



4-2005

## 25th Annual Conference on Legal Issues for Financial Institutions

Office of Continuing Legal Education at the University of Kentucky College of Law

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*25th Annual  
Conference on*

**LEGAL ISSUES  
FOR  
FINANCIAL  
INSTITUTIONS**

**April 2005**







*25th Annual  
Conference on*

**LEGAL ISSUES  
FOR  
FINANCIAL  
INSTITUTIONS**

**April 2005**

**Presented by  
OFFICE OF CONTINUING LEGAL EDUCATION  
UNIVERSITY OF KENTUCKY COLLEGE OF LAW**

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FOR FINANCIAL INSTITUTIONS**  
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*25<sup>th</sup> Annual*  
**CONFERENCE ON LEGAL ISSUES FOR  
FINANCIAL INSTITUTIONS**

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# **KENTUCKY GENERAL ASSEMBLY & LEGISLATIVE UPDATE**

*Debra K. Stamper  
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**SECTION A**



# **KENTUCKY GENERAL ASSEMBLY & LEGISLATIVE UPDATE**

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## **IV. DISCUSSION**



**NOTES**

**NOTES**

SB27

AN ACT relating to repossession of collateral by secured parties.

*Be it enacted by the General Assembly of the Commonwealth of Kentucky:*

Section 1. KRS 329A.070 is amended to read as follows:

The provisions of KRS 329A.010 to 329A.090 do not apply to:

- (1) An officer or employee of the United States, this state, another state, or any political subdivision thereof, performing his or her official duties within the course and scope of his or her employment;
- (2) A public accountant, certified public accountant, or the bona fide employee of either, performing duties within the scope of public accountancy;
- (3) A person engaged exclusively in the business of obtaining and furnishing information regarding the financial rating or standing and credit of persons;
- (4) An attorney-at-law, or an attorney's bona fide employee, performing duties within the scope of the practice of law or authorized agent with duties limited to document and record retrieval or witness interviews;
- (5) An insurance company, licensed insurance agent, or staff or independent adjuster if authorized to do business in Kentucky, performing investigative duties limited to matters strictly pertaining to an insurance transaction;
- (6) A person engaged in compiling genealogical information, or otherwise tracing lineage or ancestry, by primarily utilizing public records and historical information or databases;
- (7) A private business employee conducting investigations relating to the company entity by which he or she is employed;
- (8) An individual obtaining information or conducting investigations on his or her own behalf;
- (9) An employee of a private investigator or a private investigating firm who works



under the direction of the private investigator or the private investigating firm for less than two hundred forty (240) hours per year. The board shall promulgate administrative regulations to establish a method of verification of the number of hours worked; or

(10) A professional engineer, a professional land surveyor, or a professional engineer's or professional land surveyor's bona fide employee, performing duties within the scope of practice of engineering or land surveying; or

**(11) A secured creditor, or person acting on behalf of a secured creditor, engaged in the repossession of the creditor's collateral pursuant to KRS 355.9-609.**

SB100

AN ACT relating to liens.

***Be it enacted by the General Assembly of the Commonwealth of Kentucky:***

Section 2. KRS 376.230 is amended to read as follows:

- (1) The lien provided for in KRS 376.210 shall be dissolved unless the person who furnishes the labor, materials, or supplies shall, within sixty (60)~~thirty (30)~~ days after the last day of the month in which any labor, materials, or supplies were furnished, file in the county clerk's office of each county in which labor, materials, or supplies were furnished, except as hereinafter provided, a statement in writing verified by affidavit of the claimant or his or her authorized agent or attorney, setting forth the amount due for which the lien is claimed, the date on which labor, materials, or supplies were last furnished and the name of the canal, railroad, bridge, public highway, or other public improvement upon which it is claimed.
- (2) In all cases where a lien is claimed for labor, materials, or supplies furnished for the improvement of any bridge, public highway, or other public property owned by the state or by any county, charter county, urban-county, consolidated local government, or city, the statement of lien shall be filed only in the county clerk's office of the county in which the seat of government of the owner of the property is located.
- (3) The county clerk, upon the filing of the statement, shall make an abstract and entry thereof as now provided by law in case of mechanics' liens in the same book used for that purpose, and shall make proper index thereof. The clerk shall be paid by the party filing the claim, and for attesting any copy of the lien statement. If he or she is required to make the copy, he or she may make an additional charge as provided by law. The clerk's fees shall be determined pursuant to KRS 64.012. All of these charges may be recovered by the lien claimant as costs from the party and out of the fund against which the claim is filed.

HB248

AN ACT relating to debtor-creditor relations.

***Be it enacted by the General Assembly of the Commonwealth of Kentucky:***

Section 3. KRS 427.170 is amended to read as follows:

An individual debtor domiciled in this state is ~~not~~ authorized to exempt from property of said debtor's estate the property specified under 11 U.S.C. sec. 522(d)~~[subsection (d) of section 522 of The Bankruptcy Code of 1978, 92 Stat. 2549 (1978), Public Law 95-598].~~

HB294

AN ACT relating to the business of debt adjusting.

*Be it enacted by the General Assembly of the Commonwealth of Kentucky:*

Section 4. KRS 380.010 is amended to read as follows:

As used in this chapter, the following terms mean:

(1) ~~"Debt adjuster," a person who acts or offers to act for a consideration as an intermediary between a debtor and his creditors for the purpose of settling, compounding, or in anywise altering the terms of payment of any debts of the debtor; and to that end, receives money or other property from the debtor, or on behalf of the debtor, for payment to, or distribution among, the creditors of the debtor.~~

(2) ~~"Debtor," an individual or individuals jointly and severally, or jointly or severally indebted. }~~

**"Person" includes, but is not limited to, individuals, partnerships, associations, corporations, limited liability companies, trusts, and other legal entities;**

(2) **"Debt adjusting" means doing business in debt adjusting, budget counseling, debt management, or debt pooling service, or holding oneself out, by words of similar import, as providing services to debtors in the management of their debts, to do any of the following:**

**(a) Effect the adjustment, compromise, or discharge of any account, note or other indebtedness of the debtor;**

**(b) Receive from the debtor and disburse to the debtor's creditors any money or other thing of value; or**

**(c) Solicit business and advertise as a debt adjuster; and**

(3) **"Reside" means to live in a particular place on a temporary or permanent basis.**

SECTION 5. A NEW SECTION OF KRS CHAPTER 380 IS CREATED TO READ AS FOLLOWS:

- (1) Subject to subsection (3) of this section, a person, whether or not located in this state, engaged in debt adjusting shall do both of the following:

  - (a) Unless specifically instructed otherwise by a debtor, disburse to the appropriate creditors all funds received from the debtor, less any contributions or fees not prohibited by subsection (2) of this section, within thirty (30) days of receipt of the funds from the debtor; and
  - (b) Maintain a separate trust account for the receipt of any funds from debtors and the disbursement of the funds to creditors on behalf of the debtors.
- (2) If contributions or fees for engaging in debt adjusting are accepted, directly or indirectly, a person engaged in debt adjusting shall not do any of the following:

  - (a) Accept a contribution or fee exceeding seventy-five dollars (\$75) from a debtor residing in this state for an initial set up;
  - (b) Accept a consultation contribution or fee exceeding fifty dollars (\$50) per calendar year from a debtor residing in this state; or
  - (c) Accept a periodic contribution or fee from a debtor who resides in this state that exceeds the greater of eight and one-half percent (8.5%) of the amount paid by the debtor each month for distribution to the debtor's creditors or thirty dollars (\$30).
- (3) Subsections (1) and (2) of this section shall not prohibit a person engaged in debt adjusting for a debtor who resides in this state from charging the debtor a bad check charge of twenty dollars (\$20) or the amount passed on from the debt adjuster's bank, whichever is greater, in addition to contributions or fees not

prohibited by subsection (2) of this section.

- (4) Fees or contributions permitted in subsections (1), (2), and (3) of this section may be adjusted on an annual basis by the amount equivalent to any increase in the consumer price index, published by the United States Department of Labor, Bureau of Labor Statistics.
- (5) Any person that engages in debt adjusting shall file an initial registration form, accompanied by an initial registration fee of two hundred fifty dollars (\$250), and the registration shall be renewed each year thereafter for a fee of two hundred fifty dollars (\$250) to cover the actual cost of filing the registration, in accordance with administrative regulations promulgated by the Attorney General.
- (6) Any person that engages in debt adjusting shall arrange for and undergo an annual audit of the person's business, including any trust funds deposited and distributed to creditors on behalf of debtors, which shall be conducted by an independent, third-party certified public accountant. Both of the following shall apply to an audit performed under this subsection:
- (a) The person shall file the results of the audit and the auditor's opinion with the Consumer Protection Division of the Office of the Attorney General within thirty (30) days of the anniversary date of filing the initial registration; and
- (b) The Attorney General shall make available a summary of the results of the audit and the auditor's opinion upon written request of any person and payment of a fee not to exceed the cost of copying the summary and opinion.
- (7) A person engaged in debt adjusting shall obtain and at all times maintain insurance coverage for errors and omissions, employee dishonesty, depositor's forgery, and computer fraud in the amount of ten percent (10%) of the monthly

average for the immediately preceding six (6) months of the aggregate amount of all deposits made with the person by all debtors. The insurance coverage shall comply with all of the following:

(a) The minimum limit of the insurance coverage shall not be less than one hundred thousand dollars (\$100,000), and the maximum limit of the insurance coverage shall not be more than two hundred fifty thousand dollars (\$250,000);

(b) The insurance coverage shall not include a deductible in excess of ten percent (10%) of the face amount of the policy coverage;

(c) The insurance coverage shall be issued by an insurer and rated at least A-, or it's equivalent, by a nationally recognized rating organization; and

(d) The insurance coverage shall provide that the Consumer Protection Division of the Office of the Attorney General shall be named as an additional interested party.

(8) Any person engaged in debt adjusting shall comply with the provisions of this section.

SECTION 6. A NEW SECTION OF KRS CHAPTER 380 IS CREATED TO READ AS FOLLOWS:

The Attorney General shall promulgate administrative regulations in accordance with KRS Chapter 13A to ensure the proper administration and enforcement of this chapter.

Section 7. KRS 380.030 is amended to read as follows:

The following persons shall not be considered debt adjusters for the purposes of this chapter:

(1) Any attorney-at-law of this state;

- (2) Any person who is a regular, full-time employee of a debtor, and who acts as an adjuster of his employer's debts;
- (3) Any person acting pursuant to any order or judgment of court, or pursuant to authority conferred by any law of this state or of the United States;
- (4) Any person who is a creditor of the debtor, or an agent of one (1) or more creditors of the debtor, and whose services in adjusting the debtor's debts are rendered without cost to the debtor;
- (5) Any person who, at the request of a debtor, arranges for or makes a loan to the debtor, and who, at the authorization of the debtor, acts as an adjuster of the debtor's debts in the disbursement of the proceeds of the loan, without compensation for the services rendered in adjusting the debts; and
- (6) Any charitable, religious or educational organization, determined to be exempt from taxation under Section 501(c)(3) of the Internal Revenue Code ***that is not in the business of debt adjusting, as defined in Section 1 of this Act.***

Section 8. KRS 380.990 is amended to read as follows:

Any person who ***violates the provisions of Section 2 of this Act*** ~~acts or offers to act as a debt adjuster~~ in the state is guilty of a misdemeanor and, upon conviction, shall be punished by a fine of ***five hundred dollars (\$500)***~~[\$500]~~ or imprisonment not to exceed sixty (60) days, or both such fine and imprisonment.

Section 9. The following KRS section is repealed:

380.020 Injunction against debt adjuster -- Appointment of receiver.





**ANNUAL CASE LAW UPDATE FOR BANK COUNSEL  
2004-2005**

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**SECTION B**



# **Case Law Update**

**25th Annual Conference On  
Legal Issues For Financial Institutions  
April 15, 2005**

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# Case Law Update

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## Case Law Update

### I. TRUTH IN LENDING ACT.

A. Household Credit Services, Inc. v. Pfennig, No. 02-857, U.S. Supreme Court (4/21/04).

1. Credit card "overlimit fee" is not a part of the "finance charge".
2. Rejects Sixth Circuit's view that overlimit fee falls within TILA's statutory language (15 U.S.C. §1605(a)) defining finance charge as "all charges, payable directly or indirectly by the person to whom the credit is extended, and imposed directly or indirectly by the creditor as an incident to the extension of credit".
3. Deferring to Federal Reserve Board's express exclusion in Regulation Z (12 C.F.R. §226.4(c)(2)) of overlimit fees from the definition of "finance charge". The case is an important decision on the extent to which courts should defer to the Federal Reserve Board's Regulation Z as to the proper application of the statutory provisions of the federal Truth In Lending Act.

B. Koons Buick Pontiac GMC, Inc. v. Nigh, No. 03-377, U.S. Supreme Court (11/30/04).

1. Clarifying how a series of enactments in 1968, 1974, 1976 and 1995, affected the caps under TILA (15 U.S.C. §1640(a)) for statutory damages.
2. Supreme Court rejects 4<sup>th</sup> Circuit's view that 1995 amendments replaced a \$1,000 cap on statutory damages in individual lawsuits with a 2x the finance charge statutory damage when the violation involved situations other than consumer leases or loans secured by real property.
3. The \$1,000 cap on statutory damages in individual lawsuit applies in all cases except consumer leases or credit transactions not under an open end credit plan that is secured by real property or a dwelling.
  - a. Cap in consumer lease is 25% of total amount of monthly lease payments.
  - b. Cap in real estate secured transaction (other than open end credit plan) is \$2,000.

C. Right of Rescission And Unreasonable Fees.

1. Consumer attorneys invariably argue that various real estate fees should be included in calculating the finance charge for a residential mortgage loan under the federal Truth in Lending Act because the fees are not "bona fide and reasonable." These TILA cases then argue that the loan is rescindable for failure to disclose adequately the finance charge and annual percentage rate in the Truth in Lending disclosure statement. Typically, these challenges attack such charges as the appraisal fee, the title insurance fee and other charges that are otherwise excludable from the finance charge under Regulation Z, 12 C.F.R. § 226.4(c)(7), as real-estate related fees.

2. Recent decisions from the U.S. District Court for the Northern District of Illinois, however, have taken much of the plaintiffs' punch out of these types of claims. These cases hold that, even if a particular fee is not "bona fide and reasonable," only the excess amount of the charge must be included in the finance charge.

3. In Marquez v. New Century Mortgage Corp., 2004 WL 742205 (N.D. Ill. Apr. 5, 2004), the plaintiff claimed that he was entitled to rescind a \$68,000 loan because the title insurance premium of \$665 was not bona fide and reasonable and, therefore, should have been included in the TILA finance charge. Plaintiff claimed that the going rate for title insurance should have been \$349.95. Faced with the defendant's motion to dismiss the complaint, the court ruled that only the difference between the \$665 actually charged and the "reasonable" rate of \$349.95 should be included in the finance charge, under plaintiff's theory of the case, and that because that amount of \$315.05 was within the permissible tolerance for error of one-half percent of the total loan amount (0.5 percent of \$68,000) of \$340, plaintiff had failed to state a claim to rescind the loan.

4. In Scott v. IndyMac Bank, 2004 WL 422654 (N.D. Ill. Feb. 3, 2004), defendants filed a motion to dismiss a class action complaint in which the plaintiff contended that the lender and title company should have charged the lower "reissue rate" for title insurance on refinancings. Plaintiffs also argued that the full amount of the higher "basic rate" title insurance therefore should have been included in the TILA finance charge. In dismissing the TILA claim, the Scott court observed that TILA's allowance for a half-percent error in calculating the finance charge underscored the Act's intention that only the unreasonable portion of a particular fee should be included in the finance charge calculation. "[I]nclusion of the actual amount would render tolerance meaningless," the court stated.

5. There are only a handful of reported decisions on the issue of whether all, or only a portion, of an unreasonable fee must be included in a finance charge under TILA. *Marquez* and *Scott* are, perhaps, the first steps toward settling this issue in lenders' favor.

## II. ADMINISTRATIVE POWERS OF THE KENTUCKY OFFICE OF FINANCIAL INSTITUTIONS.

A. Consolidated Mortgage, Inc. v. Dept. Of Financial Institutions, No. 2003-CA-2122 (Ky.App. 12/10/04) (not to be published).

1. In 2003, the Kentucky Department of Financial Institutions ("DFI") learned that Consolidated Mortgage, Inc. ("CMI") had employed a closing agent who turned closing funds over to CMI, but that these funds were never paid to the appropriate creditors. Accordingly, the DFI filed a civil complaint pursuant to KRS 294.190(2)(b) in Franklin Circuit Court seeking injunctive relief to enjoin CMI and its principals from further engaging in the mortgage broker business. Ten days later, the DFI commenced a separate administrative action to revoke the brokers licenses held by CMI. CMI was properly served with notice of the administrative hearing, but filed no response. The DFI Commissioner subsequently entered a default order against CMI. Franklin Circuit Court upheld the default order.

2. On appeal, CMI argued that when the DFI filed for injunctive relief in Franklin Circuit Court, that civil action divested the DFI of jurisdiction to revoke CMI's broker licenses. The Court of Appeals rejected this argument, noting that KRS 294.090 granted the DFI Commissioner exclusive authority to revoke brokers licenses and that KRS 294.190(2)(b) granted the Commissioner authority to seek injunctive relief in Franklin Circuit Court.

B. Consolidated Mortgage, Inc. v. Dept. Of Financial Institutions, No. 2004-CA-1094 (Ky.App. 3/4/05) (not to be published).

1. In the course of its examination of CMI, the DFI subpoenaed bank records from Central Bank. A comparison of check copies provided by the bank compared to those furnished by CMI indicated that they had re-dated the checks in an effort to conceal that the funds had been used not to pay off liens as intended by the lender. Rather, the DFI concluded CMI's officers had used the funds for either operational or personal expenses. The Commissioner revoked CMI's mortgage broker license and imposed a \$15,000 fine.

2. On appeal, CMI argued that the DFI's exercise of investigative subpoena power over Central Bank's records relating to its accounts, without providing notice to CMI denied its due process rights. The Court of Appeals, citing U.S. v. Miller, 425 U.S. 435 (1976), held the depositor takes the risk, in revealing his affairs to another, that the information will be conveyed by that person to the government. Moreover, CMI "clearly had no legitimate privacy interest in Central Bank's bank records." Since CMI had no legitimate privacy interest in the bank records, the Court of Appeals reasoned that CMI had not been deprived of due process when it was not noticed on the investigative subpoena.

III. **PARTICIPATION AGREEMENTS - McCreary National Bank V. Kentucky Highlands Investment Corp.**

A. Participation Agreement stated:

"Administration.

a. Seller shall manage and administer the Loan on behalf of Seller and Participant. Participant specifically agrees that Seller shall be entitled, in good faith, to manage and administer the Loan and deal with Borrower as if Seller had made the Loan without Participant's participation and in such manner as Seller would normally act if dealing with Borrower in connection with such Loan for its own account. Seller shall endeavor in good faith to keep the Participant informed about the status of the Loan and the financial condition of the Borrower and to see that Participant has the opportunity to participate in any significant decisions which must be made respecting the Loan. The parties shall work together in good faith to see that the interests of both parties in the Loan and the collateral for the Loan are protected to the greatest extent possible.

b. Notwithstanding the foregoing, without the prior written consent of Participant, Seller shall not (i) extend the due date of the Loan, (ii) decrease the interest rate specified in the Loan Documents, or (iii) release all or any part of the property given as security for the Loan, except as may be provided in the Loan Documents.

c. Participant hereby waives any claim or cause of action that it may have against Seller as a result of the management, administration and enforcement of the Loan except as the result of bad faith or gross negligence on the part of the Seller."

B. Lead bank allowed borrower to make interest only payments for six months and substituted one personal guaranty for those of two guarantors claiming financial insolvency.



Participating bank sought to rescind the participation or recover damages from lead bank.

C. Court of Appeals found that granting temporary moratorium on principal payments was a permitted normal decision under clause (a). However, release of guarantors was in violation of restrictions of clause (b)(iii). The protections granted to the lead bank in clause (c) were not sufficient to override the specific limitations of clause (b).

IV. **SET OFF – Edwards v. Bank One, Columbus, N.A.** No. 2003-CA-1869 (Ky.App. 2/19/04) (not to be published).

A. Bank properly set off funds in borrower's checking account to pay her delinquent car loan.

B. Bank, however, acted improperly after it had depleted the checking account. To cover checks that borrower had written on the account that was overdrawn, Bank cash advances upon borrower's VISA/Money card and placed the funds in the checking account. Bank could not produce any account agreement authorizing such steps, and court rejected bank's argument that it had historically acted in this manner as a courtesy to its customers.

