This new Federal Reserve publication provides high-level summaries of issues for senior executives in banking organizations and serves to complement other aspects of the Federal Reserve’s robust outreach program for its supervised institutions, including Consumer Compliance Outlook, a Federal Reserve System publication focused on consumer compliance issues, and its companion webinar series, Outlook Live.

The Federal Reserve Board’s Division of Consumer and Community Affairs publishes the Consumer Compliance Supervision Bulletin to enhance transparency regarding the Federal Reserve’s consumer compliance supervisory activities by

- sharing information about our examiners’ observations and other noteworthy developments related to consumer protection, and
- providing practical steps that institutions may consider when addressing certain consumer compliance risks.

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1 The Consumer Compliance Outlook is available at www.consumercomplianceoutlook.org/. The Outlook Live webinar series is available at www.consumercomplianceoutlook.org/outlook-live/.
This issue of the *Consumer Compliance Supervision Bulletin* discusses Federal Reserve supervisory observations regarding fair lending in the areas of redlining, pricing, and underwriting. It also discusses certain unfair or deceptive acts or practices (UDAP) that examiners have observed involving student financial products and services, overdraft practices, and loan officer misrepresentations.

Fair lending and UDAP are two of the most significant areas of risk for institutions. Violations in these areas may cause significant consumer harm as well as legal, financial, and reputational risk to the institution. While the vast majority of institutions supervised by the Federal Reserve comply with the fair lending and UDAP laws, we are hopeful that this resource will enhance the understanding of common fact patterns and emerging risks so that institutions can manage risk appropriately and efficiently.

The final section briefly notes certain regulatory and policy developments—specifically the new Uniform Interagency Consumer Compliance Rating System and changes to the implementing regulations for the Military Lending Act—and provides links to more in-depth resources.

**Fair Lending**

**Redlining**

**Background and Observations**

“Redlining” is a form of illegal discrimination in which an institution provides unequal access to credit based on the race, color, or national origin of a neighborhood.2 The typical redlining case involves a bank that treats minority neighborhoods less favorably than non-minority ones. The term redlining stems from the maps that were at one time created by the federal government as part of its earliest loan insurance and resolution programs.3

In the wake of the Great Depression, the federal government created new institutions, such as the Home Owners’ Loan Corporation (HOLC), to stabilize housing markets. As part of that effort, the HOLC created maps for over 200 cities to grade the riskiness of lending to neighborhoods. Neighborhoods were classified based on information about housing age, occupancy, prices, and other risk-based characteristics.

Non-housing characteristics such as the racial and ethnic makeup of the mapped neighborhoods were used as well. The HOLC drew a red line around some minority neighborhoods,

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colored the area in red, and designated the areas as “hazardous” places to underwrite mortgages. These classifications were later adopted by the Federal Housing Administration and the Veterans Administration.

To address concerns about fair access to credit, Congress passed the Fair Housing Act in 1968 and the Equal Credit Opportunity Act in 1974. Since 2010, the Federal Reserve has referred six redlining matters to the U.S. Department of Justice (DOJ). The DOJ, the U.S. Department of Housing and Urban Development (HUD), and the Consumer Financial Protection Bureau (CFPB) have brought several public enforcement actions for redlining. In 2011, the DOJ settled two redlining cases based on referrals from the Federal Reserve.4

The Federal Reserve recognizes that most banks want to serve all consumers and few would intentionally choose to avoid minority areas. Nonetheless, some banks treat minority neighborhoods less favorably.

For example, redlining risk may increase because of a failure to market products or locate branches in the minority areas in the bank’s market, or because of changes in the bank’s business model, such as through mergers, acquisitions, or new lending patterns. The Federal Reserve conducts a risk-focused review of potential redlining risk, consistent with the 2009 Interagency Fair Lending Examination Procedures.5

Below are the key risk factors considered by the Federal Reserve in the redlining review as well as some practical steps controls for mitigating risk.

- **Community Reinvestment Act (CRA) assessment area.** Federal Reserve examiners review whether the bank’s assessment areas appear to inappropriately exclude majority minority census tracts.

