mortgage broker.

Revised and reissued June 1, 2011. Originally issued by the Commissioner of Financial Institutions July 3, 1990, as Mortgage Lender & Broker Circular 90-2.

Reference: § 6.2-1600 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-1605
COMPENSATION OF UNLICENSED MORTGAGE BROKERS

It has come to the Bureau's attention that some licensees under Chapter 16 of Title 6.2 are compensating unlicensed persons for mortgage loan brokering and/or referrals. The Bureau considers any person making any such referral, by whatever means, for compensation to be engaged in business as a mortgage broker. Such persons are required to be licensed as mortgage brokers unless they are (1) within a class of persons explicitly exempt from licensing under Chapter 16, or (2) a bona fide employee (pursuant to Internal Revenue Service guidelines) of the person compensating them.

The failure of a licensee to withhold taxes from compensation paid to such persons demonstrates that such persons are not bona fide employees of the licensee, but are independent contractors. No explicit statutory exemption has been found applicable to such persons. Therefore, licensees compensating unlicensed mortgage brokers in this fashion are cautioned that they are subject to (1) license revocation, (2) criminal referral to local prosecuting authorities, and (3) reporting of such practices to taxing authorities.

Revised and reissued September 30, 2002 and June 1, 2011. Issued by the Commissioner of Financial Institutions August 26, 1991,

Reference: § 6.2-1625 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-1606
CHARGING "ASSIGNMENT FEES" TO BORROWERS

Section 6.2-326 A of the Code of Virginia provides in relevant part that a lender may require a borrower to pay ". . . the reasonable and necessary charges in connection with making . . ." certain real estate-secured loans, notably first mortgage loans. (Emphasis added.) Such charges may include specifically the cost of title examination, title insurance, recording and filing fees, taxes, insurance, appraisals, credit reports, surveys, drawing of papers and closing the loan.

An "assignment fee", i.e., a fee charged a borrower by a lender to cover the cost of recording an assignment of a note and deed of trust to a purchaser of the loan, is not a charge incurred "in connection with making" the loan. Such fees are not incident to the relationship between lender and borrower, but rather arise out of the subsequent transfer of a loan from the lender to a third-party purchaser. It is concluded, accordingly, that such fees may not lawfully be charged, whether or not borrowers agree to pay them.

The charging of such an assignment fee, however denominated, will be cited as a violation of law during examinations of licensees under Chapter 16 of Title 6.2. Overcharges resulting from violations of this Letter should be reimbursed to the borrower. Violations of this law may be grounds for license revocation under § 6.2-1619 of the Code of Virginia, and may also be referred to the Attorney General pursuant to § 6.2-1626 of the Code of Virginia.

Revised and reissued September 30, 2002 and June 1, 2011. Originally issued by the Commissioner of Financial Institutions July 2, 1993. This ruling confirms a position taken in a memorandum to licensees from Assistant Commissioner E. J. Face, Jr., dated January 11, 1993, which is the effective date of the ruling.

Reference: § 6.2-326 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-1607
FEES CHARGED BY MORTGAGE BROKERS

In some instances, mortgage broker licensees have stated their fees, in agreements signed by borrowers, in language such as “not to exceed” followed by some dollar amount or percentage of the loan amount. Such language lacks the specificity contemplated by § 6.2-1616 B 4 of the Code of Virginia.

Mortgage broker licensees are cautioned that fees are to be stated as a specified dollar amount or a specified percentage of the loan amount, in agreements signed by borrowers. Failure to do so shall be treated as a violation of the cited statute.

Revised and reissued June 1, 2011. Originally issued by the Commissioner of Financial Institutions December 1, 1995.

Reference: § 6.2-1616 B 4 of the Code of Virginia

ADMINISTRATIVE LETTER BFI-AL-1610
PREPAYMENT PENALTIES IN ALTERNATIVE MORTGAGE TRANSACTIONS

Prior to December 18, 2003, the Bureau was subject to an injunction entered by the United States District Court for the Eastern District of Virginia, Richmond Division. That injunction barred the Bureau from enforcing Virginia law limits on prepayment penalties in "alternative mortgage transactions" (AMTs) entered into by non-depository housing creditors. On December 18, 2003, the parties to the case in which the injunction was issued appeared before the Court to be heard on certain motions.