C. Borrower was not entitled, however, to punitive damages against the Bank for its mishandling of the credit card.

V. **LENDER LIABILITY – Pressman v. Franklin National Bank**, No. 03-5592 (6<sup>th</sup> Cir. 9/9/04).

A. Dispute over bank's failure to fund the acquisition costs of land for a subdivision development.

B. Bank's commitment letter expressly conditioned closing on locating a participating bank on terms satisfactory to both lead and participating bank. Accordingly, bank did not act improperly when it could not locate participating bank. Bank satisfied its implied obligations to try to find a participating bank when it contacted two banks given short time until closing.

C. Offers from the founder of the bank and president of bank's holding company to providing funding assistance with his own money called into question bank's conduct and good faith. However, Court ruled there was insufficient evidence of misconduct.

VI. **MORTGAGE BROKER AGREEMENT – Tri-County Mortgage Co. v. Union Planters Bank, N.A.**, No. 2003-CA-787 (Ky.App. 11/24/04) (not to be published).

A. Mortgage broker could not recover claimed mortgage broker fee where there was not any written mortgage broker contract.

B. Kentucky statute of frauds, KRS 371.010(6), requires a written agreement in order to recover a fee unless there is some type of conduct which takes the case out of the statute of frauds.

VII. **FORECLOSURES.**

A. Bullock v. Wells Fargo Bank, No. 2003-CA-2439 (Ky.App. 12/23/04) (not to be published).

1. Commissioner's sale was properly set aside where house which was

appraised for \$24,000 sold for only \$1,000.

2. Setting aside sale was not abuse of discretion where the high bid of less than 5% of appraised value was "so grossly inadequate as to 'shock the conscience' or raise the presumption of fraud."

B. Conseco Finance Servicing Corp. v. Hurstbourne Healthcare, LLC, No. 2002-CA-1757 (Ky.App. 12/3/04) (not to be published).

1. Trial court erred in failing to set aside a default judgment on a crossclaim in a foreclosure action where the cross-plaintiff failed to properly serve process of its crossclaim.

2. KRS 426.006 requires that a crossclaim in a foreclosure action be serve in the manner of an initiating pleading under Civil Rule 4.

3. Since faulty service of process can make a judgment void,. Hertz You Drive It Yourself System, Inc. v. Castle, Ky., 317 S.W.2d 177, 177-178 (1958), then as a matter of law the default judgment was a nullity. Consequently, as a "void judgment [it] is not entitled to any deference or respect and a court has no discretion about whether or not to set it aside. As a matter of law it must hold that the judgment is a nullity."

#### VIII. LIENS.

A. Gil Ruehl Mechanical, Inc. v. Hartford Fire Ins. Co., No. 2003-CA-1250 (Ky.Ap.. 12/17/04).

1. The twelve-month limitation period set out in KRS 376.090 extinguishes not only the right to enforce the mechanics lien but extinguishes the lien itself. KRS 376.090 represents a substantive restriction upon an essential element of a valid mechanics lien.

B. Flag Drilling Co. v. Erco, Inc., 2003-CA-2244 & 2521 (Ky.App. 1/28/05)

1. Purchasers of unpaid property tax bills are entitled to recover attorney's fees pursuant to KRS 134.420(1). That statute provides that a lien imposed by the state, county, city or taxing district shall include "reasonable attorney fees." KRS 134.490(2) permits the private purchasers to legally enforce liens imposed under KRS 134.420(1). Accordingly, the Court of Appeals held purchasers "necessarily" have right to collect attorney's fees.

C. Wolter v. U.S Bancorp., No. 2003-CA-2788 (Ky.App. 12/23/04) (not to be published).

1. Bank miscalculated payment amount in loan modification agreement so borrower's payments did not fully amortize modified loan. Bank demanded additional payments at end of loan term and initially refused to release mortgage.

2. Bank acted wrongfully in demanding payments. Bank's failure to immediately release mortgage at end of loan term did not give rise to statutory liability under KRS 382.365 since Bank's had "good cause" not to immediately release when there was a bona fide dispute over whether the borrowers had to make up the shortfall in payments.

**IX. CHECK PAYMENT PROBLEMS.**

A. Republic Capital Corp. v. Lincoln General Corp., No. 2003-CA-1444 (Ky.App. 12/17/04) (not to be published).

1. Court of Appeals refused to treat as an accord and satisfaction a check that had "Insurance – Paid In Full" written on it when the amount due was not disputed.

2. "No question is more thoroughly settled than that, where one owes a fixed and definite sum, the payment or tender of a sum less than the amount of the debt, even though accompanied with a statement that it is in full, though accepted by the creditor, does not operate to defeat him from collecting the balance of his debt, for the reason that there is no consideration for the surrender of the unpaid portion."

3. No citation to KRS 355.3-311.

B. Jones v. PBK Bank, No. 2003-CA-1512 (Ky.App. 11/24/04) (not to be published).

1. Borrowers attempting to refinance their debts have three loans at bank – one secured by a first mortgage; one secured by a second mortgage, and one secured by a truck. There is confusion over which loans are supposed to be paid off when the borrowers refinance their mortgage loans. The bank applies one of the loan payment checks to the truck loan leaving a mortgage loan remaining.

2. Genuine issues of fact exist as to who is at fault for the misapplication and whether the bank knew or had reason to know where the payments were to be applied.

**X. SETTLEMENT AGREEMENTS.**

A. Stone v. Citifinancial Services, Inc., No. 2004-CA-453 (Ky.App. 2/25/05) (not to be published).

1. Court of Appeals affirms Circuit Court's order enforcing settlement in real property purchase dispute.

2. Stone offer \$101K for property, which was rejected. Stone then offered \$131K, subject to financing, which was accepted. Termites were discovered, and Stone claims to have asked for reduction in the purchase price. At closing, the documents all reflected a \$101K purchase price, and Citifinancial's representative closed assuming this was the negotiated price. As soon as other Citifinancial personnel discovered the lower price, Citifinancial attempted to undo the sale. When Stone sued, the Circuit Court ruled no valid contract existed and order the transaction rescinded. The parties then entered into settlement negotiations. Stone's attorney faxed a statement saying he had authority to transfer \$30K to Citifinancial and release the remaining \$101K in exchange for the property. Citifinancial claimed it accepted. Later, Stone's attorney claimed there was not settlement and demanded \$60,000 for improvements made to the property in the interim. Citifinancial cited the faxed agreement and appellant reneged.

3. Trial Court found there had been a settlement evidenced by the fax and the Court of Appeals affirmed.

B. Ford v. Beasley, No. 2003-CA-432 & 508 (Ky.App. 10/15/04).

1. Doctors in arbitration over division of practice. Day before arbitration furious settlement negotiations. Lawyers reach a settlement agreement, but one doctor refuses to sign final settlement agreement saying he did not agree to the terms.

2. Trial court enforces settlement and Court of Appeals affirms. Trial court's factual finding that attorney had express authority to settle was supported by evidence. Even if attorney did not have authority, doctor's remedy was suit against his attorney when other side had acted in good faith and would be prejudiced by failing to honor settlement.

## XI. ARBITRATION.

A. Louisville Peterbilt, Inc. v. Cox, Ky., 132 S.W.2d 850 (2004). Kentucky Supreme Court overruled the Court of Appeals' decision in Marks v. Bean, Ky. App., 57 S.W.3d 303 (2001), that a general fraudulent inducement claim is sufficient to avoid an arbitration clause which includes fraud within the scope of arbitration. Rather, Kentucky will follow the federal and majority state rule that requires an allegation of fraud going to the making of the arbitration clause itself rather than the underlying contract in general.

### B. Arbitration In The Secondary Mortgage Market.

1. Effective October 31, 2004, Fannie Mae will no longer invest or accept delivery of residential mortgage loan products that contain mandatory arbitration clauses. In Fannie Mae Announcement 04-06, Fannie Mae issued, among other things, new instructions to lenders outlining the policies for purchasing and accepting residential mortgage loans. Specifically, the instructions included a prohibition against purchasing or accepting delivery of residential mortgage loans containing mandatory arbitration clauses.

2. A limited exception exists, permitting the use of mandatory arbitration provisions in mortgages that contain a waiver provision. The waiver provision shall provide that if the loan is sold or an interest in the mortgage loan is transferred to Fannie Mae, the mandatory arbitration clause becomes null and void.

### C. JAMS Backs Down on Class-Action Arbitration, American Banker (03/11/05).

1. A major arbitration company, JAMS, will honor class-action waivers in mandatory arbitration clauses in states where the courts have accepted their validity, which is a reversal of its policy. In order to keep court costs down, subprime mortgage and credit card lenders often add the language--which prevents borrowers from forming class actions in arbitration--to the mandatory arbitration clause that customers must sign for certain loans. Lenders had feared that borrowers would avoid the other major arbitration companies and take their cases to JAMS because of its previous decision to refuse to accept class-action waivers.

2. State courts and federal courts are divided over the issue, and JAMS plans to let the individual arbitrator determine whether to hear a case as a class action or not.

## XII. CHECK FRAUD – Bradley v. National City Bank of Kentucky, No. 2003-CA-2711 (Ky.App. 12/30/04) (not to be published).

A. Decedent's daughter, as successor executrix, deposited tax refund checks totaling \$58,716 into her personal account at bank in October 1998. She was removed and replaced by the Public Administrator in August 2001. In January 2003, he brought an action against the bank,

seeking a return of the \$58,176. The bank defended on the three-year statute of limitations under KRS 355.3-118(7)(a) and won summary judgment.

B. The Court of Appeals upheld the trial court, declining to adopt a discovery rule absent fraudulent concealment. (KRS 386.120, regarding a bank's duty for fiduciary accounts, was not before the court.).

1. KRS 355.3-420 provides that an instrument is converted when "a bank makes or obtains payment with respect to the instrument for a person not entitled to enforce the instrument or receive payment." The statute of limitations provision at KRS 355.3-118(7)(a) states that "[f]or conversion of an instrument, for money had and received," an action "must be commenced within three (3) years after the claim for relief accrues." Plaintiff argued that if the three-year limitation was applied, it should be subject to the discovery rule.

C. As an aside, a practical issue was the public administrator's argument that he could not have discovered the cause of action until he was appointed. Nevertheless, the Court ruled the clock had started ticking. The practical less is to think twice before becoming a successor fiduciary or waiving the obligation of an accounting from one fiduciary to a successor. And, think twice before automatically waiving surety on the bond because the prior fiduciary may not be able to make the beneficiaries whole.

### XIII. EMPLOYMENT PRACTICES.

A. Biber v. Duplicator Sales & Service, Inc., No. 2003-CA-1994 (Ky.App. 12/3/04).

1. Allegedly defamatory intra-corporate communications are not protected by absolute privilege or the theory that there is no "publication" of the statements.

2. However, there is a qualified privilege in order that the employees of a corporation may freely discuss internal matters without fear of a civil lawsuit for libel or slander.

3. Moreover, in this case, allegedly defamatory statements were not actionable because they were expressions of opinion based on truthful facts about plaintiff's misconduct.

B. Jenkins v. Atlas Siding And Window Co., No. 2003-CA-2416 (Ky.App. 12/3/04) (not to be published).

1. Employee of building contract assaulted homeowner where working.

2. Employer was not liable because it was not foreseeable to employees that the employee would return to customer's house to burglarize it and assault customer. Moreover, even assuming employer knew of all of employee's past violent acts, those acts were too remote in time and completely unrelated to his employment to be foreseeable. The employee's prior crimes were of a different type from those committed against the customer.

### XIV. MISCELLANEOUS.

A. American Trim, LLC v. Oracle Corp., No. 02-4186 (6<sup>th</sup> Cir. 9/1/04) (affirming \$3MM compensatory and \$10MM punitive damage jury verdict against software developer that lied about software package development status and capabilities).

B. Stringer v. Wal-Mart Stores, Inc., No. 2001-SC-0262 (Ky. 10/21/04).

1. The Wal-Mart Candy Case.

2. The Supreme Court affirms in part, reverses in part, and vacates and remands in part, the Court of Appeals' (CA) holding in this relatively well-known case involving Wal-Mart workers in Monticello, Kentucky, who were fired for eating candy belonging to the store. The case became famous after a jury awarded each of the four plaintiffs \$1 million for injury to reputation, \$1 million for embarrassment, humiliation and mental anguish and \$3 million in punitive damages. Plaintiffs alleged a "conspiracy" by their supervisor to prevent his own demotion by fabricating a pretense for terminating them in order to reduce payroll expenses and demonstrate a "get tough on inventory shrinkage" stance.

3. Supreme Court (a) ordered dismissal of intentional infliction of emotional distress and invasion of privacy claims and (b) remanded for damages proceedings on defamation claim.

4. Moral of Story – treat employees fairly, don't make mountains out of molehills, and have a good reputation in the community.

**XV. MAJOR TRENDS AND ISSUES IN OTHER JURISDICTIONS.**

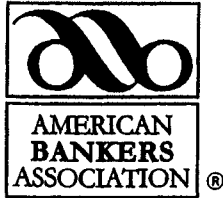
A. American Bankers Association's "Status Of Important Banking Cases" (12/1/04)

**XVI. THEFT OF CUSTOMER INFORMATION.**

A. "Credit Card Leaks Continue At Furious Pace", MSNBC (11/24/04)

B. "FTC Testifies On Security Of Consumers' Financial Data", [www.ftc.gov](http://www.ftc.gov) (4/13/05)

C. How much of your security budget are you spending on protecting your data?



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December 1, 2004

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NEW THIS MONTH:

- U.S. Supreme Court Victory in Koons v. Nigh (¶ 5)
- Amici briefs filed in Sola v. Washington Mutual case (¶ 6)
- Miller v. Bank of America hearing on tentative decision delayed (¶ 12)
- Diversity Jurisdiction at issue in Wachovia v. Schmidt (¶ 34)

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New cases and cases in which there have been significant developments since the last monthly report are marked \*.

## ANTITRUST

1. Visa, U.S.A. v. United States (S. Ct. No. 03-1521); MasterCard International v. United States (S. Ct. No. 03-1532). On October 7, 1998, Justice Department filed antitrust suit against Visa and MasterCard challenging the "rules" of both networks prohibiting their respective member banks from offering credit cards that compete with those two. The rules allegedly have the effect of eliminating real competition between Visa and MasterCard and hampering competition or potential competition from other networks. On October 9, 2001, court held that "duality" rules, by which thousands of banks can and do issue both Visa and Master Card, are not anticompetitive, but the prohibition against Visa and/or Master Card member banks also issuing American Express and/or Discover cards is an antitrust violation (163 F. Supp. 2d 322). In a final order issued in late November, 2001, the court made some modest changes without affecting the bottom line. The district court issued a stay of its order pending appeal. On September 17, 2003, the Second Circuit affirmed largely for the reasons set forth in the District Court opinion, which the appeals court held to be not unreasonable and supported by the evidence (344 F. 3d 229). A petition for rehearing en banc was denied on January 9, 2004. The stay of the final district court order remains in effect. Petitions for Writ of Certiorari were filed in the Supreme Court on May 10, 2004. U.S. Supreme Court denied certiorari on October 4, 2004.

2. Brennan v. Concord EFS, Inc. (N.D. Cal. No. 3:04 CV 02676 VRW). Filed July 2 in U.S. District Court of the Northern District of California, this case challenges on antitrust grounds the assessment of interchange fees and surcharges for customers using a number of ATM networks including the Star network acquired by defendant Concord in 2001. In addition to the network, several large financial institutions and VISA and MasterCard are named in the complaint. The plaintiffs are class action representatives alleging that the totality of the fees ATM customers pay far exceed the costs associated with the transactions and that the interchange and surcharges are assessed because there are limited or no market alternatives and customers have no choice but to pay the fees. An almost identical action, Sanchez v. Concord EFS, Inc., (SD NY No. 04 CV 06660), was filed on August 16<sup>th</sup> in the U.S. District Court for the Southern District of New York.

## ARBITRATION

3. Mandel v. Household Bank (Nevada) (Cal. App. 4th, No. GO29531) (also listed as Shea v. Household Bank). On January 7, 2003, in a case in which ABA appeared as amicus curiae, court upheld the enforceability of an arbitration clause added by statement stuffer to a credit card agreement against a variety of challenges. The one provision of the contract the court did not approve was a prohibition of class action arbitrations. That, according to the court, was unconscionable. One week later, in Discover Bank v. Superior Court of Los Angeles County (Boehr, Real Party in Interest) (Cal. App. 2d, No. B161305), a different appellate division of the state court of appeals specifically and by name disagreed with the *Mandel* decision and enforced the arbitration clause as written, including its prohibition against class action arbitrations. The California Supreme Court has granted review in both state cases. Proceedings in *Mandel* are stayed pending the outcome of *Boehr*; Plaintiff's opening brief in *Boehr* was filed May 9, 2003. On



August 13, ABA and two co-sponsors filed amici brief in *Boehr* contending that the Federal Arbitration Act requires that arbitration clauses be enforced as written, preempting any state law or court decision to the contrary. *Boehr* still pending and *Mandel* still stayed.

4. Strand v. U.S. Bank N.A. North Dakota (S. Ct. N. Dak. No. 20040068). In class action litigation over alleged late posting of payments to credit card accounts, U.S. District Court for the Central District of California certified two questions to the North Dakota Supreme Court: (1) Whether an arbitration clause that prohibited classwide dispute resolution was unconscionable under North Dakota law and (2) If so, whether the remainder of the arbitration clause in a credit card agreement was enforceable. The consumers' opening brief was filed April 26, 2004. The bank's brief and a supporting amici brief by ABA and the North Dakota Bankers Association were filed June 25. Reply brief filed on July 23, 2004. Oral argument held September 8.

#### CONSUMER PROTECTION

\* 5. Koons Buick Pontiac GMC v. Nigh (S. Ct. No. 03-377). In February, 2000, a used vehicle transaction went horribly awry, resulting in litigation by the buyer/borrower against the vehicle dealer/lender for violation of the Truth in Lending Act and numerous other claims. A jury awarded the plaintiff over \$24,000 in damages under the Truth in Lending Act. On appeal, the lender argued that there is a statutory cap on damages--twice the finance charge, but not to exceed \$1,000 (15 U.S.C. § 1640(a)(2)(A)). Nevertheless, on February 4, 2003, the Fourth Circuit affirmed, holding that since the 1995 amendments to the statute, that \$1,000 cap applied only to certain consumer lease arrangements. Prior circuit precedent had held the cap applicable to transactions of the sort at issue here as well, and there is no evidence of an actual Congressional intent that the cap would no longer apply. Notwithstanding that, Congress did what it did in 1995, and the court gave effect to the new "plain language of the statute" (4th Cir. No. 01-2201). Petition for writ of certiorari filed September 4, 2003. On October 14, ABA and two co-sponsors filed amici brief in support of the petition. The Court granted certiorari on January 20, 2004. On April 19, ABA and its cosponsors filed amici brief on the merits. Oral argument before the U.S. Supreme Court was held on October 5 and its opinion was issued on November 30, by an 8 to 1 vote with several concurring opinions in favor of the industry's position that the \$1,000 cap applied to more than consumer lease arrangements.

\* 6. Sola v. Washington Mutual Bank, F.A. (9<sup>th</sup> Cir. No. 04-55885). On April 26, 2004, the U.S. District Court for the Central District of California (CV 03-2566) dismissed a complaint filed on October 20, 2003, by a consumer class alleging a variety of Truth in Lending, Home Owners Loan Act, and Washington State law claims based on WAMU's promotional materials dealing with its overdraft protection options. Notwithstanding the promotional statements, "Don't worry, we'll cover you" and "Automatic Protection," the deposit account agreement and the monthly customer account statements preserved the ability of WAMU to exercise discretion in its payment of overdrafts. The district court granted WAMU's motion to dismiss after ruling that the overdraft charges were not "interest" under the HOLA and not "finance charges" under TILA. Plaintiffs appealed the dismissal to the Ninth Circuit on May 17, and a coalition of consumer

groups filed as amici on September 23, 2004. Defendant's brief due November 17. OTS filed an amicus brief on November 19; ABA and California Bankers Association filed an amicus brief on November 29.