- **Lending record.** Federal Reserve examiners review whether the bank’s record of Home Mortgage Disclosure Act (HMDA) mortgage lending and/or CRA small business lending shows statistically significant disparities in majority minority census tracts when compared with similar lenders.

- **Branching strategy.** Federal Reserve examiners review whether the bank’s strategy for branch or loan production office locations appears to exclude majority minority census tracts.

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Marketing and outreach strategy. Federal Reserve examiners review whether the bank’s marketing and outreach strategy appears to treat majority minority census tracts less favorably.

Complaints. Federal Reserve examiners review whether any complaints by consumers or consumer advocates raise concerns that the bank treats certain geographies differently on a prohibited basis.

Managing Risks

Some banks have asked how to manage redlining risk. While banks can manage risks by reviewing lending patterns and analyzing disparities in applications and originations as potential indicators of redlining risk, the Federal Reserve believes it is equally important for banks to focus on their business model. Banks can effectively manage risks by having policies and procedures to

- regularly review their assessment areas and credit market areas, particularly if there is a change in the business model, such as through a merger or acquisition;
- evaluate fair lending risk in connection with opening, acquiring, or closing branches or loan production offices;
- evaluate fair lending risk in marketing and outreach activities, including monitoring whether the marketing and outreach activities are reaching the whole of the assessment area or credit market area; and
- monitor complaints from various sources, look for trends that may indicate redlining risk, and take appropriate action.

Banks also can manage risks by documenting the reasons for their business decisions. For more information regarding the Federal Reserve’s redlining reviews and suggestions for managing risk, including statistical analysis, see the “2009 Interagency Fair Lending Examination Procedures” and the “2016 Interagency Fair Lending Hot Topics: Redlining Risk” webinar on Outlook Live.6

Mortgage Target Pricing

Background and Observations

It has long been recognized that discretion along with financial incentives to charge higher interest rates or fees can significantly increase fair lending risk.7 Prior to the changes to Reg-
ulation Z (Truth in Lending) in 2011, the prudential financial regulators had several mortgage pricing referrals, some of which resulted in DOJ public enforcement actions involving large amounts of restitution. These actions underscore the fair lending risks in discretion and financial incentives.

For example, the DOJ brought three enforcement actions based on mortgage pricing discrimination referrals from the Federal Reserve. In these cases, the institutions provided loan originators with the discretion to increase the note rates or fees and also provided the loan originators with financial incentives to exercise the discretion to charge higher prices. This arrangement resulted in higher prices for minority borrowers, even after taking into account legitimate factors.

Since April 2011, Regulation Z’s mortgage loan originator compensation rule has decreased the risk of financial incentives in mortgage loan pricing. The rule prohibits a bank from providing financial incentives to a mortgage loan originator based on the terms or conditions of the loan, including the price. Although this prohibition reduced the fair lending risk of financial incentives at the mortgage loan originator level, the fair lending risk for mortgage pricing was not eliminated.

For example, some banks that originate mortgage loans for the secondary market now set a “target price” for each mortgage loan originator. This means that the bank sets a specific profit margin target for the mortgage loan originator. This target price can be achieved with any combination of a higher interest rate and/or discretionary fees charged to the borrower. These target prices are based solely on discretion and not on the risk-related credit characteristics of the borrower. This arrangement may comply with Regulation Z as long as the bank does not vary the loan originator’s compensation based on different prices for borrowers. That is, the bank still complies with Regulation Z if it sets one compensation arrangement with one target price for each loan originator.

Fair lending risks can arise, however, if the institution has several mortgage loan originators with different target prices, and the mortgage loan originators with the higher target prices tend to serve minority areas. The Federal Reserve has had two referrals to the DOJ on this issue, and the DOJ has had one public enforcement action on this issue, based on a Federal Depository Insurance Corporation (FDIC) referral.

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Managing Risks
Banks that set target prices for mortgage loan originators can manage risks by
- checking for compliance with Regulation Z with respect to financial incentives;
- implementing policies and procedures to control the risk that discretion could lead to a fair lending violation;
- evaluating and managing the risk when the mortgage loan originators with the higher target prices tend to serve minority neighborhoods;
- monitoring pricing by race/ethnicity across mortgage loan originators, including the APR, interest rate, fees, and overages, using statistical analysis if there is sufficient volume; and
- considering mapping loans by target price.