After argument the Court ruled that the Bureau was not barred from enforcing Virginia law prepayment penalty limits with respect to AMTs entered into on or after July 1, 2003, the effective date of revised regulations of the Office of Thrift Supervision. Therefore, the Bureau will resume enforcement of those laws in connection with AMTs closed on or after July 1, 2003 by mortgage lenders licensed under Chapter 16 of Title 6.2.

Revised and reissued June 1, 2011. Originally issued by the Commissioner of Financial Institutions on February 18, 2004

Reference: §§ 6.2-422 and 6.2-423 of the Code of Virginia

STATE CORPORATION COMMISSION
Bureau of Financial Institutions

ADMINISTRATIVE LETTER BFI-AL-1611
NONTRADITIONAL MORTGAGE PRODUCTS

Residential mortgage lending has traditionally been a conservatively managed business with low delinquencies and losses and reasonably stable underwriting standards. In the past few years consumer demand has been growing, particularly in high priced real estate markets, for closed-end residential mortgage loan products that allow borrowers to defer repayment of principal and sometimes interest. These mortgage products, herein referred to as nontraditional mortgage loans, include such products as "interest-only" mortgages where a borrower pays no loan principal for the first few years of the loan and "payment option" adjustable-rate mortgages (ARMs) where a borrower has flexible payment options with the potential for negative amortization. The focus of this letter is on the elements of certain nontraditional mortgage products, not the product type itself.

Given the expansion of the nontraditional mortgage market and the highly publicized difficulties recently experienced in the "subprime" mortgage industry, the Bureau of Financial Institutions is publishing this Administrative Letter summarizing the Bureau's concerns and stating preferred practices to be followed in the nontraditional mortgage market.

If offering nontraditional mortgage loan products, licensees should ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product choice.

While nontraditional mortgage loans provide flexibility for consumers, the Bureau of Financial Institutions is concerned that consumers may enter into these transactions without fully understanding the product terms. Nontraditional mortgage products have been advertised and promoted based on their affordability in the near term; that is, their lower initial monthly payments compared with traditional types of mortgages. In addition to apprising consumers of the benefits of nontraditional mortgage products, licensees should take appropriate steps to alert consumers to the risks of these products, including the likelihood of increased future payment obligations. This information should be provided in a timely manner—before disclosures may be required under the Truth in Lending Act or other laws—to assist the consumer in the product selection process.

More than traditional ARMs, mortgage products such as payment option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization that may not be fully understood by consumers. For example, consumer payment obligations may increase substantially at the end of an interest-only period or upon the "recast" of a payment option ARM. The magnitude of these payment increases may be affected by factors such as the expiration of promotional interest rates, increases in the interest rate index, and negative amortization. Negative amortization also results in lower levels of home equity as compared to a traditional amortizing mortgage product. When borrowers go to sell or refinance the property, they may find that negative amortization has substantially reduced or eliminated their equity in it even when the property has appreciated. The concern that consumers may not fully understand these products would be exacerbated by marketing and promotional practices that emphasize potential benefits without also providing clear and balanced information about material risks.

In light of these considerations, communications with consumers, including advertisements, oral statements, promotional materials, and monthly statements should provide clear and balanced information about the relative benefits and risks of these products, including the risk of payment shock and the risk of negative amortization. Clear, balanced, and timely communication to consumers of the risks of these products will provide consumers with useful information at crucial decision-making points, such as when they are shopping for loans or deciding which monthly payment amount to make. Such communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the licensee.

Licensees offering nontraditional mortgage products must ensure that they do so in a manner that complies with all applicable laws and regulations. With respect to the disclosures and other information provided to consumers, applicable laws and regulations include the following:

- Truth in Lending Act (TILA) and its implementing regulation, Regulation Z.
- Section 5 of the Federal Trade Commission Act (FTC Act).

TILA and Regulation Z contain rules governing disclosures licensees must provide for closed-end mortgages in advertisements, with an application, before loan consummation, and when interest rates change. Section 5 of the FTC Act prohibits unfair or deceptive acts or practices. Other federal laws, including the fair lending laws and the Real Estate Settlement Procedures Act (RESPA), also apply to these transactions.