7. McIntosh v. Irwin Union Bank & Trust Co. (1st Cir. No. 02-8022). On May 13, 2003, U.S. District Court for Massachusetts held, among other things, that borrowers seeking rescission of a loan for alleged Truth in Lending Act violations could proceed with their case as a class action (215 F.R.D. 26), and lender appealed. On September 23, Massachusetts Bankers Association, ABA and two other co-sponsors filed a motion for leave to participate in the appeal as amici curiae because of the immense practical consequences of allowing class-wide rescission. On October 9, however, the First Circuit refused to entertain an interlocutory appeal of the class certification order.

8. Wells Fargo Bank, N.A. v. Boutris (9th Cir. Nos. 03-16194, 16197, 16461). California law prohibits charging interest on residential first mortgages more than one day prior to the recording of a mortgage deed, even though the borrowed funds may have long since been disbursed. On January 27, 2003, national bank sued to enjoin investigation and enforcement of the statute by the state's Department of Corporations. The complaint alleged that only the Comptroller of the Currency may exercise visitorial powers over national banks and their separately incorporated nonbank subsidiaries, and that the prohibition in the law was preempted by the Depository Institutions Deregulation and Monetary Control Act of 1980, from which California had not "opted out." On May 9, 2003, court granted summary judgment to Wells Fargo, holding that the Comptroller has exclusive "visitorial" powers over national banks and their nonbank operating subsidiaries, and that the per diem statute was indeed preempted by DIDMCA (252 F. Supp. 2d 1065)(See also National City Bank of Indiana v. Boutris (E. D. Cal. No. S-03-0655 GEB JFM [May 7, 2003] and 2003 WL 21536818 [July 2, 2003]). Department of Corporations appealed to the Ninth Circuit (Case No. 03-16194) and final briefs were filed January 16, 2004. Motion for partial summary judgment filed January 23, 2004; motion considered February 23, 2004. Record on appeal transmitted to the Ninth Circuit on September 23, 2004.

Two "clones" of this case were filed in district courts elsewhere; one has been decided and oral argument was recently held in the other:

Wachovia Bank, N.A. v. Burke (D. Conn. No. 3:03 CV 0738 [JCH]) challenged Connecticut's requirement that a state-chartered nonbank mortgage subsidiary of a national bank to be licensed under rules applicable to other mortgage lenders. Wachovia filed a motion for summary judgment. ABA and other co-sponsors filed an amici brief supporting Wachovia on September 25, 2003. On May 25, court granted the motion, deferring to the Comptroller's interpretation of the "visitorial powers" provision of the National Bank Act as exclusive and preemptive. The Connecticut Attorney General filed a notice of appeal to the United States Court of Appeals for the Second Circuit on June 30. ABA and others filed an amici brief in support of Wachovia on November 8th.

Wachovia Bank, N.A., v. Watters, (W.D. Mich. Civil Action No. 5:03CV0105) was filed against the Commissioner of the Michigan Office of Financial and Insurance Services during the summer of 2003. A motion for summary judgment was filed in this case as well, and supporting amici briefs were filed by Consumer Mortgage Coalition, ABA and others on January 30, 2004. On August 30<sup>th</sup>, the Michigan Court granted the motion and ruled that the OCC's visitorial powers and the recently promulgated visitorial regulations were valid, thereby preempting the attempt by the Michigan Office of Insurance and Financial Services to exert supervisory authority over Wachovia's mortgage subsidiary. The court stated, "Although the state of Michigan maintains an interest in protecting its citizens, those compelling policy reasons do not undermine the reasonableness of the OCC's regulation." Wachovia's motion for damages pursuant to 42 U.S.C. 1983 was denied. Appeal to the Sixth Circuit filed in early October.

9. Bankwest v. Baker. (11th Cir. No. 04-12420 CC). Georgia legislature enacted statute, scheduled to go into effect May 1, 2004, that generally makes payday lending unlawful as it is now practiced in the state. The law recognizes that the state cannot apply its usury laws to out-of-state lenders exporting their home state interest rates to Georgians, but it takes pains to apply the new law to nonbank "agents" of out of state lenders where the "agents" have the "predominant economic interest" in an individual transaction. Four state chartered banks from South Dakota and Delaware filed suit alleging that the state law was preempted by the Federal Deposit Insurance Act that protects the right of state-chartered banks to export interest rates. The court granted a two-week temporary restraining order against enforcement of the act, but on May 13, 2004, denied a motion for a preliminary injunction, holding that the banks had no likelihood of success on the merits of their claims (N.D. Ga. No. 1:04-CV-988-MHS). The banks were granted an expedited appeal to the 11th Circuit and filed briefs June 16, 2004. Oral argument was held on July 21.

10. Bank One v. Wilens (C.D. Cal. No. SACV 03-01258 JVS (ANx)). California law requires that certain disclosures be made in connection with a bank's offering of "convenience checks" to customers. Wilens filed suit against the bank in state court to enforce this obligation even though she had and alleged no personal harm arising from the charged noncompliance. California law permits such a suit as a "private attorney general" acting on behalf of the general public. Bank One, in turn, filed suit in federal court to enjoin any such state court litigation on the grounds that it would constitute in essence an enforcement action, and that is a matter left by federal law exclusively to the Comptroller of the Currency under the "visitorial powers" provision of the National Bank Act. In October, 2003, the court issued a tentative order denying the defendant's motion to dismiss the bank's complaint as barred by the Anti-Injunction Act and granting the bank's motion for summary judgment. (See also, Bank One v. Wilens, 2003 WL 21703629 (C.D. Cal., July 8, 2003).)

11. Karis House, et al. v. Bank of America (C.D. Cal. No. CV 04 2898). A new twist in the check cashing fee cases, Bank of America has been sued, not over the charging of a fee to cash checks for noncustomers, but rather because it failed to disclose to employers that a fee would be charged and that the employers using Bank of America to issue payroll checks would be in violation of a California labor law provision that prohibits charging a worker for access to his or her

wages. Bank of America filed to remove the case to federal court on diversity and federal question jurisdiction. The federal judge, after scheduling and canceling a hearing on the federal jurisdiction question, rejected Bank of America's arguments and returned the case to state court. The case is awaiting assignment.

12. Riley v. Fleet National Bank (D. Mass. No. 03-10123 NGJ). On January 23, 2003, a class action suit was filed by Social Security recipients claiming that it was a violation of the anti-alienation provisions of the Social Security Act for a bank, exercising its general contractual right of setoff, to take funds from the bank accounts of the plaintiffs in satisfaction of overdue loan payments when the source of the funds in the accounts were only monthly Social Security benefits. Matter has been dismissed with prejudice.

\* In a similar case, Miller v. Bank of America, (Cal. Super., San Francisco County. No. 301917) a state judge, specifically disregarding the controlling Ninth Circuit precedent, Lopez v. WaMu, 302 F. 3d 900, instructed a jury that Social Security benefits could not be taken by setoff to cover overdrafts and associated fees. On February 25, 2004, the jury found the bank in violation of the state's unfair business practices act for doing so and awarded \$75 million in damages plus \$1,000 for each of an estimated 1.1 million class members. On April 1, the plaintiff filed a motion for an injunction against any continuation of Bank of America's practices in this respect. ABA and several co-sponsors filed amici brief on May 7 opposing that motion and the U.S. Justice Department filed a "Statement of Interest" on behalf of the United States, likewise opposing the motion. Oral argument was held on May 19. The court issued a Tentative Statement of Decision on October 13, 2004, finding against Bank of American on all counts and awarding restitution in the amount of \$284,385, 741 representing NSF fees paid to a class of Bank of America customers in California who received directly deposited social security benefits (and other government benefits) anytime after August 14, 1994. In addition, each class member would receive \$1,000 under the California Consumer Legal Remedies Act. Parties contesting the ruling would be required to file their objections by November 4 and the hearing set for November 30 has been moved to December 8.

13. Smith v. Chrysler Financial Co., L.L.C. (D. N.J. Civil Action No. 00-6003). Auto dealers originate and technically make loans to customers, then immediately assign such loans to captive finance company. Finance company sets a "buy rate," the lowest interest rate at which it will take a dealer-originated loan. The dealer is free to originate loans at a higher rate than that, with the dealer and finance company then splitting the difference. African-American borrowers alleged disparate treatment by a dealer in violation of the Equal Credit Opportunity Act in that African-Americans ended up paying disproportionately greater discretionary finance charges and higher rates than otherwise identically situated white borrowers. Finance company, though it did not originate or make the loans, was also named as a defendant. ABA and three co-sponsors filed an amici brief on April 17, 2001, arguing, among other things, that assignees of dealer paper are specifically excluded from the definition of "creditor" in the Equal Credit Opportunity Act in the absence of knowledge of discrimination. See also Jones v. Ford Motor Credit Co., 2002 WL 88431

(S.D.N.Y., January 22, 2002) (allegation that Ford "authorized subjective markups" having a disparate impact was sufficient to state a claim under ECOA).

14. Schwartz v. Visa International (Alameda Co. [Cal.] Super. Ct. No. 822404-4). On April 7, 2003, a state court ordered Visa and MasterCard to amend their respective rules and regulations to assure "full and effective disclosure" of currency conversion fees charged to customers who incur debts denominated in something other than U.S. dollars, and to make restitution to customers charged such a fee since February, 1996. Similar cases have been filed in state courts in eight other states. Visa and MasterCard currency conversion fees are also challenged on antitrust grounds in a case before the Southern District of New York (In re: Currency Conversion Fee Antitrust Litigation, MDL No. 1409) where the court, in July, 2003, denied a motion to dismiss the complaint. American Express is defendant in a series of similar cases in the Southern District of Florida.

15. Department of Legal Affairs v. Lehman Commercial Paper (Broward Co. [FL] Cir. Ct. No. 0310116). In June, 2003, state Attorney General filed suit alleging that First Alliance Mortgage Co. engaged in predatory lending practices through unfair and deceptive trade practices and through fraud in violation of state law. According to the complaint, First Alliance could not have done so but for financing provided by Lehman Commercial which actually knew or should have known of First Alliance's practices. The complaint seeks an injunction against Lehman Commercial's engaging in financing activities for *any* mortgage or consumer lender in Florida, and for actual damages to consumers, punitive damages, civil penalties, costs and attorney's fees.

16. People of the State of New York v. First Horizon Home Loan Corp. (S.Ct. of N.Y. [Albany County] Index No. 272-04). On January 20, 2004, Attorney General of New York filed Complaint against an operating subsidiary of a national bank for alleged violations of state's General Business Law. The Complaint alleges that mortgage borrowers carried out the terms of their 25-year mortgage, but that the defendant (who had acquired the loan from the original lender) refused to release the lien and required additional payments. It seems the original lender had miscalculated the monthly P&I payment by about \$16 in favor of the borrower, and the acquiring lender wished to recover the 25 years accumulated shortfall. The lender's efforts are said to violate the GBL, which makes it unlawful for a creditor to assert a claim that it knows does not exist, and makes it unlawful to commit deceptive acts and practices. Answer filed February 20, 2004.

A week before the complaint was released, the Comptroller of the Currency published a final rule in the Federal Register in which he claimed that the National Bank Act granted him exclusive visitorial powers over national banks and their nonbank operating subsidiaries, so as to preclude state authorities from enforcing state laws against them (69 Fed. Reg. 1895 [January 13, 2004]). The state Attorney General's action here is admittedly a test case designed to challenge the validity of the Comptroller's rule in a concrete setting (and in a state court rather than a federal court). The lender and the borrower have resolved the dispute between them extra-judicially.

## CREDIT UNIONS

17. American Bankers Association v. National Credit Union Administration (D. Utah, No. 2:03cv00621 JTG). On July 15, 2003, ABA, Utah Bankers Association and four member banks sued the regulator of federal credit unions for its approval of a six-county area of northern Utah, containing 1.4 million people and two distinct Standard Metropolitan Statistical Areas, as a "local well defined community" and authorizing three federal credit unions to serve that "community." The bankers contend that it is an abuse of discretion, in light of the actual facts, to find that the area in question is a single community in which the residents interact and share common interests. The three credit unions in question and three credit union trade groups moved to intervene as parties in the case and the defendant agency has filed an answer to the complaint. On February 11, court refused to allow plaintiffs to conduct even limited discovery, concluding that review was limited to the administrative record--which had not yet been filed. ABA brief on the merits of the case filed May 7. NCUA reply filed July 13, 2004. ABA reply brief filed August 6; oral argument was held October 7.

18. Postal Community Credit Union v. Commissioner of Banks (2004 WL 1657584). A state appeals court has upheld a lower court ruling banning Postal Community CU from converting to a mutual savings bank. In its ruling, the court stated the state Division of Banking ruled properly when it said state law prohibits credit union conversions to mutual savings bank. The \$120 million credit union had sought the charter switch because of a declining field of membership.

## POSTAL

19. Rate and Service Changes to Implement Functionally Equivalent Negotiated Service Agreement with Bank One Corporation (Postal Rate Commission Docket No. MC2004-3); Rate and Service Changes to Implement Functionally Equivalent Negotiated Service Agreement with Discover Financial Services, Inc. (Postal Rate Commission Docket No. MC2004-4). In June, 2004, the Postal Service filed requests with the Postal Rate Commission for Negotiated Service Agreements "NSAs" with Discover and Bank One which are "functionally equivalent" with the NSA previously approved with Capital One. This NSA gave Capitol One increased postage worksharing discounts in exchange for increased efforts to reduce the Postal Service's costs associated with undeliverable-as-addressed mail and increased volumes of First-Class Mail. ABA intervened in these cases in support of the banks and expedited consideration of these requests. The Discover and Bank One NSAs are the first functionally equivalent NSAs and their approval is expected to pave the way for other mailers seeking to take advantage of this type of proceeding to reduce their own postage costs. In September, ABA filed a brief in each case urging the PRC to approve the requested NSAs. On September 30, the Postal Rate Commission issued an Opinion and Recommended Decision approving the Discover Financial Services NSA. The Commission's decision will go to the Board of Governors of the Postal Service for final action. In the Bank One NSA, ABA joined the negotiated, proposed settlement that will be considered by the Commission in the near term.

## PRIVACY

20. Mainstream Marketing Services Inc. v. Federal Trade Commission (S. Ct. No. 03-1552). Association representing telemarketers filed suit on January 29, 2003, challenging FTC's creation of a national "do not call" list, contending that it violates First and Fifth Amendment rights, is in excess of statutory authority and is arbitrary and capricious. A companion case was filed the same day by the Direct Marketing Association in federal district court in Oklahoma City (U.S. Security v. FTC, W.D. Okla. No. 03-122-W). On September 23, 2003, the Oklahoma federal court held that the FTC lacked the statutory authority to adopt, implement and enforce the do not call rule. That outcome was changed by legislation that was introduced, passed by both houses of Congress and signed by the President in six days. On September 25, however, the Colorado federal court held the do not call rule unconstitutional as a violation of the First Amendment in that the rule exempted charities, politicians and some others while binding commercial callers. (D. Colo. No. 03-N-184).

The Federal Communications Commission adopted a rule complementary to the FTC's so as to cover certain industries (such as our own) not subject to FTC jurisdiction. On July 28, 2003, a Petition for Review of that rule was filed. American Teleservices Association v. FCC (10th Cir. No. 03-9571). On September 26, the court denied a request for a stay of that rule, holding that the telemarketers had not demonstrated a sufficient likelihood of success on the merits to warrant a stay. On September 29, the Circuit Justice (Breyer) declined, on behalf of the Supreme Court, to disturb that holding. Thus the FCC rule went into effect as scheduled on October 1, 2003, though the FTC rule on which it was premised in the first place did not. The Colorado federal court said, also on September 29, that the FTC would be in contempt if it shared its do not call list with the FCC. The FTC appealed that to the Tenth Circuit on September 30. On October 7, the Tenth Circuit issued a stay of the district court's permanent injunction, holding that the balance of harms tipped ever so slightly in favor of the FTC and that the FTC had shown a sufficient likelihood of success on the merits to warrant the stay (345 F. 3d 850). The FTC announced that it would begin enforcement immediately. On February 17, 2004, the court issued an opinion in four consolidated cases upholding the constitutionality and statutory authority for the list as a narrowly tailored method of pursuing the important governmental interests of protecting its citizens' privacy in their own homes and at their own instigation. The fact that the list did not bar charitable or political calls does not change the result. "Underinclusiveness" is a First Amendment problem only if it results in an effort that is so insignificant as to be hardly worth the effort--clearly not the case here (358 F. 3d 1228). Petition for writ of certiorari filed May 14, 2004. On October 4, 2004, the U.S. Supreme Court denied certiorari.

21. American Bankers Association v. Lockyer. (9th Cir. No. 04-16334). California statute, colloquially known as SB 1, scheduled to go into full effect on July 1, 2004, regulates the sharing of customer information among affiliates in ways that are inconsistent with federal requirements. Subsequent to passage of SB 1, federal Congress enacted the FACT Act amendments to the Fair Credit Reporting Act, making permanent the earlier temporary preemption of state laws governing the subject matter. Nevertheless, the state law remained on the books. On

April 19, 2004, ABA and other parties filed suit for a declaratory judgment and an injunction against enforcement of the state law on the grounds of preemption by FCRA. On June 30, the court granted summary judgment to the defendants. The FCRA is limited to the regulation of "consumer reports," allowing states to enact "privacy" statutes governing other things, as SB 1 does here. Despite the plain language of the statute, FCRA does not preempt the state affiliate sharing law (E.D. Cal. No. Civ. S-04-778 MCE). A notice of appeal was filed July 2, and a motion for expedited consideration of the appeal filed with the state's support. The Court of Appeals for the 9th Circuit granted the motion for expedition. Plaintiffs filed their brief on August 2; amici filings in support of plaintiffs were filed on August 9. Among the amici filing in support of the plaintiffs were the federal banking regulators, the NCUA, and the FTC. California filed its brief August 31, and the reply brief of plaintiffs was filed on September 15. Oral argument is scheduled for December 6.

22. New York State Bar Association v. Federal Trade Commission (D.D.C. No. 1:02cv00810). Gramm-Leach-Bliley Act requires "financial institutions" to disclose privacy policies to their clients and establishes civil sanctions of up to \$10,000 per violation for failure to do so. By FTC's definition, "financial institution" is one that provides services to clients that are "financial activities." Arguably, that would include attorneys engaged in tax planning, estate planning, real estate closings and bankruptcy, although there is little doubt that Congress had no such thing in mind when it enacted the law. Bar association sought an exemption from FTC's privacy rules for such attorneys or at least an interpretation of the law or regulations to the effect that it did not apply to attorneys. FTC refused to provide any guidance on the subject one way or the other. On April 29, 2002, the association filed suit claiming that the agency's unwillingness to grant an exemption was arbitrary and capricious. The American Bar Association filed essentially the same lawsuit in the same court in September, 2002. The two cases were consolidated. The court denied a motion to dismiss the complaints on August 11, 2003, finding that "it does not appear that Congress intended for the privacy provisions of the GLBA to apply to attorneys." On April 30, 2004, the court granted summary judgment to the bar associations, essentially incorporating by reference the earlier opinion. Having now had the benefit of viewing the administrative record that was not before the court at the time of the earlier ruling, the court found no reason to change its original inclination. A comparable case in North Carolina (North Carolina Bar Association v. Federal Trade Commission [E.D. N.C. No. 5:02cv941]) remains pending.

23. American Council of Life Insurers v. Vermont Department of Banking (Washington County [VT] Superior Ct. No. 56-1-02 Wncv). In November, 2001, state regulator of banking, insurance, securities and healthcare administration promulgated regulations, effective February 15, 2002, that purports to govern the disclosure of nonpublic personal financial and health information about individuals by Vermont licensees subject to the Commissioner's jurisdiction to non affiliated third parties. On January 30, 2002, five insurance trade associations filed suit contending that there is no state law that grants power to the Commissioner to issue regulations governing this subject matter, at least as to the insurance business, and that therefore the regulations are in excess of her statutory authority. On February 12, 2004, trial court denied the trade associations' motion for summary judgment and granted summary judgment to the Commissioner. The generality and



expansive nature of the rulemaking authority granted the Commissioner by statute was sufficient to justify this particular rule even though no specific mention of authority to adopt rules in this area is made in the statute.

## PRODUCTS & SERVICES

24. Massachusetts Bankers Association v. Bowler (D. Mass. No. 03 CV 11522 JLT). In February, 2003, the First Circuit dismissed a Petition for Review filed by the Massachusetts Insurance Commissioner challenging a determination by the Comptroller of the Currency that various provisions of the Commonwealth's insurance statutes were preempted with respect to national banks by the Gramm-Leach-Bliley Act. The court held that there was no justiciable controversy presented by that Petition since the Comptroller's determination did not have and was not intended to have the force and effect of law. The decision left unresolved the question of whether the provisions of the statute at issue applied to the banks or not. On August 13, 2003, Massachusetts Bankers Association and eight individual institutions filed suit against the insurance commissioner for a declaratory judgment to the effect that those same provisions of the statute were indeed preempted by the federal law. ABA and four cosponsors filed an amici brief on March 19 supporting the MBA's motion for summary judgment. Oral argument held April 27.