For more information regarding the Federal Reserve’s mortgage pricing reviews, see the 2009 Interagency Fair Lending Examination Procedures and the 2013 and 2014 Interagency Fair Lending webinars on Outlook Live.\(^\text{10}\)

Small Dollar Loan Pricing

Background and Observations
Many community banks offer unsecured, small-dollar loans that serve a critical need for consumers. These loans reflect the bank’s commitment to serving the credit needs of the community and are not typically a significant source of revenue. The loans are often for relatively small amounts, such as a few hundred or thousand dollars. The terms are typically 12 to 24 months, and the interest rates are generally 12 to 18 percent per year.

The Federal Reserve recognizes that these loans may serve important credit needs in a responsible manner. Nevertheless, as noted below, some fair lending issues stem from a lack of clear pricing criteria. Fair lending risk can be readily addressed and should not dissuade banks from offering the product.

Some common issues observed by examiners include
- lack of rate sheets or other pricing guidelines,
- broad pricing discretion at the loan officer level,

- lack of clear documentation of reasons for pricing decisions (including exceptions), and
- lack of monitoring for potential pricing disparities.

In some cases, these issues have resulted in minority borrowers and/or women paying higher interest rates that cannot be explained by legitimate pricing factors. In the past few years, the Federal Reserve has made six referrals to the DOJ on this issue. In addition, the DOJ has had four public enforcement actions on this issue, based on FDIC referrals.\(^\text{11}\)

**Managing Risks**

Some banks have asked how to manage the fair lending risk for these loans and whether they need to use sophisticated statistical modeling. In fact, the Federal Reserve believes that banks can manage the fair lending risk through three fairly straightforward processes:

1. provide loan officers with rate sheets that clearly describe the bank’s objective criteria for pricing decisions,
2. ensure that loan officers document the reasons for any exceptions to the pricing criteria, and
3. monitor exceptions (frequency and amount) for potential disparities on a prohibited basis.\(^\text{12}\)

For more information regarding the Federal Reserve’s consumer loan pricing reviews, see the 2009 Interagency Fair Lending Examination Procedures and the 2013 Interagency Fair Lending webinar on *Outlook Live*.\(^\text{13}\)

**Disability Discrimination**

**Background and Observations**

Discrimination on the basis of disability has long been prohibited by the fair lending laws and regulations. The Fair Housing Act prohibits discrimination on the basis of “handicap,” and the Equal Credit Opportunity Act and Regulation B prohibit discrimination on the basis of the receipt of public assistance.


Some banks’ practices with respect to disability income have raised concerns about potential discrimination. While investors generally require that underwriting be based on long-term, stable income, some banks have imposed more onerous standards on loan applicants receiving disability income.

For example, some banks have required applicants receiving Social Security Disability Income to demonstrate income stability by submitting a doctor’s letter describing the nature of the disability and whether it is expected to continue for at least three years. However, Fannie Mae, Freddie Mac, and HUD’s Federal Housing Administration do not require a bank to request a doctor’s letter as evidence of stable income.\textsuperscript{14}

In the past few years, the DOJ and HUD have had several public enforcement actions on this issue. In 2016, the DOJ brought an enforcement action based on a disability discrimination referral from the Federal Reserve.\textsuperscript{15}

Managing Risks

Banks can manage this fair lending risk in a straightforward manner by reviewing their policies, procedures, and training to ensure that they are designed to address this risk and designed to ensure compliance with the Fair Housing Act, the Equal Credit Opportunity Act, and Regulation B.

Maternity Leave Discrimination

Background and Observations

Discrimination on the basis of sex and familial status has long been prohibited by the fair lending laws and regulations. The Fair Housing Act, the Equal Credit Opportunity Act, and Regulation B prohibit discrimination on the basis of sex, and the Fair Housing Act prohibits discrimination on the basis of familial status.\textsuperscript{16} However, some banks have treated women on maternity leave differently than other loan applicants in a way that violates these statutes.