Recommended practices for addressing issues raised by nontraditional mortgage products include the following:

Communications with Consumers—When promoting or describing nontraditional mortgage products, licensees should give consumers information that is designed to help them make informed decisions when selecting and using these products. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers. Thus, licensees should give consumers information at a time that will help consumers select products and choose among payment options. For example, licensees should offer clear and balanced product descriptions when a consumer is shopping for a mortgage—such as when the consumer makes an inquiry to the licensee about a mortgage product and receives information about nontraditional products, or when marketing relating to nontraditional mortgage products is given by the licensee to the consumer—not just upon the submission of an application or at consummation. The provision of such information would serve as an important supplement to the disclosures currently required under TILA and Regulation Z or other laws.

- *Promotional Materials and Product Descriptions*
  Promotional Materials and other product descriptions should provide information about the costs, terms, features, and risks of nontraditional mortgages that can assist consumers in their product selection decisions, including information about the matters discussed below.

  - *Payment Shock*. Licensees should apprise consumers of potential increases in payment obligations for these products, including circumstances in which interest rates or negative amortization reach a contractual limit. For example, product descriptions could state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example once amortizing payments are required and the interest rate and negative amortization caps have been reached. Such information also could describe when structural payment changes will occur (e.g., when introductory rates expire, or when amortizing payments are required), and what the new payment amount would be or how it would be calculated. As applicable, these descriptions could indicate that a higher payment may be required at other points in time due to factors such as negative amortization or increases in the interest rate index.

  - *Negative Amortization*. When negative amortization is possible under the terms of a nontraditional mortgage product, consumers should be apprised of the potential for increasing principal balances and decreasing home equity, as well as other potential adverse consequences of negative amortization. For example, product descriptions should disclose the effect of negative amortization on loan balances and home equity, and could describe the potential consequences to the consumer of making minimum payments that cause the loan to negatively amortize. (One possible consequence is that it could be more difficult to refinance the loan or to obtain cash upon a sale of the home.)

  - *Prepayment Penalties*. If the lender may impose a penalty in the event that the consumer prepays the loan, consumers should be alerted to this fact and to the need to ask the lender about the timing and amount of any such penalty.

  - *Cost of Reduced Documentation Loans*. If a licensee offers both reduced and full documentation loan programs and there is a pricing premium attached to the reduced documentation program, consumers should be alerted to this fact.

- *Practices to Avoid*
  Licensees also should avoid practices that obscure significant risks to the consumer. For example, if a licensee advertises or promotes a nontraditional mortgage by emphasizing the comparatively lower initial payments permitted for these loans, the licensee also should give clear and comparably prominent information alerting the consumer to the risks. Such information should explain, as relevant, that these payment amounts will increase, that a balloon payment may be due, and that the loan balance will not decrease and may even increase due to the deferral of interest and/or principal payments. Similarly, licensees should avoid promoting payment patterns that are structurally unlikely to occur. Such practices could raise legal and other risks for licensees.

  Licensees also should avoid practices such as giving consumers unwarranted assurances or predictions about the future direction of interest rates (and, consequently, the borrower's future obligations); making one-sided representations about the cash savings or expanded buying power to be realized from nontraditional mortgage products in comparison with amortizing mortgages; suggesting that initial minimum payments in a payment option ARM will cover accrued interest (or principal and interest) charges; and making misleading claims that interest rates or payment obligations for these products are "fixed."

Revised and reissued June 1, 2011. Originally issued by the Commissioner of Financial Institutions on March 29, 2007.

ADMINISTRATIVE LETTER BFI-AL-1802
THREATENING CRIMINAL PROCEEDINGS

Section 6.2-1816 (9) of the Code of Virginia provides that "a licensee shall not threaten, or cause to be instigated, criminal proceedings against a borrower if a check given as security for a loan is dishonored."

Based on this statute, a licensee is prohibited from informing or otherwise suggesting to a borrower that criminal action may or will be taken or pursued in the event that the borrower does not repay his loan and the check given as security for the loan is dishonored. Licensees are cautioned that terms and phrases such as "prosecute" and "press charges" are normally associated with criminal proceedings. Therefore, the Bureau of Financial Institutions considers the use of these or similar terms and phrases by a licensee (or an employee of a licensee) in connection with making or trying to collect a payday loan to be a violation of § 6.2-1816 (9). Additionally, words such as "jail" and "arrested," as well as statements indicating that law enforcement authorities may be contacted if a borrower does not repay his loan, also violate Chapter 18 of Title 6.2.

Revised and reissued June 1, 2011. Originally issued by the Commissioner of Financial Institutions October 26, 2007.

Reference: § 6.2-1816 of the Code of Virginia