25. Fidelity National Information Solutions v. Sinclair (3d Cir. No. 04-2237). Pennsylvania law, 63 P.S. §§ 457.1, et seq., requires appraisals in non-federally related transactions, and requires that such appraisals be performed by Pennsylvania board-certified appraisers. Fidelity National provides, and sells to lenders, a comparatively inexpensive, largely automated "evaluation" of the value of properties that are to serve as security for mortgages. On August 26, Fidelity filed suit to enjoin enforcement of the Pennsylvania law, alleging that federal law and regulation specifically allows the use of something less than a full-blown appraisal under certain circumstances (e.g. mortgage loans of less than \$250,000), and that that federal law preempts contrary state law. In September, 2002, the Pennsylvania Bankers Association, on behalf of its members who would be deprived of a valuable product by virtue of the Board's enforcement actions, joined the case as a named plaintiff. On February 19, 2003, ABA joined suit as a plaintiff on behalf of its non-Pennsylvania members to allege that Pennsylvania law constituted an undue burden on interstate commerce as well. On March 31, 2004, court issued a split decision, holding that FIRREA preempted state law with respect to "federally-related" transactions, but not with respect to non-federally related real estate loans (E.D. Pa. No. 02-6928). Notice of Appeal filed by plaintiffs on April 30. On September 16, 2004, the parties filed an uncontested motion to refer the case to mediation and suspend the briefing schedule. On November 24, a Stipulation of Voluntary Dismissal of Cross-Appeals was filed.

26. American Land Title Association v. Radian Group (Cal. Super., Orange County, Case No. \_\_\_\_\_). Under California state law, it is illegal to sell title insurance in the state without being licensed, and any insurer which transacts any class of insurance other than title insurance anywhere in the United States is ineligible for a title insurance license. Radian Group is a private mortgage insurer that sells, among other things, a "lien protection program" to residential

mortgage lenders. The lien protection program is said to accomplish essentially the same goals as traditional title insurance, but is sufficiently different in its structure so as to fall outside the definition of "title insurance." Being unimpressed by the fine points, the trade association for title insurers filed suit in late November, 2001, contending that Radian was engaged in the unlicensed and illegal sale of title insurance in California. On June 20, 2002, the California Department of Insurance, in a separate proceeding, concluded that the lien protection program was, indeed, title insurance, and issued a cease and desist order to Radian. Several other state insurance commissioners have reached the same conclusion. On April 15, 2003, however, the California Insurance Commissioner rejected his Department's conclusions and, while leaving the ban temporarily in place, called for the taking of additional evidence and legal argument. On July 22, the Commissioner released his decision after the consideration of the additional materials, and elected to affirm the original Department decision.

27. Kruse v. Wells Fargo Home Mortgage, Inc. (2<sup>nd</sup> Cir. No. 03-7665). Decided by the Second Circuit on September 10<sup>th</sup>, the court ruled against Wells Fargo and the case was returned to the district court for further action based on a finding of deference for HUD's policy statement interpreting Section 8 of RESPA. In particular, the class action plaintiffs alleged that Wells violated Section 8 because it charged excessive and unreasonable fees for settlement services provided directly by Wells, and "marked up" settlement services fees when provided by a third party. On the first issue, the court found in favor of Wells. On the second issue, the "mark up" of third party services, the Court afforded HUD's policy statement on Section 8 *Chevron* deference and held that RESPA applied to mark ups. The Second Circuit returned the case to the district court for further proceedings on whether Wells provided any additional services supporting the mark up of third party fees. A motion for rehearing has been filed and ABA joined with other financial trade association in filing October 1 a brief in support of Wells Fargo Home Mortgage.

#### TRUST

28. Tittle v. Enron (S.D. Tex. No. H-01-3913). Among the myriad of issues to be litigated in this massive consolidated *Enron* case is the question of any responsibility for the fiasco that directed trustees might have. These are the financial institutions that held the Enron employees' savings plans while the value of those plans, largely invested in Enron stock, plummeted, and during a "lockout period," during which employees were not permitted any transactions within their respective plans. The trustees have moved to dismiss complaints as to them on the grounds that their status, duties, responsibilities and liabilities as directed trustees were specifically recognized and governed by ERISA, and that they lacked the legal and contractual capacity to conduct themselves in any fashion other than the way they did in this case. On August 30, 2002, the Secretary of Labor filed an amicus brief opposing the motions to dismiss, seeking to impose upon directed trustees a higher duty than has previously been recognized for them. In October, ABA filed amicus brief addressing only the Secretary's arguments, pointing out that they were unsupported by statutory language and contradicted by legislative history. On September 30, 2003, the court refused to dismiss out the trustees, adopting the Secretary of Labor's view of the case.

## MISCELLANEOUS

29. Federal Deposit Insurance Corporation v. Ernst & Young. (7th Cir. No. 03-2619). When Superior Bank, FSB, an insured institution, failed, FDIC was appointed receiver. It proceeded to file a complaint *in its corporate capacity* against the bank's auditor for gross negligence, fraud and accounting malpractice for having blessed a variety of accounting methods that had enabled Superior to exaggerate its financial condition. On April 15, the court dismissed the suit holding that FDIC lacked standing to sue in its corporate capacity. Had the agency filed the suit in its capacity as receiver, it would have been bound by a mandatory arbitration clause and waiver of punitive damages in the contract between E&Y and Superior Bank (in whose shoes FDIC as receiver would stand) (N.D. Ill. No. 02 C 7914). On July 8, 2004, a three-judge panel of the U.S. Court of Appeals for the Seventh Circuit in Chicago upheld a lower-court ruling that the FDIC could not bring its suit against Ernst & Young in its corporate capacity. Controversy is now in arbitration.

30. King v. First Capital Financial Services. (S. Ct. Ill. Nos. 97263 & 97761). This is a consolidation of about 38 separate lawsuits in which plaintiffs seek to recover document preparation fees assessed by mortgage lenders. The claim is that preparing mortgage documents is the practice of law, but the persons actually preparing the documents are not lawyers and therefore cannot lawfully charge "legal fees." Lower courts have dismissed all the cases on various grounds but the state Supreme Court has agreed to review those decisions. On July 2, 2004, ABA, Illinois Bankers Association, Consumer Mortgage Coalition and five other cosponsors filed amici curiae brief contending that parties to any transaction are free to use non-lawyers to prepare paperwork that is for their own use and benefit. Oral argument held September 28, 2004.

31. Kitson v. Bank of Edwardsville (Ill. App. 5th Dist. No. 5-04-0199). In a series of commercial promissory notes, bank specified a particular interest rate and disclosed that the interest would be calculated on a 365/360 basis. Borrower filed suit claiming that the 365/360 method resulted in an actual interest rate that was .138% above the stated rate and the discrepancy was a violation of the Illinois Consumer Fraud and Deceptive Business Practices Act. Trial court certified the case as a class action and denied the bank's motion for judgment on the pleadings. On application by the bank, the court certified questions to the Appellate Court for an interlocutory appeal. On March 25, ABA and Illinois Bankers Association filed a brief urging the Appellate Court to exercise its discretion in favor of granting the interlocutory appeal based upon the importance of the case to the industry at large. Most commercial loans calculate interest on the 365/360 basis and hundreds of thousands of such loans disclose that method of calculation in language identical to that used in the notes at issue here. The court granted leave for the appeal on April 16; opening briefs, including an amici brief on the merits by ABA and IBA filed May 21. Oral argument was not requested and the case will be submitted for advisement on October 18, 2004.

32. Pioneer Commercial Funding v. American Financial Mortgage Corp. (S. Ct. Pa. No. 279 EAL 2002). American Financial was indebted to CoreStates by reason of a series of overdrafts. When a wire transfer of funds arrived in the American Financial deposit account at CoreStates, the bank applied it to offset the debt. Pioneer, which had a series of dealings with American Financial, claimed that the wire-transferred funds actually belonged to it, instead, and that the funds had been wired to the American Financial account in error. They should have been wired to Pioneer's account in another bank. CoreStates declined to reverse the offset and Pioneer sued. A jury awarded actual, consequential and punitive damages against the bank and the bank appealed. Pennsylvania Superior Court affirmed on most issues, but vacated the punitive damages award and remanded for a new trial on that issue (797 A. 2d 269). The bank sought allowance from Pennsylvania Supreme Court to appeal. On January 26, 2004, ABA and Pa. Bankers Association filed amici brief urging reversal based upon the bank's correct adherence throughout the transaction to UCC Article 4A. Oral argument held April 13. On August 19<sup>th</sup>, the Supreme Court of Pennsylvania reversed the Superior Court's ruling and found in favor of CoreStates and dismissed the need for any further proceedings.

33. National Union Fire Insurance Co. v. Manufacturers & Traders Trust Co. (4<sup>th</sup> Cir. No. 03-2276). On August 12<sup>th</sup>, the ABA and the Maryland Bankers Association filed an amici brief in the case concerning liability for check fraud and the duty owed by a bank to investigate when opening a new account. The insurance company sued to recover monies deposited in the bank (and quickly withdrawn) that were the result of embezzlement through the issuance and payment of fraudulent purchase orders for which legitimate checks were issued. The checks were used to open the accounts. The defendant bank argued that at the time the accounts were opened, the bank properly followed the requirements of the UCC. The lower court agreed. On appeal, the insurance company asserted that a higher duty to investigate entities opening new accounts was required under the UCC asserting, notwithstanding the fact that the checks were validly issued and not forged or altered, that the forged or altered duty standard should apply. The amici brief filed highlighted the standard of care in place at the time of the transactions and urged the court not to apply the more recent Patriot Act standards. Oral argument tentatively scheduled for February 2005.

\* 34. Wachovia v. Schmidt (4<sup>th</sup> Cir. No. 03-2061). On November 1, the 4<sup>th</sup> Circuit determined that Wachovia, a national bank, was located for purposes of diversity jurisdiction in any state in which it has branches and remanded the underlying case to state court for consideration. The plaintiff raised the issue of diversity jurisdiction for the first time on appeal from a district court denial of Wachovia's petition to compel arbitration of claims. The decision is in marked contrast to decisions in the Fifth, Seventh, and Ninth Circuits. Petition for rehearing filed November 15; OCC filed an amicus brief in support of the motion for rehearing on November 29.

#### CALENDAR

December 6

Oral argument in ABA v. Lockyer (SB 1)

December 8

Hearing in Miller v. Bank of America

February 2005

Oral argument in Nat'l Union Fire Ins. Co. v. M&T Trust Co.

**THE CURRENT LEGAL ISSUES  
INVOLVED IN OVERDRAFT PROTECTION PLANS**

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**SECTION C**

**UNIVERSITY OF KENTUCKY**

**ANNUAL CONFERENCE ON LEGAL ISSUES FOR FINANCIAL INSTITUTIONS**

**APRIL 15, 2005**

**THE CURRENT LEGAL ISSUES INVOLVED IN OVERDRAFT PROTECTION PLANS**

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**THE CURRENT LEGAL ISSUES  
INVOLVED IN OVERDRAFT PROTECTION PLANS**

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## Overdraft Protection Programs

### **I. Overdraft Protection Programs - Generally**

#### **A. Lines of Credit or Linked Accounts**

#### **B. Discretionary, Ad-hoc Evaluation**

1. NSF fees not finance charges.
2. Fees the same whether honored or returned.
3. Subject to disparate treatment.

#### **C. Automated Evaluation – Undisclosed**

1. Efficient.
2. Fair.

#### **D. Disclosed Discretionary “Bounce” Protection**

1. Fee income.
2. Packaged programs (technology, legal analysis, marketing, customer communication).

#### **E. Disclosed Protection**

1. Communicated to customers as a discretionary deposit service with an aggregate limit – Typically \$100 to \$700.
2. Communications concerning overdraft protection programs.
  - a. Conservative communication – account disclosure agreement.
  - b. Moderate communication – explanatory announcement letter.
  - c. Aggressive communication – mass media advertising.
3. Coverage is essentially automatic if certain criteria are met such as time account has been opened and regularity of deposits.
4. Service covers checks, debit cards, pre-authorized automatic debits, ATM withdrawals, telephone and internet transactions, etc.
5. Flat fee whether or not overdraft item paid (daily fee?).
6. Closed end loans to customers who fail to bring account positive within a certain time – often 60 days.

### **II. Concerns/Consumer Group Criticism**

- A. It takes unfair advantage of unwary customers and encourages irresponsible banking habits.**
- B. Predatory Lending – Overdraft protection amounts to a form of short-term, high cost credit.**
- C. Deceptive marketing practices – Overdraft protection programs are intentionally deceptive and predatory.**
- D. Consumers with frequent overdrafts.**

### **III. Customer Reactions to Overdraft Protection Programs**

#### **A. Customer Reactions**

1. Little or no embarrassment.
  2. No merchant fee in addition to bank fees.
  3. No adverse credit report.
- B. Wide Acceptance.**  
Over 2000 Institutions offer some variety of an overdraft protection program, mostly smaller community or independent banks.

**IV. Fundamental Tensions.**

- A. Deposit Service or Extension of Credit.**
- B. Inadvertence or Credit Decision.**
- C. Fee or Interest/Finance Charge.**
- D. Service Relationship or Irresponsibility (cold checks).**
- E. Meaningful Explanations or Fine Print.**

**V. Brief Legal Analysis. (For a more detailed Legal Risks Analysis see Exhibit 4.)**

- A. Truth in Lending Act and Regulation Z**
1. Require certain disclosures such as APR in certain consumer credit transactions.
  2. For Regulation Z to apply to a transaction the credit must (a) be subject to a finance charge or (b) be payable by written agreement in more than four installments.
  3. NSF fees are not "finance charges" if the same fee is charged for both honored and dishonored overdraft items.
- B. Equal Credit Opportunity Act and Regulation B**
1. Prohibit discrimination in credit transactions.
  2. Require adverse action notices.
  3. NSF fees in programs not covered by Regulation Z would generally qualify as "incidental" credit under Regulation B and not require an adverse action notice.
  4. Age discrimination when protection limits differ for accounts marketed to senior citizens under 62.
- C. Truth in Savings Act and Regulation DD**
1. Deposit account disclosures must include fee amounts and conditions.
  2. Require advance notice of adverse account changes.
  3. Prohibit misleading statements.
- D. Electronic Fund Transfer Act and Regulation E**
1. Require monthly statements if EFT transaction has occurred such as ATM withdrawal or point-of-sale debit card transaction.

2. Statements must be accurate and understandable.
- E. Federal Trade Commission Act and Unfair or Deceptive Acts or Practices – Enforceable by Federal Agencies**  
Advertisements or other account disclosure representations must not be inaccurate or misrepresent the service being offered.
  - F. Fair Credit Reporting Act**  
Avoid adverse action notice by not relying on information from a consumer reporting agency in honor/dishonor decisions.
  - G. The Green Book**
    1. Guide for processing Federal ACH payments and collections.
    2. 30 day account closing notice.
  - H. State Laws concerning cold checks, usury and automatically deposited government checks.**
  - I. Regulation O includes overdrafts as an extension of credit – those covered may not participate.**
  - J. Regulation CC prohibits NSF fees if bank has increased time before funds available without notice to customer.**
- VI. Significant Overdraft Protection Litigation. (An analysis of the following two cases is attached hereto as Exhibit 3.)**
- A. Paul Miller individually and on behalf of all others similarly situated v. Bank of America.**
  - B. In Re Washington Mutual Overdraft Protection Litigation.**
- VII. Interagency Guidance on Overdraft Protection Programs. (A reproduction of the Joint Guidance on Overdraft Protection is attached hereto as Exhibit 1.)**
- A. The Interagency Guidance on Overdraft Protection Programs was issued on February 18, 2005 by The Office of the Comptroller of the Currency; The Board of Governors of the Federal Reserve System; The Federal Deposit Insurance Corporation; and The National Credit Union Administration.**
  - B. Safety and Soundness Considerations.**
    1. Written policies and procedures to address credit, operational and other risks.
    2. Reports detailing volume, profitability and credit performance.
    3. Overdraft balances charged off in 60 days unextended by repayment plan.
    4. Balances reported as loans and charge offs against ALLL.
    5. Rigorous loss estimation procedures.
    6. Available amounts reported as “unused commitments.”
    7. Risk based capital treatment with weighting according to obligor.
    8. Due diligence of third party vendors.

**C. Legal Risks**

1. Review by counsel prior to implementation.
2. Regulation Z definition of "finance charge" subject to review.
3. Institutions must avoid engaging in deceptive, inaccurate, misrepresentative or unfair practices, and closely review all aspects of their overdraft protection programs, especially any material that inform consumers about the programs.
4. When overdraft protection services are added to an existing account, advance notice to the account holder may be required, for example, if the fee for the service exceeds the fee for accounts that do not have the service.

**D. Best Practices.**

1. Marketing and Communications with Customers.
  - a. do not encourage routine or intentional overdrafts.
  - b. fairly present alternatives such as overline credit arrangements and train staff to explain such alternatives to customers.
  - c. explain discretionary nature of program.
  - d. do not promote "free" checking and overdraft protection programs at the same time.
  - e. clearly explain check clearing policies (processing order).
  - f. disclose type of transactions covered.
  - g. clearly disclose the dollar amount of the fee for each overdraft.
2. Program Features and Options.
  - a. election or opt out of program.
  - b. alert customer to overdraft on non check transactions or if not possible post notices on proprietary ATMs.
  - c. distinguish actual balances from overdraft availability.
  - d. notify customers of each overdraft event; program features with first use; and when terminated.
  - e. consider daily limits – number or \$ amount.
  - f. monitor excessive customer usage – inform of options.
  - g. fairly report to consumer reporting agencies and avoid negative info if overdrafts paid within program guidelines.

**E. Differences Between the Proposed and Final Guidance on Overdraft Protection (A side by side comparison of the Proposed and Final Guidance on Overdraft Protection is attached hereto as Exhibit 5.)**

1. The Proposed Guidance suggested that overdraft balances be charged off within 30 days from the date first overdrawn but the Final Guidance extended that time period to 60 days.
2. The Proposed Guidance asks that the financial institution describe the circumstances in which the institution would refuse to pay an overdraft but this suggestion is not in the Final Guidance.
3. The Proposed Guidance states that a financial institution should clearly disclose to consumers the order in which the institution pays checks or processes other transactions but this suggestion was removed from the Final Guidance.

**VIII. Office of Thrift Supervision – Guidance on Overdraft Protection. (A reproduction of the OTS Guidance on Overdraft Protection is attached hereto as Exhibit 2.)**

**A. The OTS Guidance on Overdraft Protection was issued on February 14, 2005 by The Office of Thrift Supervision.**

**B. Separate Final Guidance on Overdraft Protection.**

1. The OTS did not join in the Interagency Guidance on Overdraft Protection despite being a part of the Proposed Guidance that was published for comment.
2. The OTS choose to issue its own Guidance on overdraft protection on February 14, 2005 prior to the the Interagency's Guidance which was issued on February 18, 2005.

**C. Significant Differences Between the Interagency Guidance and the OTS Guidance. (A side by side comparison of the Interagency Guidance and the OTS Guidance is attached hereto as Exhibit 6.)**

1. The Interagency Guidance overtly states that "When overdrafts are paid, credit is extended." The OTS Guidance does not have a parallel statement to that effect.
2. The OTS Guidance does not contain a "Legal Risks" section. The OTS has not explained why it did not include a Legal Risks section.
3. A new provision was added to the "Best Practices" section which requests that savings associations not manipulate transaction clearing rules.
4. The OTS Guidance states that if canceling a transaction which would trigger an overdraft is not feasible for a particular type of transaction, then savings associations should allow consumers the option of limiting access to the overdraft protection program unavailable by transaction type, even if it results in limiting access to the overdraft protection amount only to check transactions.