Specifically, some banks have treated women on maternity leave as though they are unemployed for underwriting purposes. Numerous media articles have addressed this issue.\textsuperscript{17}


\textsuperscript{16} Under the Fair Housing Act, “familial status” means a parent or guardian living with children under the age of 18. See 42 USC section 3602(k).

While some banks may have mistakenly believed this treatment was required by Fannie Mae or Freddie Mac, this is not the case. Fannie Mae, Freddie Mac, and HUD have provided guidance on this issue.\textsuperscript{18} In the past few years, HUD has had several public enforcement actions on this issue,\textsuperscript{19} and the Federal Reserve has had one referral to the DOJ on this issue.

**Managing Risks**

Banks can manage this fair lending risk in a straightforward manner by reviewing their policies, procedures, and training to ensure that they are designed to address this risk and to ensure compliance with the Fair Housing Act, the Equal Credit Opportunity Act, and Regulation B (Equal Credit Opportunity).

**Unfair or Deceptive Acts or Practices**

**Student Financial Products and Services**

**Background and Observations**

The benefits of a college education are well-documented and supported by research, which finds that college graduates, on average, have higher earnings and lower rates of unemployment as compared to high school graduates.\textsuperscript{20} Because the costs for attending college have risen over time, many families seek financial aid to fund their education goals.\textsuperscript{21} Students and their families face challenges understanding information about the costs asociat-


ed with various financial aid options. Banks, sometimes through third parties, have entered into agreements with post-secondary schools to provide student deposit accounts, debit, and pre-paid card services as methods for disbursing financial aid refunds. These arrangements can fill an important need and help banks attract students as longer-term customers.

As with all products and services, banks need to comply with consumer protection laws, including section 5 of the Federal Trade Commission (FTC) Act, which prohibits UDAP. These laws extend to bank arrangements with third parties. Banks can manage risks by ensuring that terms and features of student deposit accounts and campus cards are clearly disclosed to consumers, enabling students and their families to select the products and services that are appropriate for them.

A 2014 Government Accountability Office (GAO) report detailed several concerns about student debit card and prepaid card services. In particular, the report found that student cards charged fees for certain pin-debit transactions that “mainstream debit cards typically do not charge.” The report also found instances where there was a limited availability of fee-free automated teller machines (ATMs) and further raised concerns that students were not provided objective information about banks’ arrangements with their schools when selecting products to access their financial aid funds.

The report set forth several possible measures to address these concerns, including publicizing the agreements between banks and schools and requiring the presentation of neutral information to students.

In the past few years, the Federal Reserve has addressed deceptive practices in this area through public enforcement actions. In an action brought by the Board in 2015, the Federal Reserve assessed a $2.25 million civil money penalty and issued a consent order requiring nearly $24 million in restitution to address deceptive practices that misled students who obtained financial aid disbursements from institutions of higher education through a nonbank

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22 As noted in a 2014 GAO report, schools with card agreements offer debit cards to students as a cashless way to access financial aid fund disbursements. “Federal student aid can be used to pay for tuition and fees, room and board, books, supplies, and other living expenses. The aid is generally paid directly to the school, which deducts its charges, such as tuition and fees. If a student’s total payments from all sources, including financial aid, exceed the school’s charges, the school pays the difference (also known as a credit balance or credit balance refund) to the student. The bulk of the funds paid to students may be federal student aid remaining after paying for tuition and fees, and the money is intended to help students pay for non-school items related to their education, such as living expenses and transportation costs.” U.S. GAO, “College Debit Cards: Actions Needed to Address ATM Access, Student Choice, and Transparency,” U.S. GAO, Report No. GAO-14-91 (Washington: GAO: February 2014), 4–5, www.gao.gov/assets/670/660919.pdf.


entity. In a related action brought in 2016, the Federal Reserve assessed a civil money penalty of $960,000 and issued a consent order to cease and desist against a state-member bank. The enforcement actions specifically addressed deceptive practices that misled students about the fees and other terms of a deposit account that was offered in connection with financial aid disbursement.