**IX. Proposed Regulation DD Amendments. (A reproduction of the Proposed Regulation DD Amendements are attached hereto as Exhibit 7.)**

**A. Concern about uniformity and adequacy of overdraft fee disclosures and promoted automated "bounced-check proteciton services."**

**B. Monthly and year to date aggregate fee on statements.**

**C. Account opening disclosures to specify eligible transactions, whether check, debit card, ATM withdrawal, etc.**

**D. Advertisements to include:**

1. fees
2. covered transaction types
3. time to repay or cover
4. circumstances for non-payment of overdraft
5. exemption for billboards, broadcast media and telephone responses

**E. No Misleading advertisements, announcements or solicitations, which for example represent or describe program:**

1. as a "line of credit"
2. as honoring all overdrafts
3. as allowing indefinite negative balance
4. as applying solely to checks
5. as part of a "free" deposit account

**X. Guidelines as a Safe Harbor.**

## **EXHIBIT INDEX**

**Exhibit 1 – Final Joint Guidance on Overdraft Protection Programs**

**Exhibit 2 – Final OTS Guidance on Overdraft Protection Programs**

**Exhibit 3 – Significant Overdraft Protection Litigation**

**Exhibit 4 – Legal Risks Review for Financial Institutions**

**Exhibit 5 – Side by Side Comparison – Proposed and Final Joint Guidance**

**Exhibit 6 – Side by Side Comparison – OTS Guidance and Final Joint Guidance**

**Exhibit 7 – Proposed Regulation DD Amendments**





**EXHIBIT 1**

**FINAL JOINT GUIDANCE ON OVERDRAFT PROTECTION PROGRAMS**





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## Press Releases

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Joint Release

**Board of Governors of the Federal Reserve System  
Federal Deposit Insurance Corporation  
National Credit Union Administration  
Office of the Comptroller of the Currency**

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For Immediate Release  
FDIC-PR-11-2005

February 18, 2005

### Agencies Issue Final Guidance on Overdraft Protection Programs

The federal bank and credit union regulatory agencies today announced final joint guidance to assist insured depository institutions in the disclosure and administration of overdraft protection programs.

Depository institutions may offer overdraft protection programs to transaction account customers as an alternative to traditional ways of covering overdrafts. In response to concerns about the marketing, disclosure, and implementation of these programs, the agencies published for comment proposed interagency guidance on overdraft protection programs in June 2004. The final joint guidance responds to comments received by consumer and community groups, individual consumers, depository institutions, trade associations, vendors offering overdraft protection products, other industry representatives, and state agencies.

The final joint guidance contains three primary sections: Safety and Soundness Considerations; Legal Risks; and Best Practices. The safety and soundness discussion seeks to ensure that financial institutions offering overdraft protection programs adopt adequate policies and procedures to address credit, operational, and other associated risks.

The legal risks discussion alerts institutions of the need to comply with all applicable federal and state laws, and advises institutions to have their overdraft protection programs reviewed by legal counsel to ensure overall compliance prior to implementation. Several federal consumer compliance laws are outlined in the guidance.

The best practices section addresses the marketing and communications that accompany the offering of overdraft protection programs as well as the disclosure and operation of these programs. Some of these best practices include: avoiding the promotion of poor account management; providing a clear explanation of the discretionary nature of the overdraft protection program; clearly disclosing fees; explaining the impact of transaction clearing policies on the overdraft fees consumers may incur; and monitoring program usage. The agencies also advise insured depository institutions to distinguish overdraft protection services from "free" account features, to prominently distinguish balances from overdraft protection funds availability, and to alert consumers before a transaction triggers any fees.

The guidance is being issued by the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Office of the Comptroller of the Currency (OCC). It will be published shortly in the Federal Register.

The Federal Register notice is attached.

###

Attachment: [Joint Guidance on Overdraft Protection Programs - PDF 226k \(PDF Help\)](#)

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Last Updated 02/18/2005

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**DEPARTMENT OF THE TREASURY**

**Office of the Comptroller of the Currency**

**[Docket No. 05-03]**

**FEDERAL RESERVE SYSTEM**

**[Docket No. OP-1198]**

**FEDERAL DEPOSIT INSURANCE CORPORATION**

**NATIONAL CREDIT UNION ADMINISTRATION**

## **Joint Guidance on Overdraft Protection Programs**

**AGENCIES:** Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and National Credit Union Administration (NCUA).

**ACTION:** Final Guidance.

**SUMMARY:** The OCC, Board, FDIC, and NCUA (the Agencies), are issuing final Joint Guidance on Overdraft Protection Programs (guidance). This guidance is intended to assist insured depository institutions in the responsible disclosure and administration of overdraft protection services.

### **FOR FURTHER INFORMATION CONTACT:**

**OCC:** Michael Bylsma, Director, Margaret Hesse, Special Counsel, or Deana Lee, Attorney, Community and Consumer Law Division, (202) 874-5750; or Kim Scherer, National Bank Examiner/Credit Risk Specialist, Credit Risk Policy, (202) 874-5170.

**Board:** Minh-Duc T. Le, Senior Attorney, Daniel Lonergan, Counsel, or Elizabeth Eurgubian, Attorney, Division of Consumer and Community Affairs, (202) 452-3667; or William H. Tiernay, Supervisory Financial Analyst, Division of Bank Supervision and Regulation, (202) 452-2412. For users of Telecommunications Device for the Deaf ("TDD") only, contact (202) 263-4869.

**FDIC:** Mark Mellon, Counsel, (202) 898-3884, Legal Division; James Leitner, Examination Specialist, (202) 898-6790; Patricia Cashman, Senior Policy Analyst, (202) 898-6534; or April Breslaw, Chief, Compliance Section, (202) 898-6609, Division of Supervision and Consumer Protection.

**NCUA:** Elizabeth A. Habring, Program Officer, Office of Examination and Insurance, (703) 518-6392; or Ross P. Kendall, Staff Attorney, Office of the General Counsel, (703) 518-6562.

### **SUPPLEMENTARY INFORMATION:**

#### **I. Background**

The Agencies have developed this final joint guidance to address a service offered by insured depository institutions commonly referred to as "bounced-check protection" or "overdraft protection." This service is sometimes offered to transaction account customers as an alternative to traditional ways of covering overdrafts (e.g., overdraft lines of credit or linked accounts).

While both the availability and customer acceptance of these overdraft protection services have increased, aspects of the marketing, disclosure, and implementation of

some of these programs have raised concerns with the Agencies. In a 2001 letter, the OCC identified some of these particular concerns.<sup>1</sup> In November 2002, the Board sought comment about the operation of overdraft protection programs.<sup>2</sup>

In response to concerns raised about overdraft protection products, the Agencies published for comment proposed Interagency Guidance on Overdraft Protection Programs, 69 FR 31858 (June 7, 2004).<sup>3</sup> The proposed guidance identified the historical and traditional approaches to providing consumers with protection against account overdrafts, and contrasted these approaches with the more recent overdraft protection programs that are marketed to consumers. The Agencies also identified some of the existing and potential concerns surrounding the offering and administration of such overdraft protection programs that have been identified by federal and state bank regulatory agencies, consumer groups, financial institutions, and their trade representatives.

In response to these concerns, the Agencies provided guidance in three primary sections: Safety and Soundness Considerations, Legal Risks, and Best Practices. In the section on Safety and Soundness Considerations, the Agencies sought to ensure that financial institutions offering overdraft protection services adopt adequate policies and procedures to address the credit, operational, and other risks associated with these services. The Legal Risks section of the proposed guidance outlined several federal consumer compliance laws, generally alerted institutions offering overdraft protection services of the need to comply with all applicable federal and state laws, and advised institutions to have their overdraft protection programs reviewed by legal counsel to ensure overall compliance prior to implementation. Finally, the proposed guidance set forth best practices that serve as positive examples of practices that are currently observed in, or recommended by, the industry. Broadly, these best practices address the marketing and communications that accompany the offering of overdraft protection services, as well as the disclosure, and operation, of program features.

The Agencies together received over 320 comment letters in response to the proposed guidance. Comment letters were received from depository institutions, trade associations, vendors offering overdraft protection products, and other industry representatives, as well as government officials, consumer and community groups, and individual consumers.

## **II. Overview of Public Comments**

The Agencies received comments that addressed broad aspects of the guidance, as well as its specific provisions. Many industry commenters, for instance, were concerned about the overall scope of the guidance and whether it would apply to financial institutions that *do not* market overdraft protection programs to consumers but *do* cover

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<sup>1</sup> OCC Interpretive Letter 914, September 2001.

<sup>2</sup> 67 FR 72618, December 6, 2002. The Board received approximately 350 comments; most were from industry representatives describing how the programs work.

<sup>3</sup> The Office of Thrift Supervision joined the Agencies proposing the interagency guidance.



the occasional overdraft on a case-by-case basis. Commenters also addressed the three specific sections of the proposed guidance.

In regard to the Safety and Soundness section, for example, many industry commenters suggested extending the proposed charge-off period from 30 days to a longer period such as 45 or 60 days, in part because they believed a longer charge-off period would provide consumers with more time to repay overdrafts and avoid being reported to credit bureaus as delinquent on their accounts. Comments were also received addressing technical reporting and accounting issues.

The Agencies received numerous comments regarding the Legal Risks section – particularly the Equal Credit Opportunity Act and Truth in Lending Act (TILA) discussions. For instance, many consumer and consumer group comments stated that overdraft protection should be considered credit covered by TILA's disclosures and other required protections. Some of these comments likened the product to payday lending, which is covered by TILA. Many industry commenters argued against the coverage of overdraft programs by TILA and Regulation Z, and argued that the payment of overdrafts does not involve credit and finance charges requiring TILA disclosures and protections.

Lastly, many commenters also offered specific criticism or recommended edits with respect to particular best practices identified in the proposal. Several industry commenters sought general clarification on whether examiners would treat the best practices as law or rules when examining institutions offering overdraft protection services.

### **III. Final Joint Guidance**

The final joint guidance incorporates changes made by the Agencies to provide clarity and address many commenter concerns. In particular, language has been added to clarify the scope of the guidance. The Safety and Soundness section expressly states that it applies to all methods of covering overdrafts. The introduction to the Best Practices section clarifies that while the Agencies are concerned about promoted overdraft protection programs, the best practices may also be useful for other methods of covering overdrafts.

In response to the comments regarding the Safety and Soundness section, the Agencies have extended the charge-off requirement to 60 days.<sup>4</sup> Other technical edits have been made to further clarify reporting and accounting aspects of this section of the guidance.

The discussion regarding the applicability of TILA has been shortened to more closely focus on the relevant, existing regulatory provisions. In the proposed guidance, the discussion of TILA and Regulation Z, like the individual discussions of other laws

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<sup>4</sup> Federal credit unions are required by regulation to establish a time limit, not to exceed 45 calendar days, for a member to either deposit funds or obtain an approved loan from the credit union to cover each overdraft. 12 CFR § 701.21(c)(3).

and regulations (e.g., the Federal Trade Commission Act), was not intended to represent a full explication of the scope, terms, and exceptions to those provisions. Rather, it was intended to highlight that, commonly, fees charged in connection with overdraft protection programs and traditional methods of paying overdrafts fall within an existing regulatory exception to the “finance charge” definition. Disparate commenters urged the Board to take positions on various aspects of TILA and Regulation Z that are unnecessary in light of the exception addressed and the appropriate scope of the guidance. The revisions to this section, and the addition of language to the Safety and Soundness section to address the credit nature of overdrafts, is not intended as a commentary on the statute, nor the adoption of any particular commenter point of view. As indicated in the proposal, the existing regulatory exceptions were created for the occasional payment of overdrafts, and as such could be reevaluated by the Board in the future, if necessary. Were the Board to address these issues more specifically, it would do so separately under its clear authority.

Lastly, in the final joint guidance, the Agencies reaffirm that the best practices are practices that have been recommended or implemented by financial institutions and others, as well as practices that may otherwise be required by applicable law. The best practices, or principles within them, are enforceable to the extent they are required by law. In addition, as mentioned above, the final guidance explicitly states that while the Agencies are particularly concerned about promoted overdraft protection programs, these practices may be useful in connection with other methods of covering overdrafts. The Agencies have also revised numerous best practices for clarity, in response to particular commenter suggestions.

The text of the final Joint Guidance on Overdraft Protection Programs follows:

#### **Joint Guidance on Overdraft Protection Programs**

The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), and National Credit Union Administration (NCUA), collectively “the Agencies,” are issuing this joint guidance concerning a service offered by insured depository institutions that is commonly referred to as “bounced-check protection” or “overdraft protection.” This credit service is sometimes offered on both consumer and small business transaction accounts as an alternative to traditional ways of covering overdrafts. This joint guidance is intended to assist insured depository institutions in the responsible disclosure and administration of overdraft protection services, particularly those that are marketed to consumers.<sup>5</sup>

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<sup>5</sup> Federal credit unions are already subject to certain regulatory requirements governing the establishment and maintenance of overdraft programs. 12 CFR § 701.21(c)(3). This regulation requires a federal credit union offering an overdraft program to adopt a written policy specifying the dollar amount of overdrafts that the credit union will honor (per member and overall); the time limits for a member to either deposit funds or obtain a loan to cover an overdraft; and the amount of the fee and interest rate, if any, that the credit union will charge for honoring overdrafts. This joint guidance supplements but does not change these regulatory requirements for federal credit unions.

## Introduction

To protect against account overdrafts, some consumers obtain an overdraft line of credit, which is subject to the disclosure requirements of the Truth in Lending Act (TILA). If a consumer does not have an overdraft line of credit, the institution may accommodate the consumer and pay overdrafts on a discretionary, ad-hoc basis. Regardless of whether the overdraft is paid, institutions typically have imposed a fee when an overdraft occurs, often referred to as a nonsufficient funds or “NSF” fee. Over the years, this accommodation has become automated by many institutions. Historically, institutions have not promoted this accommodation. This approach has not raised significant concerns.

More recently, some depository institutions have offered “overdraft protection” programs that, unlike the discretionary accommodation traditionally provided to those lacking a line of credit or other type of overdraft service (e.g., linked accounts), are marketed to consumers essentially as short-term credit facilities. These marketed programs typically provide consumers with an express overdraft “limit” that applies to their accounts.

While the specific details of overdraft protection programs vary from institution to institution, and also vary over time, those currently offered by institutions incorporate some or all of the following characteristics:

- Institutions inform consumers that overdraft protection is a feature of their accounts and promote the use of the service. Institutions also may inform consumers of their aggregate dollar limit under the overdraft protection program.
- Coverage is automatic for consumers who meet the institution’s criteria (e.g., account has been open a certain number of days; deposits are made regularly). Typically, the institution performs no credit underwriting.
- Overdrafts generally are paid up to the aggregate limit set by the institution for the specific class of accounts, typically \$100 to \$500.
- Many program disclosures state that payment of an overdraft is discretionary on the part of the institution, and may disclaim any legal obligation of the institution to pay any overdraft.
- The service may extend to check transactions as well as other transactions, such as withdrawals at automated teller machines (ATMs), transactions using debit cards, pre-authorized automatic debits from a consumer’s account, telephone-initiated funds transfers, and on-line banking transactions.<sup>6</sup>

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<sup>6</sup> Transaction accounts at credit unions are called share draft accounts. For purposes of this joint guidance, the use of the term “check” includes share drafts.

- A flat fee is charged each time the service is triggered and an overdraft item is paid. Commonly, a fee in the same amount would be charged even if the overdraft item was not paid. A daily fee also may apply for each day the account remains overdrawn.
- Some institutions offer closed-end loans to consumers who do not bring their accounts to a positive balance within a specified time period. These repayment plans allow consumers to repay their overdrafts and fees in installments.

### **Concerns**

Aspects of the marketing, disclosure, and implementation of some overdraft protection programs, intended essentially as short-term credit facilities, are of concern to the Agencies. For example, some institutions have promoted this credit service in a manner that leads consumers to believe that it is a line of credit by informing consumers that their account includes an overdraft protection limit of a specified dollar amount without clearly disclosing the terms and conditions of the service, including how fees reduce overdraft protection dollar limits, and how the service differs from a line of credit.

In addition, some institutions have adopted marketing practices that appear to encourage consumers to overdraw their accounts, such as by informing consumers that the service may be used to take an advance on their next paycheck, thereby potentially increasing the institutions' credit exposure with little or no analysis of the consumer's creditworthiness. These overdraft protection programs may be promoted in a manner that leads consumers to believe that overdrafts will always be paid when, in reality, the institution reserves the right not to pay some overdrafts. Some institutions may advertise accounts with overdraft protection coverage as "free" accounts, and thereby lead consumers to believe that there are no fees associated with the account or the overdraft protection program.

Furthermore, institutions may not clearly disclose that the program may cover instances when consumers overdraw their accounts by means other than check, such as at ATMs and point-of-sale (POS) terminals. Some institutions may include overdraft protection amounts in the sum that they disclose as the consumer's account "balance" (for example, at an ATM) without clearly distinguishing the funds that are available for withdrawal without overdrawing the account. Where the institution knows that the transaction will trigger an overdraft fee, such as at a proprietary ATM, institutions also may not alert the consumer prior to the completion of the transaction to allow the consumer to cancel the transaction before the fee is triggered.

Institutions should weigh carefully the risks presented by the programs including the credit, legal, reputation, safety and soundness, and other risks. Further, institutions should carefully review their programs to ensure that marketing and other communications concerning the programs do not mislead consumers to believe that the program is a traditional line of credit or that payment of overdrafts is guaranteed, do not mislead consumers about their account balance or the costs and scope of the overdraft

protection offered, and do not encourage irresponsible consumer financial behavior that potentially may increase risk to the institution.

### **Safety & Soundness Considerations**

When overdrafts are paid, credit is extended. Overdraft protection programs may expose an institution to more credit risk (e.g., higher delinquencies and losses) than overdraft lines of credit and other traditional overdraft protection options to the extent these programs lack individual account underwriting. All overdrafts, whether or not subject to an overdraft protection program, are subject to the safety and soundness considerations contained in this section.

Institutions providing overdraft protection programs should adopt written policies and procedures adequate to address the credit, operational, and other risks associated with these types of programs. Prudent risk management practices include the establishment of express account eligibility standards and well-defined and properly documented dollar limit decision criteria. Institutions also should monitor these accounts on an ongoing basis and be able to identify consumers who may represent an undue credit risk to the institution. Overdraft protection programs should be administered and adjusted, as needed, to ensure that credit risk remains in line with expectations. This may include, where appropriate, disqualification of a consumer from future overdraft protection. Reports sufficient to enable management to identify, measure, and manage overdraft volume, profitability, and credit performance should be provided to management on a regular basis.

Institutions also are expected to incorporate prudent risk management practices related to account repayment and suspension of overdraft protection services. These include the establishment of specific timeframes for when consumers must pay off their overdraft balances. For example, there should be established procedures for the suspension of overdraft services when the account holder no longer meets the eligibility criteria (such as when the account holder has declared bankruptcy or defaulted on another loan at the bank) as well as for when there is a lack of repayment of an overdraft. In addition, overdraft balances should generally be charged off when considered uncollectible, but no later than 60 days from the date first overdrawn.<sup>7</sup> In some cases, an institution may allow a consumer to cover an overdraft through an extended repayment plan when the consumer is unable to bring the account to a positive balance within the required time frames. The existence of the repayment plan, however, would not extend the charge-off determination period beyond 60 days (or shorter period if applicable) as measured from the date of the overdraft. Any payments received after the account is charged off (up to the amount charged off against allowance) should be reported as a recovery. Some overdrafts are rewritten as loan obligations in accordance with an institution's loan policy and supported by a documented assessment of that consumer's ability to repay. In those instances, the charge-off timeframes described in the Federal Financial Institutions

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<sup>7</sup> Federal credit unions are required by regulation to establish a time limit, not to exceed 45 calendar days, for a member to either deposit funds or obtain an approved loan from the credit union to cover each overdraft. 12 CFR § 701.21(c)(3).

Examination Council (FFIEC) Uniform Retail Credit Classification and Account Management Policy would apply.<sup>8</sup>

With respect to the reporting of income and loss recognition on overdraft protection programs, institutions should follow generally accepted accounting principles (GAAP) and the instructions for the Reports of Condition and Income (Call Report), and NCUA 5300 Call Report. Overdraft balances should be reported on regulatory reports as loans. Accordingly, overdraft losses should be charged off against the allowance for loan and lease losses. The Agencies expect all institutions to adopt rigorous loss estimation processes to ensure that overdraft fee income is accurately measured. Such methods may include providing loss allowances for uncollectible fees or, alternatively, only recognizing that portion of earned fees estimated to be collectible.<sup>9</sup> The procedures for estimating an adequate allowance should be documented in accordance with the Policy Statement on the Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions.<sup>10</sup>

If an institution advises account holders of the available amount of overdraft protection, for example, when accounts are opened or on depositors' account statements or ATM receipts, the institution should report the available amount of overdraft protection with legally binding commitments for Call Report, and NCUA 5300 Call Report purposes. These available amounts, therefore, should be reported as "unused commitments" in regulatory reports.

The Agencies also expect proper risk-based capital treatment of outstanding overdrawn balances and unused commitments.<sup>11</sup> Overdraft balances should be risk-weighted according to the obligor. Under the federal banking agencies' risk-based capital guidelines, the capital charge on the unused portion of commitments generally is based on an off-balance sheet credit conversion factor and the risk weight appropriate to the obligor. In general, these guidelines provide that the unused portion of a commitment is subject to a zero percent credit conversion factor if the commitment has an original maturity of one year or less, or a 50 percent credit conversion factor if the commitment has an original maturity over one year. Under these guidelines, a zero percent conversion factor also applies to the unused portion of a "retail credit card line" or "related plan" if it is unconditionally cancelable by the institution in accordance with applicable law.<sup>12</sup> The phrase "related plans" in these guidelines includes overdraft checking plans. The

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<sup>8</sup> For federally insured credit unions, charge-off policy for booked loans is described in NCUA Letter to Credit Unions No. 03-CU-01, "Loan Charge-off Guidance," dated January 2003.

<sup>9</sup> Institutions may charge off uncollected overdraft fees against the allowance for loan and lease losses if such fees are recorded with overdraft balances as loans and estimated credit losses on the fees are provided for in the allowance for loan and lease losses.

<sup>10</sup> Issued by the Board, FDIC, OCC, and Office of Thrift Supervision. The NCUA provided similar guidance to credit unions in Interpretive Ruling and Policy Statement 02-3, "Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions," 67 FR 37445, May 29, 2002.

<sup>11</sup> Federally insured credit unions should calculate risk-based net worth in accordance with the rules contained in 12 CFR Part 702.

<sup>12</sup> See 12 CFR Part 3, Appendix A, Section 3 (b)(5) (OCC); 12 CFR Part 208, Appendix A, Section III.D.5 (Board); and 12 CFR Part 325, Appendix A, Section II.D.5 (FDIC).

Agencies believe that the overdraft protection programs discussed in this joint guidance fall within the meaning of “related plans” as a type of “overdraft checking plan” for the purposes of the federal banking agencies’ risk-based capital guidelines. Consequently, overdraft protection programs that are unconditionally cancelable by the institution in accordance with applicable law would qualify for a zero percent credit conversion factor.

Institutions entering into overdraft protection contracts with third-party vendors must conduct thorough due diligence reviews prior to signing a contract. The interagency guidance contained in the November 2000 Risk Management of Outsourced Technology Services outlines the Agencies’ expectations for prudent practices in this area.

### **Legal Risks**

Overdraft protection programs must comply with all applicable federal laws and regulations, some of which are outlined below. State laws also may be applicable, including usury and criminal laws, and laws on unfair or deceptive acts or practices. It is important that institutions have their overdraft protection programs reviewed by counsel for compliance with all applicable laws prior to implementation. Further, although the guidance below outlines federal laws and regulations as of the date this joint guidance is published, applicable laws and regulations are subject to amendment. Accordingly, institutions should monitor applicable laws and regulations for revisions and to ensure that their overdraft protection programs are fully compliant.

#### Federal Trade Commission Act / Advertising Rules

Section 5 of the Federal Trade Commission Act (FTC Act) prohibits unfair or deceptive acts or practices.<sup>13</sup> The banking agencies enforce this section pursuant to their authority in section 8 of the Federal Deposit Insurance Act, 12 U.S.C. § 1818.<sup>14</sup> An act or practice is unfair if it causes or is likely to cause substantial injury to consumers that is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition. An act or practice is deceptive if, in general, it is a representation, omission, or practice that is likely to mislead a consumer acting reasonably under the circumstances, and the representation, omission, or practice is material.

In addition, the NCUA has promulgated similar rules that prohibit federally insured credit unions from using advertisements or other representations that are inaccurate or misrepresent the services or contracts offered.<sup>15</sup> These regulations are broad enough to prohibit federally insured credit unions from making any false representations to the public regarding their deposit accounts.

Overdraft protection programs may raise issues under either the FTC Act or, in connection with federally insured credit unions, the NCUA’s advertising rules, depending

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<sup>13</sup> 15 U.S.C. § 45.

<sup>14</sup> See OCC Advisory Letter 2002-3 (March 2002); and joint Board and FDIC Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks (March 11, 2004).

<sup>15</sup> 12 CFR § 740.2.

upon how the programs are marketed and implemented. To avoid engaging in deceptive, inaccurate, misrepresentative, or unfair practices, institutions should closely review all aspects of their overdraft protection programs, especially any materials that inform consumers about the programs.

#### Truth in Lending Act

TILA and Regulation Z require creditors to give cost disclosures for extensions of consumer credit.<sup>16</sup> TILA and the regulation apply to creditors that regularly extend consumer credit that is subject to a finance charge or is payable by written agreement in more than four installments.<sup>17</sup>

Under Regulation Z, fees for paying overdraft items currently are not considered finance charges if the institution has not agreed in writing to pay overdrafts.<sup>18</sup> Even where the institution agrees in writing to pay overdrafts as part of the deposit account agreement, fees assessed against a transaction account for overdraft protection services are finance charges only to the extent the fees exceed the charges imposed for paying or returning overdrafts on a similar transaction account that does not have overdraft protection.

Some financial institutions also offer overdraft repayment loans to consumers who are unable to repay their overdrafts and bring their accounts to a positive balance within a specified time period.<sup>19</sup> These closed-end loans will trigger Regulation Z disclosures, for example, if the loan is payable by written agreement in more than four installments. Regulation Z will also be triggered where such closed-end loans are subject to a finance charge.<sup>20</sup>

#### Equal Credit Opportunity Act

Under the Equal Credit Opportunity Act (ECOA) and Regulation B, creditors are prohibited from discriminating against an applicant on a prohibited basis in any aspect of a credit transaction.<sup>21</sup> This prohibition applies to overdraft protection programs. Thus, steering or targeting certain consumers on a prohibited basis for overdraft protection programs while offering other consumers overdraft lines of credit or other more favorable credit products or overdraft services, will raise concerns under the ECOA.

In addition to the general prohibition against discrimination, the ECOA and Regulation B contain specific rules concerning procedures and notices for credit denials and other

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<sup>16</sup> 15 U.S.C. §§ 1601 *et seq.* TILA is implemented by Regulation Z, 12 CFR Part 226.

<sup>17</sup> *See* 15 U.S.C. § 1602(f) and 12 CFR 226.2(a)(17). Institutions should be aware that whether a written agreement exists is a matter of state law. *See, e.g.*, 12 CFR § 226.5.

<sup>18</sup> *See* 12 CFR 226.4(c)(3). Traditional lines of credit, which generally are subject to a written agreement, do not fall under this exception.

<sup>19</sup> For federal credit unions, this time period may not exceed 45 calendar days. 12 CFR § 701.21(c)(3).

<sup>20</sup> *See* 12 CFR 226.4.

<sup>21</sup> 15 U.S.C. §§ 1691 *et seq.* The ECOA is implemented by Regulation B, 12 CFR Part 202. The ECOA prohibits discrimination on the basis of race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to contract), the fact that all or part of the applicant's income derives from a public assistance program, and the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act.



adverse action. Regulation B defines the term “adverse action,” and generally requires a creditor who takes adverse action to send a notice to the consumer providing, among other things, the reasons for the adverse action.<sup>22</sup> Some actions taken by creditors under overdraft protection programs might constitute adverse action but would not require notice to the consumer if the credit is deemed to be “incidental credit” as defined in Regulation B. “Incidental credit” includes consumer credit that is not subject to a finance charge, is not payable by agreement in more than four installments, and is not made pursuant to the terms of a credit card account.<sup>23</sup> Overdraft protection programs that are not covered by TILA would generally qualify as incidental credit under Regulation B.

#### Truth in Savings Act

Under the Truth in Savings Act (TISA), deposit account disclosures must include the amount of any fee that may be imposed in connection with the account and the conditions under which the fee may be imposed.<sup>24</sup> In addition, institutions must give advance notice to affected consumers of any change in a term that was required to be disclosed if the change may reduce the annual percentage yield or adversely affect the consumer.

When overdraft protection services are added to an existing deposit account, advance notice to the account holder may be required, for example, if the fee for the service exceeds the fee for accounts that do not have the service.<sup>25</sup> In addition, TISA prohibits institutions from making any advertisement, announcement, or solicitation relating to a deposit account that is inaccurate or misleading or that misrepresents their deposit contracts.

Since these automated and marketed overdraft protection programs did not exist when most of the implementing regulations were issued, the regulations may be reevaluated.

#### Electronic Fund Transfer Act

The Electronic Fund Transfer Act (EFTA) and Regulation E require an institution to provide consumers with account-opening disclosures and to send a periodic statement for each monthly cycle in which an electronic fund transfer (EFT) has occurred and at least quarterly if no transfer has occurred.<sup>26</sup> If, under an overdraft protection program, a consumer could overdraw an account by means of an ATM withdrawal or POS debit card transaction, both are EFTs subject to EFTA and Regulation E. As such, periodic statements must be readily understandable and accurate regarding debits made, current balances, and fees charged. Terminal receipts also must be readily understandable and accurate regarding the amount of the transfer. Moreover, readily understandable and accurate statements and receipts will help reduce the number of alleged errors that the

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<sup>22</sup> See 12 CFR §§ 202.2(c) and 9.

<sup>23</sup> See 12 CFR § 202.3(c).

<sup>24</sup> 12 U.S.C. §§ 4301 *et seq.* TISA is implemented by Regulation DD at 12 CFR Part 230 for banks and savings associations, and by NCUA’s TISA regulation at 12 CFR Part 707 for federally insured credit unions.

<sup>25</sup> An advance change in terms notice would not be required if the consumer’s account disclosures stated that their overdraft check may or may not be paid and the same fee would apply.

<sup>26</sup> 15 U.S.C. §§ 1693 *et seq.* The EFTA is implemented by Regulation E, 12 CFR Part 205.

institution must investigate under Regulation E, which can be time-consuming and costly to institutions.

### **Best Practices**

Clear disclosures and explanations to consumers of the operation, costs, and limitations of an overdraft protection program and appropriate management oversight of the program are fundamental to enabling responsible use of overdraft protection. Such disclosures and oversight can also minimize potential consumer confusion and complaints, foster good customer relations, and reduce credit, legal, and other potential risks to the institution. Institutions that establish overdraft protection programs should, as applicable, take into consideration the following best practices, many of which have been recommended or implemented by financial institutions and others, as well as practices that may otherwise be required by applicable law. While the Agencies are concerned about promoted overdraft protection programs, the best practices may also be useful for other methods of covering overdrafts. These best practices currently observed in or recommended by the industry include:

#### Marketing and Communications with Consumers

- **Avoid promoting poor account management.** Institutions should not market the program in a manner that encourages routine or intentional overdrafts. Institutions should instead present the program as a customer service that may cover inadvertent consumer overdrafts.
- **Fairly represent overdraft protection programs and alternatives.** When informing consumers about an overdraft protection program, inform consumers generally of other overdraft services and credit products, if any, that are available at the institution and how the terms, including fees, for these services and products differ. Identify for consumers the consequences of extensively using the overdraft protection program.
- **Train staff to explain program features and other choices.** Train customer service or consumer complaint processing staff to explain their overdraft protection program's features, costs, and terms, including how to opt out of the service. Staff also should be able to explain other available overdraft products offered by the institution and how consumers may qualify for them.
- **Clearly explain discretionary nature of program.** If payment of an overdraft is discretionary, make this clear. Institutions should not represent that the payment of overdrafts is guaranteed or assured if the institution retains discretion not to pay an overdraft.
- **Distinguish overdraft protection services from "free" account features.** Institutions should not promote "free" accounts and overdraft protection programs in

the same advertisement in a manner that suggests the overdraft protection program is free of charges.

- **Clearly disclose program fees.** In communications about overdraft protection programs, clearly disclose the dollar amount of the fee for each overdraft and any interest rate or other fees that may apply. For example, rather than merely stating that the institution's standard NSF fee will apply, institutions should restate the dollar amount of any applicable fee or interest charge.
- **Clarify that fees count against the disclosed overdraft protection dollar limit.** Consumers should be alerted that the fees charged for covering overdrafts, as well as the amount of the overdraft item, will be subtracted from any overdraft protection limit disclosed.
- **Demonstrate when multiple fees will be charged.** If promoting an overdraft protection program, clearly disclose, where applicable, that more than one overdraft fee may be charged against the account per day, depending on the number of checks presented on, and other withdrawals made from, the consumer's account.
- **Explain impact of transaction clearing policies.** Clearly explain to consumers that transactions may not be processed in the order in which they occurred, and that the order in which transactions are received by the institution and processed can affect the total amount of overdraft fees incurred by the consumer.
- **Illustrate the type of transactions covered.** Clearly disclose that overdraft fees may be imposed on transactions such as ATM withdrawals, debit card transactions, preauthorized automatic debits, telephone-initiated transfers or other electronic transfers, if applicable, to avoid implying that check transactions are the only transactions covered.

#### Program Features and Operation

- **Provide election or opt-out of service.** Obtain affirmative consent of consumers to receive overdraft protection. Alternatively, where overdraft protection is automatically provided, permit consumers to "opt out" of the overdraft program and provide a clear consumer disclosure of this option.
- **Alert consumers before a transaction triggers any fees.** When consumers attempt to withdraw or transfer funds made available through an overdraft protection program, provide a specific consumer notice, where feasible, that completing the withdrawal may trigger the overdraft fees (for example, it presently may be feasible at a branch teller window). This notice should be presented in a manner that permits consumers to cancel the attempted withdrawal or transfer after receiving the notice. If this is not feasible, then post notices (e.g., on proprietary ATMs) explaining that transactions may be approved that overdraw the account and fees may be incurred.

Institutions should consider making access to the overdraft protection program unavailable through means other than check transactions, if feasible.

- **Prominently distinguish balances from overdraft protection funds availability.** When disclosing a single balance for an account by any means, institutions should not include overdraft protection funds in that account balance. The disclosure should instead represent the consumer's own funds available without the overdraft protection funds included. If more than one balance is provided, separately (and prominently) identify the balance without the inclusion of overdraft protection.
- **Promptly notify consumers of overdraft protection program usage each time used.** Promptly notify consumers when overdraft protection has been accessed, for example, by sending a notice to consumers the day the overdraft protection program has been accessed. The notification should identify the date of the transaction, the type of transaction, the overdraft amount, the fee associated with the overdraft, the amount necessary to return the account to a positive balance, the amount of time consumers have to return their accounts to a positive balance, and the consequences of not returning the account to a positive balance within the given timeframe. Notify consumers if the institution terminates or suspends the consumer's access to the service, for example, if the consumer is no longer in good standing.
- **Consider daily limits on the consumer's costs.** Consider imposing a cap on consumers' potential daily costs from the overdraft program. For example, consider limiting daily costs from the program by providing a numerical limit on the total overdraft transactions that will be subject to a fee per day or by providing a dollar limit on the total fees that will be imposed per day.
- **Monitor overdraft protection program usage.** Monitor excessive consumer usage, which may indicate a need for alternative credit arrangements or other services, and inform consumers of these available options.
- **Fairly report program usage.** Institutions should not report negative information to consumer reporting agencies when the overdrafts are paid under the terms of overdraft protection programs that have been promoted by the institutions.

This concludes the text of the final Joint Guidance on Overdraft Protection Programs.

[THIS SIGNATURE PAGE PERTAINS TO THE FINAL "JOINT GUIDANCE ON  
OVERDRAFT PROTECTION PROGRAMS"]

Dated: February 15, 2005

Julie L. Williams (signed)  
Julie L. Williams,  
Acting Comptroller of the Currency.

[THIS SIGNATURE PAGE PERTAINS TO THE FINAL "JOINT GUIDANCE ON  
OVERDRAFT PROTECTION PROGRAMS"]

By order of the Board of Governors of the Federal Reserve System, February 17, 2005.

Robert deV. Frierson (signed)  
Robert deV. Frierson,  
Deputy Secretary of the Board.

[THIS SIGNATURE PAGE PERTAINS TO THE FINAL "JOINT GUIDANCE ON  
OVERDRAFT PROTECTION PROGRAMS"]

Dated at Washington, D.C., the 16th day of February, 2005.

By order of the Federal Deposit Insurance Corporation.

Robert E. Feldman (signed)  
Robert E. Feldman,  
Executive Secretary.

[THIS SIGNATURE PAGE PERTAINS TO THE FINAL "JOINT GUIDANCE ON  
OVERDRAFT PROTECTION PROGRAMS"]

By the National Credit Union Administration Board on February 17, 2005.

Mary F. Rupp (signed)  
Mary F. Rupp,  
Secretary of the Board.





**EXHIBIT 2**

**FINAL OTS GUIDANCE ON OVERDRAFT PROTECTION PROGRAMS**



## Office of Thrift Supervision

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FOR RELEASE at 4:45 P.M. EST

For further information

Monday, February 14, 2005

Contact: Kevin Petrasic

OTS 05-03

202/906-6677

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### OTS ANNOUNCES ISSUANCE OF FINAL GUIDANCE ON THRIFT OVERDRAFT PROTECTION PROGRAMS

WASHINGTON, D.C. – The Office of Thrift Supervision (OTS) announced today that it is issuing final guidance on overdraft protection programs for savings associations. The guidance is intended to assist institutions in ensuring adequate disclosures in connection with, and the responsible administration of, overdraft protection programs made available to their customers.


OTS is issuing this guidance in response to numerous concerns raised about a relatively new type of overdraft protection service commonly referred to as “bounced-check protection” or “overdraft protection” being offered to depository institution customers. This issue was highlighted in guidance first proposed by the federal banking agencies last June. Today, OTS is finalizing for savings associations best practices—similar to those previously proposed by the federal banking agencies—that address marketing and communications that accompany the offering of overdraft protection services, as well as the disclosure, and operation, of an institution’s program features.

The final OTS guidance provides significant flexibility to thrifts in designing and implementing overdraft protection programs, but also requires institutions to implement programs in a manner that fairly and equitably respects the interests of their customers. In particular, institutions may not manipulate transaction-clearing procedures to inflate fees charged to their customers.

A key aspect of the final guidance requires thrift institutions to alert their customers before a transaction triggers a fee. Thrift customers attempting to withdraw, transfer, or otherwise access funds—other than by check—made available through an overdraft protection program should be provided a specific consumer notice that completing the transaction will trigger an overdraft protection fee. The notice should be presented in a manner that permits a customer to cancel any attempted transaction after receiving the notice. For types of transactions for which this is not feasible, an institution should provide its customers an opportunity to “opt out” of overdraft protection programs for such types of transactions, even if the overall effect of the “opt out” limits overdraft protection only to check transactions.

Pursuant to the final guidance, thrifts are expected to implement best practices in order to apprise their customers regarding overdraft protection programs, including:

- Fairly representing overdraft protection programs and available alternatives;
- Training thrift institution staff to explain program features and other available overdraft protection programs offered by the institution;
- Clearly explaining the discretionary nature of overdraft protection programs offered by the institution;
- Clearly disclosing overdraft protection program fees;
- Explaining the impact of the institution’s transaction-clearing policies; and
- Monitoring overdraft protection program usage by the institution’s customers.

Final Guidance 

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The Office of Thrift Supervision, an office of the Department of the Treasury, regulates and supervises the nation's thrift industry. OTS's mission is to ensure the safety and soundness of, and compliance with consumer protection laws by, thrift institutions, and to support their role as home mortgage lenders and providers of other community credit and financial services. OTS also oversees the activities and operations of thrift holding companies that own or control thrift institutions. Copies of OTS news releases and other documents are available at the OTS web page at [www.ots.treas.gov](http://www.ots.treas.gov).

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*Created: Monday, 2/14/2005*

Dated: February 14, 2005.

Martha Curry,

Acting Director, Taxpayer Advocacy Panel.

[FR Doc. 05-3219 Filed 2-17-05; 8:45 am]

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## DEPARTMENT OF THE TREASURY

### Office of Thrift Supervision

[No. 2005-05]

#### Guidance on Overdraft Protection Programs

**AGENCY:** Office of Thrift Supervision, Treasury (OTS).

**ACTION:** Final guidance.

**SUMMARY:** OTS is issuing this final Guidance on Overdraft Protection Programs (Guidance). This Guidance is intended to assist savings associations in the responsible disclosure and administration of overdraft protection services.