The marketing and enrollment process for this deposit account product included several practices that the Federal Reserve found to be deceptive, such as failing to inform students about how to get their financial aid refunds without having to open a deposit account; it also failed to inform students about unusual fees, features, and limitations associated with the deposit account before they selected the account as the method to receive their financial aid refunds.

The Federal Reserve continues to examine for unfair or deceptive acts or practices related to student financial products and services.

Banks may face an increased UDAP risk when working with a third party to provide bank-related products or services, such as the student deposit account discussed above. While these arrangements can be beneficial to banks and consumers, it is critical for banks to manage these risks and establish effective processes to oversee third-party service providers.

Managing Risks

Banks can manage the risks related to unfair or deceptive acts or practices involving third-party service providers by adopting the following practices:

- Prior to entering into an agreement with a third-party service provider, evaluate a service provider’s financial condition and experience in providing the proposed service.
- Monitor consumer complaint activity, even if the service provider is contractually responsible for complaint resolution.
- Ensure that personnel with oversight and management responsibilities for service providers are actively engaged in assessing and monitoring the outsourcing arrangement. For example, if a service provider has responsibility for consumer-facing communication, bank personnel can manage risks by reviewing any such communication prior to its dissemination to ensure that any fees, limitations, and other characteristics of the product are adequately disclosed.

Overdrafts
Background and Observations

An overdraft occurs when a consumer debits or withdraws more money than is in his or her deposit account. Banks generally charge consumers overdraft fees when they honor transactions that result in an overdraft, and the amount of such fees can be significant for consumers, especially those who incur frequent overdrafts. While overdraft programs may benefit some consumers, in certain circumstances these programs also may present elevated risks of UDAP violations.

In particular, certain bank practices related to charging overdraft fees to consumers have been identified as unfair or deceptive acts or practices in violation of section 5 of the FTC Act. UDAP violations and risks have been identified when a bank makes misleading omissions or representations concerning its overdraft program. In addition, unfair or deceptive practices have arisen in connection with the use of third-party vendor software to process overdraft transactions and assess overdraft fees.

For example, the Federal Reserve has cited an unfair or deceptive practice based on a certain overdraft processing methodology applied to point of sale (POS), signature-based transactions. In effect, the UDAP violation occurred when a bank imposed overdraft fees on POS transactions based on insufficient funds in the account’s available balance at the time of posting, even though the bank had previously authorized the transaction based on sufficient funds in the account’s available balance when the consumer entered into the transaction. There can be a delay of one to a few days between the authorizing and posting of a POS transaction, during which time the account’s available balance may have decreased and the POS transaction could exceed the account’s available balance at the time of posting. Charging an overdraft fee on the POS transaction in this circumstance was found to violate section 5 of the FTC Act.

The Federal Reserve has conducted outreach to educate banks about this practice. For more information on the practice described above, see the 2016 Interagency Overdraft Services Consumer Compliance webinar on Outlook Live.\textsuperscript{30}

The Federal Reserve has also provided information about general best practices related to overdraft programs. In 2005, the Federal Reserve, Office of the Comptroller of the Currency, National Credit Union Administration, and FDIC issued interagency supervisory guidance for overdraft protection programs that includes, among other information, the best practices for such programs.\textsuperscript{31}

**Managing Risks**

Banks can identify and manage their UDAP risks related to overdraft practices by taking the following steps:

- Exercise appropriate vendor management.
- Understand the bank’s overdraft processing methodology and ensure that the bank does not provide incorrect information to consumers about that methodology.
- Refrain from assessing unfair overdraft fees on POS transactions when they post to consumers’ accounts with insufficient available funds after having authorized those transactions based on sufficient available funds.
- Review applicable overdraft guidance and consider implementing best practices, such as setting limits on the overdraft fees charged to consumers and monitoring for excessive use of overdrafts by consumers.

**Loan Officer Misrepresentations**

**Background and Observations**

Many banks actively assist consumers in the loan origination process, a practice that benefits both the consumer and the bank. However, in some instances loan officers have made misrepresentations concerning a consumer’s eligibility for a certain loan program or qualification for a loan. These misrepresentations may violate section 5 of the FTC Act.