**DATES:** This Guidance is effective February 18, 2005.

**FOR FURTHER INFORMATION CONTACT:** Maurice McClung, Program Manager, Market Conduct, Thrift Policy, (202) 906-6182; Richard Bennett, Counsel, Regulations and Legislation Division, (202) 906-7409, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

#### SUPPLEMENTARY INFORMATION:

##### I. Background

OTS has developed this final Guidance after careful consideration of comments received on the proposed Interagency Guidance on Overdraft Protection Programs, 69 FR 31858 (June 7, 2004) (proposed guidance) issued by the Federal Financial Institution Examination Council (FFIEC) agencies, i.e., the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), and National Credit Union Administration (NCUA). It addresses a service offered by insured depository institutions commonly referred to as "bounced-check protection" or "overdraft protection." This service is sometimes offered to transaction account customers as an alternative to traditional ways of covering overdrafts (e.g., overdraft lines of credit or linked accounts). While both the availability and customer acceptance of these overdraft protection services have increased, aspects of the marketing, disclosure, and implementation of some of these programs have raised concerns for OTS.

The proposed guidance identified the historical and traditional approaches to providing consumers with protection against account overdrafts and contrasted these approaches with the more recent overdraft protection programs that are marketed to consumers. The Agencies also identified some of the existing and potential concerns surrounding the offering and administration of such overdraft protection programs that have been identified by Federal and State bank regulatory agencies, consumer groups, financial institutions, and their trade representatives.

In response to these concerns, the Agencies provided proposed guidance in three primary sections: Safety and Soundness Considerations, Legal Risks, and Best Practices. In the section on Safety and Soundness Considerations, the Agencies wanted to ensure that financial institutions offering overdraft protection services adopt adequate policies and procedures to address the risks associated with these services. The Legal Risks section of the proposed guidance outlined several federal consumer compliance laws, generally alerted institutions offering overdraft protection services of the need to comply with all applicable Federal and State laws, and advised institutions to have their overdraft protection programs reviewed by legal counsel to ensure overall compliance prior to implementation. Finally, the proposed guidance set forth Best Practices that serve as positive examples of practices that are currently observed in, or recommended by, the industry. Broadly, these Best Practices address the marketing and communications that accompany the offering of overdraft protection services, as well as the disclosure and operation, of program features.

The Agencies received a total of over 320 comment letters in response to the proposed guidance. Comment letters were received from depository institutions, trade associations, vendors offering overdraft protection products, and other industry representatives, as well as government officials, consumer and community groups, and individual consumers.

##### II. Overview of Public Comments

The Agencies received comments that addressed broad aspects of the proposed guidance, as well as its specific provisions. Many industry commenters, for instance, were concerned about the overall scope of the proposed guidance and whether it would apply to financial institutions that do not offer bounce protection programs but do cover the

occasional overdraft on a case-by-case basis. Commenters also addressed the three specific sections of the proposed guidance.

In regard to the Safety and Soundness section, for example, many industry commenters suggested extending the charge-off period from 30 days to either 45 or 60 days because they believed a longer charge-off period would provide consumers with more time to repay overdrafts and avoid being reported to credit bureaus as delinquent on their accounts. Comments were also received addressing technical reporting and accounting issues.

The Agencies received numerous comments regarding the Legal Risks section, particularly the Truth in Lending Act (TILA) and Equal Credit Opportunity Act (ECOA) discussions. For instance, many consumers and consumer group comments stated that overdraft protection should be considered credit covered by TILA's disclosures and other required protections. They likened the product to payday lending, which is covered by TILA. Many industry commenters argued against the coverage of overdraft programs by TILA and the Board's Regulation Z, and urged that the payment of overdrafts does not involve credit and finance charges requiring the disclosures and protections afforded by this body of law.

Lastly, many commenters offered specific criticisms or recommended edits with respect to particular Best Practices identified in the proposal. Several industry commenters sought general clarification of whether examiners would treat the Best Practices as law or rules when examining institutions offering overdraft protection services.

##### III. Final Guidance

This final Guidance incorporates changes made by OTS to provide clarity and address many commenter concerns. Language has been added to clarify the scope of the Guidance. The Safety and Soundness section expressly states that it applies to all methods of covering overdrafts. The introduction to the Best Practices section clarifies that while OTS is concerned about promoted overdraft protection programs, the Best Practices may also be useful for other methods of covering overdrafts.

In response to the comments regarding the Safety and Soundness section, OTS now indicates that overdraft balances, including uncollected fees, should generally be written off when considered uncollectible, but no later than 60 days from the date first overdrawn. This OTS

Guidance does not address whether overdrafts are credit because OTS believes that some "bounce protection" programs are provided to customers as a fee for service rather than an extension of credit. Other overdraft plans, particularly those where the savings association performs a credit check on the borrower, provide a period of time to repay the overdraft, and charge interest based on the amount and time the overdraft is outstanding, are loans. It is not within the scope of this Guidance to make a determination of whether any particular overdraft program is credit. Other technical edits have been made to further clarify reporting and accounting aspects of this section of the Guidance.

This OTS Guidance has eliminated the discussion of Legal Risks. This section engendered substantial comment and controversy, particularly over whether overdrafts are credit for purposes of TILA and Regulation Z.

OTS reminds savings associations, however, that overdraft protection programs must comply with all applicable Federal laws and regulations. It is important that savings associations have their overdraft protection programs reviewed by counsel for compliance with all applicable laws prior to implementation. As these laws and regulations are subject to amendment, savings associations are reminded to monitor applicable laws and regulations for revisions and to ensure that their overdraft protection programs are fully compliant with them.

Lastly, OTS reaffirms that the Best Practices are practices that have been recommended or implemented by financial institutions and others, as well as practices that may otherwise be required by applicable law. The Best Practices, or principles within them, are enforceable to the extent they are required by other federal statutes and regulations. The final Guidance explicitly states that while OTS is particularly concerned about promoted overdraft protection programs, the Best Practices may also be useful for other methods of covering overdrafts. OTS also revised or shortened numerous Best Practices for clarity, in response to particular commenter suggestions.

OTS's Best Practices depart from those in the proposed guidance issued by the FFIEC agencies in a few respects. OTS's Best Practices include not manipulating transaction-clearing (including, but not limited to, check-clearing rules and batch debit processing) to inflate fees and not allowing consumers to access overdraft amounts unless the consumer is informed that the transaction will

trigger an overdraft fee and is given an opportunity to cancel the transaction. If this is not feasible for a particular type of transaction, the savings association should allow consumers the choice to make access to the overdraft protection program unavailable by transaction type.

For savings associations interested in further reading on the subject of best practices, OTS recommends an American Bankers Association publication entitled, "Overdraft Protection: A Guide for Bankers."

The text of the OTS Guidance on Overdraft Protection Programs follows: *OTS Guidance on Overdraft Protection Programs*

The Office of Thrift Supervision (OTS) is issuing this guidance concerning a service offered by savings associations that is commonly referred to as "bounced-check protection" or "overdraft protection." This service is sometimes offered on both consumer and small business transaction accounts as an alternative to traditional ways of covering overdrafts. This guidance is intended to assist savings associations in the responsible disclosure and administration of overdraft protection services, particularly those that are marketed to consumers.

#### Introduction

To protect against account overdrafts, some consumers obtain an overdraft line of credit, which is subject to the disclosure requirements of the Truth in Lending Act (TILA). If a consumer does not have an overdraft line of credit, the institution typically returns the check as unpaid and charges the consumer a nonsufficient funds or "NSF" fee. Some institutions may accommodate the consumer and pay overdrafts on a discretionary, ad-hoc basis. Regardless of whether the overdraft is paid, institutions typically charge the NSF fee when an overdraft occurs. Over the years, this accommodation has become automated by many institutions. Historically, institutions have not promoted this accommodation. This approach has not raised significant supervisory concerns.

More recently, some depository institutions have offered "overdraft protection" programs that, unlike the discretionary accommodation traditionally provided to those lacking a line of credit or other type of overdraft service (e.g., linked accounts), are marketed to consumers essentially as a convenience or fee for service program.

While the specific details of overdraft protection programs vary from institution to institution and also vary

over time, those currently offered by institutions incorporate some or all of the following characteristics:

- Institutions inform consumers that overdraft protection is a feature of their accounts and advertise the use of the service.
- Coverage is automatic for consumers who meet the institution's criteria (e.g., account has been open a certain number of days, deposits are made regularly). Typically, the institution performs no credit underwriting.
- Overdrafts generally are paid up to the aggregate limit set by the institution for the specific class of accounts, typically \$100 to \$500.
- Institutions with an express aggregate "dollar limit" inform consumers of their limit under the program.
- Many program disclosures state that payment of an overdraft is discretionary on the part of the institution and may disclaim any legal obligation of the institution to pay any overdraft.
- The service may extend to check transactions as well as other transactions, such as withdrawals at automated teller machines (ATMs), transactions using debit cards, pre-authorized automatic debits from a consumer's account, telephone-initiated funds transfers, and on-line banking transactions.
- A flat fee is charged each time the service is triggered and an overdraft item is paid. Commonly, a fee in the same amount would be charged even if the overdraft item were not paid. A daily fee also may apply for each day the account remains overdrawn.
- Some institutions offer closed-end loans to consumers who do not bring their accounts to a positive balance within a specified time period. These repayment plans allow consumers to repay their overdrafts and fees in installments.

#### Concerns

Aspects of the marketing, disclosure, and implementation of some overdraft protection programs are of concern to OTS. For example, some institutions have promoted this service in a manner that leads consumers to believe that it is a line of credit by informing them that their account includes an overdraft protection limit of a specified dollar amount without clearly disclosing the terms and conditions of the service, including how fees reduce overdraft protection dollar limits and how the service differs from a line of credit.

In addition, some institutions have adopted marketing practices that appear to encourage consumers to overdraw

their accounts, such as by informing consumers that the service may be used to routinely overdraw their accounts, with little or no analysis of the consumer's creditworthiness. These overdraft protection programs may be promoted in a manner that leads consumers to believe that overdrafts will always be paid when, in reality, the institution reserves the right not to pay some overdrafts. Some institutions may advertise accounts with overdraft protection coverage as "free" accounts and thereby lead consumers to believe that there are no fees associated with the account or the overdraft protection program.

Furthermore, institutions may not clearly disclose that the program may cover instances when consumers overdraw their accounts by means other than check, such as at ATMs and point-of-sale (POS) terminals. Some institutions may include overdraft protection amounts in the figure that they disclose as the consumer's account "balance" (for example at an ATM) without clearly distinguishing the funds that are available for withdrawal without overdrawing the account. Where the institution knows that the transaction will trigger an overdraft fee, such as at a proprietary ATM, institutions also may not alert the consumer prior to the completion of the transaction to allow the consumer to cancel the transaction before the fee is triggered.

Savings associations should carefully weigh the risks presented by the programs. Further, savings associations should carefully review their programs to ensure that marketing and other communications concerning the programs do not mislead consumers to believe that the program is a traditional line of credit or that payment of overdrafts is guaranteed, do not mislead consumers about their account balance or the costs and scope of the overdraft protection offered, and do not encourage irresponsible consumer financial behavior or other behavior that potentially may unacceptably increase risk to the savings association.

#### *Safety & Soundness Considerations*

Overdraft protection programs may expose an institution to a higher level of nonpayment than traditional line of credit programs where the institution has performed appropriate credit underwriting. All overdrafts, whether or not subject to an overdraft protection program, are subject to the safety and soundness considerations contained in this section.

Savings associations providing overdraft protection programs should

adopt written policies and procedures adequate to address the operational, and other risks associated with these types of programs. Prudent risk management practices include the establishment of express account eligibility standards and well-defined and properly documented dollar limit decisions and other criteria. Savings associations also should monitor these accounts on an ongoing basis and be able to identify consumers who do not manage their accounts in a satisfactory manner. Overdraft protection programs should be administered and adjusted, as needed, to ensure that the performance of such programs is satisfactory and in line with expectations. This may include, where appropriate, disqualification of a consumer from future overdraft protection. Reports sufficient to enable management to identify, measure, and manage overdraft volume, profitability, and performance should be provided to management on a regular basis.

Savings associations also are expected to incorporate prudent risk management practices related to account repayment and suspension of overdraft protection services. These include the establishment of specific timeframes for when consumers must pay off their overdraft balances. For example, savings associations should have established procedures for the suspension of overdraft services when the account holder no longer meets the eligibility criteria (such as when the account holder has declared bankruptcy or defaulted on a loan at the savings association) as well as for when there is a lack of timely repayment of an overdraft. In addition, overdraft balances, including uncollected fees, should generally be written off when considered uncollectible, but no later than 60 days from the date first overdrawn.

Some overdrafts are rewritten as loan obligations in accordance with an institution's loan policy and supported by a documented assessment of that consumer's ability to repay. In those instances, the overdraft is considered a loan and the delinquency and charge-off timeframes described in the FFIEC Uniform Retail Credit Classification and Account Management Policy apply. See also OTS CEO Memorandum #128 (July 27, 2000) ("Revised Uniform Retail Credit and Account Management Policy"), available at <http://www.ots.treas.gov/docs/2/25128.pdf>.

With respect to the reporting of income and loss recognition on overdraft protection programs, savings associations should follow generally accepted accounting principles (GAAP).

OTS expects all savings associations to adopt rigorous loss estimation processes to ensure that overdraft fee income is accurately measured. Such methods may include providing loss allowances for uncollectible amounts or fees or, alternatively, only recognizing that portion of earned fees estimated to be collectible.

Savings associations entering into overdraft protection contracts with third-party vendors must conduct thorough due diligence reviews prior to signing a contract. The interagency guidance contained in the Outsourcing Technology Services Booklet part of the FFIEC's IT Examination Handbook, outlines OTS's expectations for prudent practices in this area. See also OTS CEO Memorandum #201 (July 15, 2004), available at <http://www.ots.treas.gov/docs/2/25201.pdf>.

#### *Best Practices*

Clear disclosures and explanations to consumers of the operation, costs, and limitations of an overdraft protection program and appropriate management oversight of the program are fundamental to enabling responsible use of overdraft protection. Such disclosures and oversight can also minimize potential consumer confusion and complaints, foster good customer relations, and reduce credit, legal, and other potential risks to the savings association. Savings associations that establish overdraft protection programs should, as applicable, take into consideration the following Best Practices, many of which have been recommended or implemented by financial institutions and others, as well as practices that may otherwise be required by applicable law. While OTS is concerned about promoted overdraft protection programs, the Best Practices may also be useful for other methods of covering overdrafts. These Best Practices currently observed in or recommended by the industry include:

#### *Marketing and Communications With Consumers*

- *Avoid promoting poor account management.* Savings associations should not market the program in a manner that encourages routine or intentional overdrafts; rather present the program as a customer service that may cover inadvertent consumer overdrafts.
- *Fairly represent overdraft protection programs and alternatives.* When informing consumers about an overdraft protection program, inform consumers generally of other overdraft services or credit products, if any, that are available at the savings association and how the terms, including fees, for



these services or products differ. Identify for consumers the consequences of extensively using the overdraft protection program.

- *Train staff to explain program features and other choices.* Train customer service or consumer complaint processing staff to explain their overdraft protection program's features, costs, and terms, including how to opt out of the service. Staff also should be able to explain other available overdraft products offered by the savings association and how consumers may qualify for them.

- *Clearly explain the discretionary nature of program.* If payment of an overdraft is discretionary, make this clear. Savings associations should not represent that the payment of overdrafts is guaranteed or assured if the savings association retains discretion not to pay an overdraft.

- *Distinguish overdraft protection services from "free" account features.* Savings associations should not promote "free" accounts and overdraft protection services in the same advertisement in a manner that suggests the overdraft protection service is free of charges.

- *Clearly disclose program fees.* In communications about overdraft protection programs, clearly disclose the dollar amount of the fee for each overdraft and any interest rate or other fees that may apply. For example, rather than merely stating that the savings association's standard NSF fee will apply, savings associations should restate the dollar amount of any applicable fees or interest charges.

- *Clarify that fees count against the disclosed overdraft protection dollar limit.* Consumers should be alerted that the fees charged for covering overdrafts, as well as the amount of the overdraft item, will be subtracted from any overdraft protection limit disclosed.

- *Demonstrate when multiple fees will be charged.* If promoting an overdraft protection program, clearly disclose that more than one overdraft fee may be charged against the account per day, depending on the number of checks presented and other withdrawals made from the consumer's account.

- *Do not manipulate transaction-clearing rules.* Transaction-clearing rules (including check-clearing and batch debit processing) should not be

administered unfairly or manipulated to inflate fees.

- *Explain the impact of transaction-clearing policies.* Clearly explain to consumers that transactions may not be processed in the order in which they occurred and that the order in which they are received by the savings association and processed can affect the total amount of overdraft fees incurred by the consumer. Savings associations should also clearly disclose rules for processing and clearing transactions.

- *Illustrate the type of transactions covered.* Clearly disclose that overdraft protection fees may be imposed on transactions such as ATM withdrawals, debit card transactions, preauthorized automatic debits, telephone-initiated transfers, or other electronic transfers, if applicable, to avoid implying that check transactions are the only transactions covered.

#### Program Features and Operation

- *Provide election or opt-out of service.* Obtain affirmative consent of consumers to receive overdraft protection. Alternatively, where overdraft protection is automatically provided, permit consumers to "opt out" of the overdraft program and provide a clear consumer disclosure of this option.

- *Alert consumers before a transaction triggers any fees.* When consumers attempt to withdraw, transfer, or otherwise access funds made available through an overdraft protection program (other than by check), savings associations should alert consumers that completing the transaction will trigger an overdraft protection fee. Savings associations should also give consumers an opportunity to cancel the attempted transaction. If this is not feasible for a particular type of transaction, then savings associations should allow consumers the choice to make access to the overdraft protection program unavailable by transaction type, even if it results in limiting access to the overdraft protection amount only to check transactions.

- *Prominently distinguish balances from overdraft protection funds availability.* When disclosing a single balance for an account by any means, savings associations should not include overdraft protection funds in that

account balance. The disclosure should instead represent the consumer's own funds available without the overdraft protection funds included. If more than one balance is provided, separately (and prominently) identify the balance without the inclusion of overdraft protection.

- *Promptly notify consumers of overdraft protection program usage each time used.* In addition to any alert at the time of transaction, promptly notify consumers when overdraft protection has been accessed, for example, by sending a notice to consumers the day the overdraft protection program has been accessed. The notification should identify the date of the transaction, the type of transaction, the overdraft amount, the fee associated with the overdraft, the amount necessary to return the account to a positive balance, the amount of time consumers have to return their accounts to a positive balance, and the consequences of not returning the account to a positive balance within the given timeframe. Notify consumers if the savings association terminates or suspends the consumer's access to the service, for example, if the consumer is no longer in good standing.

- *Consider daily limits on fees imposed.* Consider providing a daily cap on overdraft fees charged against any one account, while continuing to provide coverage for overdrafts up to the overdraft limit.

- *Monitor overdraft protection program usage.* Monitor excessive consumer usage, which may indicate a need for alternative arrangements or other services and inform consumers of these available options.

- *Fairly report program usage.* Savings associations should not report negative information to consumer reporting agencies when the overdrafts are paid under the terms of overdraft protection programs that have been promoted by the savings association.

This concludes the text of the OTS Guidance on Overdraft Protection Programs.

Dated: February 15, 2005.

By the Office of Thrift Supervision

James E. Gilleran,

Director.

[FR Doc. 05-3195 Filed 2-17-05; 8:45 am]

BILLING CODE 6720-01-P

### EXHIBIT 3

#### SIGNIFICANT OVERDRAFT PROTECTION LITIGATION

##### Paul Miller individually and on behalf of all others similarly situated v. Bank of America

On February 24, 2004 a San Francisco Superior Court jury reached a verdict against Bank of America after a six-week trial. The verdict requires Bank of America to pay \$75 million to the California class action participants, plus \$1,000 in special damages to each customer who shows the bank caused "substantial emotional or economic harm." The class action, which was filed on August 14, 1998, involved allegations that Bank of America unlawfully utilized funds from Social Security direct deposit accounts of customers to collect for fees, insufficient funds, overdrafts and other bank debts.

The California Code of Civil Procedure §704.080 states that a deposit account in which payments of Social Security benefits are directly deposited by the government or its agent is exempt from claims of creditors, even a bank, up to \$2,425.00. This exemption continues for amounts that exceed that threshold to the extent that it consists of payments of Social Security benefits. Attorneys representing the affected California customers argued the Bank of America's actions violated California laws, citing a 1974 state Supreme Court case that prohibits banks from taking Social Security benefits to recover its own debts. The opinion reasoned that "[t]he assertion of a banker's set off...deprives the depositor of the income which the state provided him to meet subsistence expenses, compelling the state either to give him additional money or leave him without means of physical survival." *Kruger v. Wells Fargo Bank*, 521 P.2d 441, 452-453 (Cal. Sup. Ct. 1974). This reasoning armed with the aforementioned statute is what led to the recent verdict, based entirely on California state law, in the Bank of America case.