Misrepresentations are typically discovered through consumer complaints. For example, a loan officer of a state member bank misrepresented to co-applicants that they would qualify for a mortgage loan if they reduced their debt-to-income ratio by paying off certain credit card debts, when, in fact, they still did not qualify after paying off those debts.


Other loan officers have made misrepresentations that consumers would qualify for certain mortgage loan programs notwithstanding prior bankruptcies or short sales that subsequently prevented them from qualifying. Consumers have in some cases relied on loan officer misrepresentations to their detriment, and banks have been required to pay restitution as a result.

**Managing Risks**

Banks can continue to actively assist consumers and manage their risks related to unfair or deceptive acts or practices during loan origination by adopting the following practices:

- Monitor consumer complaints for potential loan officer misrepresentations.
- Refrain from representing to consumers that they do, or will, qualify for a loan while qualification remains uncertain. For example, if a consumer's approval is uncertain, loan officers can manage risks by avoiding language suggesting to a consumer that he or she will be approved for a loan, such as “you are the perfect candidate” and “qualifying you is not going to be a problem.”
- Clearly and accurately disclose the full set of requirements for loan qualification, including the documentation required by the institution for the applicant to qualify.
- Review and modify internal policies regarding completed applications, prequalifications, and preapprovals to reduce the risk of misrepresentations.
- Avoid mischaracterizing loan approval recommendations by the automated underwriting systems of government-sponsored enterprises as loan approvals when additional criteria still must be met.
- Provide training to employees that communicates clear expectations about who within the organization is authorized to underwrite loans and communicate underwriting decisions and other loan terms and conditions to applicants, as well as when they may do so.32

**Regulatory and Policy Developments**

**Uniform Interagency Consumer Compliance Rating System**

In November 2016, the Federal Financial Institutions Examination Council (FFIEC) announced the issuance of an updated Uniform Interagency Consumer Compliance Rating System (CC Rating System).33 The CC Rating System is used by the FFIEC member agen-

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cies’ examiners to evaluate financial institutions’ adherence to consumer compliance laws and regulations. The updated rating system applies to consumer compliance examinations that began on or after March 31, 2017.

The new CC Rating System recognizes that an institution’s strong compliance management system, or CMS, can effectively prevent violations of law and support consumer protection in the delivery of financial services. The CC Rating System is aligned with the Federal Reserve’s risk-focused approach to supervision. It establishes incentives for institutions to promote consumer protection by preventing, self-identifying, and addressing compliance issues in a proactive manner.

For more information about the CC Rating System, see the Consumer Compliance Outlook article “Implementing the New Uniform Interagency Consumer Compliance Rating System” or Federal Reserve CA Letter 16-8.34

**Military Lending Act**

The Military Lending Act (MLA) was enacted in 2006 with the goal of protecting active duty military personnel, as well as their spouses and other dependents, engaged in consumer credit transactions. Among its key protections, the MLA notably limits the cost of covered transactions, which are subject to a Military Annual Percentage Rate (MAPR) cap of 36 percent.

In July 2015, the U.S. Department of Defense (DoD) amended the MLA's implementing regulation. Some of the notable changes in the DoD's 2015 rule include the following:

- The original MLA regulation applied solely to certain payday loans, motor vehicle title loans, and tax refund anticipation loans. The amended regulation broadens considerably the types of consumer credit products that it covers. It now generally applies to most types of traditional consumer credit covered under the Truth in Lending Act and Regulation Z. For example, credit cards, deposit advance products, overdraft lines of credit, and certain installment loans are now subject to MLA protections. However, the MLA regulation continues to exempt home-secured credit and loans to finance the purchase of motor vehicles and other consumer goods that are secured by the purchased item.

- The MLA also includes expanded disclosure requirements that apply when a creditor extends consumer credit to a covered borrower. Specifically, a creditor must provide such a borrower with a statement of the annualized MAPR applicable to the consumer credit, any disclosure required by Regulation Z, and a clear description of the payment obligation.

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For more detailed information on the MLA, the Servicemembers Civil Relief Act, and other federal laws and protections applicable to servicemembers, see the Consumer Compliance Outlook article “Servicemember Financial Protection: An Overview of Key Federal Laws and Regulations.”\(^{35}\)