The Bank of America verdict, however, appears in direct conflict with *Lopez v. Washington Mutual Bank* 311 F.3d 928 (9<sup>th</sup> Cir. Cal. 2002), a case handed down by the United States Court of Appeals for the Ninth Circuit. In *Lopez* the Court stated that the California Code of Civil Procedure §704.080 was preempted by federal law, namely 12 C.F.R. § 557.11. This federal regulation was issued in 1997 by the Office of Thrift Supervision ("OTS") which asserted its authority under the Home Owners' Loan Act to promulgate regulations that preempt state law affecting federal savings associations. It is well settled that federal law preempts state law where Congress' intent to preempt is explicitly stated in the statute's language and that federal regulations have no less preemptive effect than federal statutes. The regulation overtly states that the "OTS hereby occupies the entire field of federal savings associations' deposit related regulations" thereby expressing its intention to preempt state law governing deposit related regulations and therefore shall control over any state statutes. In *Lopez*, the Court reasoned:

This state law, which exempts Social Security and SSI benefits from any enforcement action, would impose requirements governing "checking accounts" because it would prohibit the use of certain deposits to the accounts to clear overdrafts and mandate the type of disclosures a bank must make regarding account and deposit transactions. It would also impose requirements regarding "funds availability" by prohibiting federal savings associations from treating

certain benefits as available to clear overdrafts and pay fees. Finally, it would impose requirements governing “service charges and fees,” because it would prohibit the bank from deducting overdraft fees from directly deposited benefits. By imposing requirements governing “checking accounts,” Section 704.080 falls within the specific categories of laws that are preempted under Section 557.12.

When the Bank of America verdict is appealed it is entirely possible that the decision will be reversed on preemption grounds. The Office of the Comptroller of the Currency (“OCC”) has a regulation similar to the OTS regulation at issue in *Lopez*. 12 C.F.R. Part 7.4002 gives a national bank the authority to impose non-interest charges and fees, including deposit account service charges to its customers.

The court in *Lopez* also dealt with the issue of whether or not the use of directly deposited Social Security benefits to satisfy obligations owed to the depositing bank was in violation of federal law. The court reasoned that because the plaintiffs (a) voluntarily opened an account with the bank and executed an account holder agreement which outlined the terms and conditions of the Washington Mutual’s overdraft policies, (b) established a direct deposit for their benefits, an agreement to which Washington Mutual was not a party, and (c) remained free at all times to close their account or change their direct deposit instructions, each deposit to the account after an overdraft should therefore be treated as a voluntary payment of debt incurred.

The scope of the Bank of America verdict should ultimately be limited to state chartered banks doing business in California. We are not aware of similar public benefit direct deposit restrictions in other states.

### **In Re Washington Mutual Overdraft Protection Litigation**

On April 26, 2004, the United States District Court, Central District of California, dismissed a class action lawsuit against Washington Mutual Bank (“WAMU”) that alleged that WAMU violated the Truth in Lending Act (“TILA”), 15 U.S.C. §§ 1601, et seq., the Home Owners’ Loan Act (“HOLA”), 12 U.S.C. §§ 1461, et seq., and various Washington and California state laws. The plaintiffs in the case alleged that WAMU extended credit to its customers through an overdraft courtesy program called Overdraft Limit. They also claimed WAMU’s overdraft protection promotional materials represented that WAMU agreed as a matter of contract to be legally obligated to pay all overdraft items up to a certain assigned limit and thus created a credit relationship. The promotional materials included the following phrases: “Don’t worry, we’ll cover you,” “Automatic protection provided to all new checking accounts,” and “Up to your limit, we’ll pay your checks.”

The plaintiffs asserted that overdraft fees are “finance charges” covered by TILA and thus require proper annual percentage rate disclosures under TILA regulations. The Court concluded that the plaintiffs failed to allege that the overdraft fees were “finance charges.” The Court cited Section 226.4(b)(2) of Regulation Z in coming to this conclusion. Regulation Z states that, “any charge imposed on a checking account” is deemed a finance charge only if it “exceeds the charge for a similar account without a credit feature.” In other words, “[i]f a charge for an account with a credit feature does not exceed the charge for an account without a credit feature, the charge is not a finance charge under §226.4(b)(2).” 12 C.F.R. §226.4, Supp. 1, ¶4(b)

The plaintiffs also claimed that WAMU's overdraft fee was the same amount for accounts with or without the credit feature; therefore, the overdraft fee would not be a finance charge under Regulation Z. The Court concluded that the plaintiff failed to sufficiently allege that the parties had a written credit agreement pertaining to the payment of items that create an overdraft as an additional reason in support of the conclusion that the overdraft fees are not finance charges. The plaintiffs had alleged that WAMU "represented in its promotional materials that it was agreeing as a matter of contract to be legally obligated to pay all overdraft items up to the 'limit' assigned to the account." The Court rightly concluded that promotional materials are not agreements and therefore to the extent that the promotional materials directly contradict a subsequent depository agreement, they will not support a legal conclusion that the parties agreed in writing to payment of the overdraft fees.

In addition, the plaintiffs argued that overdraft fees are "interest" and therefore are subject to limits imposed by HOLA. The Court ruled that overdraft fees were not "interest" imposed in connection with a credit transaction, but were instead charges arising from the terms of the depository agreement. The Court cited Nicolas v. Deposit Guar. Nat'l Bank, 182 F.R.D. at 231 as providing the most persuasive argument for the Court's conclusion. In Nicolas, the United States District Court for the Southern District of Mississippi, Southern Division, relied on a brief filed by the Office of the Comptroller of the Currency ("OCC"). According to the OCC, the overdraft fee was not "interest" in connection with an extension of credit since the bank charge(s) the fee without regard to whether the Bank pays the item creating the overdraft. The Court found that instead the fee was a deposit account service charge governed by the depository agreement. WAMU charged an overdraft fee regardless of whether a check was honored or returned unpaid and therefore the court concluded that the overdraft charges were not "interest" imposed in connection with an extension of credit under HOLA, § 12 U.S.C. § 1463(g)(1).

Further, the plaintiffs asserted that ATM and Debit cards are "credit cards" when they include an overdraft courtesy feature and therefore are subject to TILA regulations that prohibit unsolicited issuance of credit cards and require disclosure of the annual percentage rate in periodic statements. The Court ruled that the plaintiff's claim failed because ATM cards and debit cards are not subject to Regulation Z's disclosure requirements for credit cards. Under Regulation Z, 12 C.F.R. §226.5a, a credit card issuer must make certain disclosures when it solicits an application to open a credit card account. However, section 226.5a(a)(3) expressly excludes "overdraft lines of credit tied to asset accounts accessed by check-guarantee cards or by debit cards; or lines of credit accessed by check-guarantee cards or debit cards that can be used only at ATMs." In addition, because the overdraft fees are not "finance charges," Regulation Z does not require disclosure of an annual percentage rate. Based on the aforementioned analysis the Court determined that the plaintiffs failed to state a claim under TILA.

The aforementioned federal law violations were dismissed, as a result, the Court exercised its discretion to decline supplemental jurisdiction of the pendent state law claims and therefore dismissed the state law claims without prejudice or comment.



**EXHIBIT 4**

**LEGAL RISKS REVIEW FOR FINANCIAL INSTITUTIONS**

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## LEGAL RISKS REVIEW FOR FINANCIAL INSTITUTIONS

### A. Regulation B (12 CFR Part 202); Equal Credit Opportunity Act (15 USC § 1691).

Regulation B prohibits discrimination in credit transactions based on "race, color, religion, national origin, sex, marital status or age." 12 CFR § 202.2(z). This prohibition extends from advertising through applications, adverse action notices, loans, collections, and charge-offs. The OverdraftHonor® program is implemented on all accounts that meet the established screening criteria. Thus certain consumers are not targeted for the ODH program while other consumers are offered other more favorable credit products or overdraft services. Regulation B defines "credit" as "the right granted by a creditor to an applicant to defer payment of a debt, incur debt and defer its payment, or purchase property or services and defer payment thereof" 12 CFR § 202.2(j). In addition, Regulation B defines the term "adverse action" and generally requires a creditor who takes adverse action to send a notice to the consumer providing among other things, the reasons for the adverse action, however, usual and customary practice has been that when a financial institution returns a check because insufficient funds exist in the customer's account, the institution need not provide the credit analysis of this decision required by Regulation B. Some actions taken by financial institutions under overdraft protection programs might constitute adverse action but would not require notice to the consumer if the credit is deemed to be "incidental credit" as defined in Regulation B. "Incidental credit" includes consumer credit that is not subject to a finance charge, is not payable by agreement in more than four installments, and is not made pursuant to the terms of a credit card account. Regulation B does not include paying an overdraft in its definition of a finance charge. Applying this analysis to the OverdraftHonor® leads to the conclusion that no adverse action notice is required by Regulation B.

### B. Regulation O (12 CFR Part 215).

Regulation O requires reporting extensions of credit by a financial institution to an "executive officer, director or principal shareholder," and related interests of same. 12 CFR § 215.1. For purposes of Regulation O only, and no other federal statute or Federal Reserve Board Regulation, an overdraft is expressly considered an extension of credit. See 12 CFR § 215.3. The OverdraftHonor® policy stating when an NSF will be paid or returned cannot be offered to persons covered by Regulation O.

### C. Regulation Z (12 CFR Part 226): Truth-In-Lending Act (15 USC § 1601)

Regulation Z requires disclosure of significant terms of consumer credit through the use of prescribed language and document formats. Regulation Z applies to extensions of credit, which are defined as "the right to defer payment of debt or to incur debt and defer its payment." 12 CFR § 226.2(a)(14). Four conditions must be satisfied for Regulation Z to apply to a transaction: "(i) the credit is offered or extended to consumers; (ii) the offering or extension of credit is done regularly; (iii) the credit is subject to a finance charge or is payable by a written agreement in more than four installments; and (iv) the credit is primarily for personal, family, or household purposes." 12 CFR § 226.1(c)(1). Three cases have examined this third requirement and held that flat fees charged to checking accounts for insufficient fund checks did not violate





Regulation Z. The most recent, on April 26, 2004, the United States District Court, Central District of California, dismissed a class action lawsuit against Washington Mutual Bank that alleged that Washington Mutual Bank's overdraft fees were "finance charges" covered by the Truth in Lending Act. OverdraftHonor®™ as well as the overdraft program utilized by Washington Mutual Bank assesses the same fee for insufficient fund items, whether the item is paid or returned and therefore is not a finance charge. Thus, the Regulation Z disclosures will not be required in connection with the OverdraftHonor® program as they were not required for Washington Mutual Bank. (See also *Taylor v. Union Planters Bank of Southern Mississippi*, 964 F.Supp. 1120 (S.D. Miss. 1997); *Nicolas v. Deposit Guaranty National Bank*, 182 FRD 226 (SD. Miss. 1998)).

In addition, the Joint Guidance on Overdraft Protection Programs issued in February 2005 clearly states "fees for paying overdraft items currently are not considered finance charges if the institution has not agreed in writing to pay overdrafts. Even where the institution agrees in writing to pay overdrafts as part of the deposit account agreement, fees assessed against a transaction account for overdraft protection services are finance charges only to the extent the fees exceed the charges imposed for paying or returning overdrafts on a similar transaction account that does not have overdraft protection."

**D. Regulation DD (12 CFR Part 230); Truth-In-Savings Act (12 USC § 4301).**

Regulation DD governs much of the content of the bank's Truth-In-Savings disclosure brochures or forms required to be given to a new deposit account customer. See 12 CFR § 230.4. In addition, when a change in terms occurs that may reduce the annual percentage yield or adversely effect the consumer in terms of higher fees, the financial institution must give notice of this change and disclose the effective date of the change to the customer at least 30 calendar days before the effective date of the change. See 12 CFR § 230.5.

OverdraftHonor® does not affect the terms or fees associated with deposit accounts. OverdraftHonor® simply clarifies a process already in place at an institution for paying or returning checks when a customer experiences an NSF. For this reason, **no 30-day notification is required. However, if the financial institution changes its overdraft fee at the same time it implements this program, Regulation DD disclosure will be required.**

Regulation DD also limits how accounts may be advertised. Specifically, descriptions of an account as "free" or "no cost" are prohibited if minimum balances must be maintained to avoid transaction fees, there is a maximum number of transactions allowed on the account or regular service or transaction fees are imposed on the account. 12 CFR § 230.4(b)(4). 12 CFR § 230.4(b)(4) Supp. I, lists specific fees that must be disclosed, including monthly service fees, "fees for special services, such as stop-payment fees, fees for balance inquiries or verification of deposits, fees associated with checks returned unpaid." The overdraft fee charged under this policy does not expressly fall under the types of fees that must be disclosed to the customer. However, these fees could be considered "transaction and service fees that consumers reasonably expect to be imposed on a regular basis." 12 CFR § 230.8(a) Supp. I. Thus, OverdraftHonor® is implemented on a number of different consumer account types and not just "free" accounts.

The NSF and overdraft fees are not fees imposed on a specific type of deposit account, but are fees associated with customers experiencing an NSF in relation to their account.



Therefore, these fees have not been considered activity fees associated with a specific deposit account.

**E. Regulation CC (12 CFR Part 229).**

Regulation CC requires banks to make deposited funds available for withdrawal by depositors on a specified schedule. Regulation CC issues are usually addressed in a financial institution's Truth-in-Savings disclosure brochures or forms. Regulation CC addresses the financial institution's responsibilities if an item resulting in an NSF situation is returned unpaid. *See* 12 CFR §§ 229.30 - 229.33. **The Regulation does not pertain to a financial institution's decision to pay or return an item, which results in an NSF situation.** In addition, 12 CFR § 229.13 prohibits a financial institution from collecting overdraft fees if the it has increased the time before funds will be made available without giving notice to the customer. The theory behind this limitation is the overdraft would not have occurred if the funds availability had not been delayed and the deposited check actually paid.

**F. Regulation E (12 CFR Part 205).**

Regulation E regulates issuance of ATM cards and limits customer liability for misuse. *See* 12 CFR §§ 205.5 - 205.6. Regulation E issues are often addressed through the Truth-in-Savings disclosure brochures or forms. As it relates to our program, Reg. E requires that financial institutions cannot insist that the auto-transfers to repay a New Start Repayment Program come from a specific account chosen by the financial institution, but can come from an account chosen by the customer.

**G. Fair Credit Reporting Act (15 USC § 1681) / Fair and Accurate Credit Transaction Act of 2003 (the "FACT Act").**

The Fair Credit Reporting Act (the "FCRA") regulates the consumer-credit reporting industry in an effort to promote more accurate reporting of credit information. *See* 15 USC § 1681(b). This Act was extended, effective as of 1997, to require that adverse action notices be provided to consumer's for not just credit, insurance, or employment situations, but ANY action adverse to the interests of the consumer if the financial institution's action is based in whole or in part on information in a consumer report. *See* 15 USC § 1681(k).

For purposes of the FCRA, a consumer report is defined as "any written, oral, or other communication of any information by a consumer reporting agency bearing on a consumer's credit worthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living" 15 U.S.C. 1681a(d)(1). A consumer report from Chex Systems used to deny a consumer the ability to open a checking account at a financial institution would require the issuance of an adverse action notice to the consumer under the FCRA.

Financial institutions have generally not considered the decision to pay or return an overdraft as requiring adverse action reporting. **It is important under the OverdraftHonor® policy that the financial institution does not use any communication or information provided by a consumer-reporting agency in the decision making process for paying or returning an NSF transaction.**



The Fair and Accurate Credit Transaction Act of 2003 (the “FACT Act”) was signed into law on December 4, 2003. The purpose of this new law is to expand the provisions of the FCRA with a goal of uniform national standards in a number of key areas. In addition, the FACT Act is intended to provide consumers with additional tools to fight identity theft and to ensure the accuracy of their credit reports. As part of these additional tools the FACT Act requires financial institutions to provide negative information notices to customers before sending such information to a consumer reporting agency. **This requirement became effective December 1, 2004.**

The following are excerpts from the FACT Act and the FCRA that explain who is required to provide the negative information notice:

§ 623(7)(A)(i): If any financial institution that extends credit and regularly and in the ordinary course of business furnishes information to a consumer reporting agency described in section 603(p) of this title furnishes negative information to such an agency regarding credit extended to a customer, the financial institution shall provide a notice of such furnishing of negative information, in writing, to the customer.

§ 603(p): The term “consumer reporting agency that compiles and maintains files on consumers on a nationwide basis” means a consumer reporting agency that regularly engages in the practice of assembling or evaluating, and maintaining, for the purpose of furnishing consumer reports to third parties bearing on a consumer’s credit worthiness, credit standing, or credit capacity, each of the following regarding consumers residing nationwide:

- (1) Public record information.
- (2) Credit account information from persons who furnish that information regularly and in the ordinary course of business.

The definition of a consumer reporting agency is broad enough to include agencies such as ChexSystems. As such, collection letters should proactively inform consumers of negative information that will be provided to consumer reporting agencies. The model disclosures set forth in the regulations only address the negative impact on a consumer’s credit report, however, we have always recommended that consumers be informed of the possibility of not being able to obtain checking account privileges at other financial institutions.

The FACT Act requires institutions to send a negative information notice to customers before furnishing such notice to the consumer reporting agency, but in no event later than 30 days after the occurrence of the reporting event. Once reported, the financial institution is not required to send further notices if additional negative information concerning the same transaction, extension of credit, account, or customer is provided to the consumer reporting agency.

Until we receive further clarification, we recommend the following sample language be added to collection letters and brochures. The FACT Act states that a financial institution shall be deemed to be in compliance with the negative notice requirement if the financial institution uses the model disclosure form prescribed by the Federal Reserve Board. The last two lines are from the model disclosure form.



SAMPLE LANGUAGE

We may report information about your account to consumer reporting agencies, which may affect your ability to obtain checking account privileges at other financial institutions. We may also report information about your account to credit bureaus. Late payments, missed payments, or other defaults on your account may be reflected in your credit report.

**H. Federal Deposit Insurance Act § 27 (12 USC § 1831d); National Banking Act § 85 (12 USC § 85).**

Section 27 of the Federal Deposit Insurance Act, 12 USC § 1831d, sets forth the maximum level of interest chargeable by a state chartered, federally insured bank. In interpreting Section 27, the FDIC General Counsel has held that cases decided under Section 85 of the National Banking Act, 12 USC § 85, are controlling as to the definition of interest for purposes of Section 27. Section 85 of the National Banking Act regulates the interest rate a federally chartered bank may charge customers. Under Section 85, the preliminary issue is if the charge is considered interest under applicable state law. If the fee were considered interest under the applicable state's law, it would be subject to the restriction on maximum interest rates imposed by either Section 27 or Section 85. Each financial institution implementing the OverdraftHonor® program will need to perform an analysis of applicable state legal issues.

**I. Federal Trade Commission Act (15 U.S.C. § 45)**

Section 5 of the Federal Trade Commission Act (FTC Act) prohibits unfair or deceptive acts or practices. The banking agencies enforce this section pursuant to their authority in section 8 of the Federal Deposit Insurance Act, 12 U.S.C. § 1818.14 An act or practice is unfair if it causes or is likely to cause substantial injury to consumers that is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition. An act or practice is deceptive if, in general, it is a representation, omission, or practice that is likely to mislead a consumer acting reasonably under the circumstances, and the representation, omission, or practice is material.

The OverdraftHonor® program disclosures clearly inform consumers of all aspects of the overdraft service including the fee charged for each NSF item, and that the institution is not encouraging accountholders to overdraw their accounts or become dependent on the policy to meet short-term cash needs.

**J. Green Book Guidelines (Enrollment – Section G Termination of Enrollment, Termination by the Financial Institution).**

<http://www.fms.treas.gov/greenbook/enroll/enroll-g.html>

The Green Book is a comprehensive guide for financial institutions processing Federal government ACH payments and collections.

Financial institutions may close an account to which Federal benefit payments are currently being sent by providing a 30-day written notice to the recipient prior to closing the account. In cases involving fraud, accounts may be closed immediately. The financial institution cannot revoke the enrollment authorization by notifying the Federal agency and not the recipient.



The 30-day written notice should remind the recipient to make other arrangements for the handling of his/her payments. The financial institution must credit to the recipient's account any payments received during the 30-day notice period. The financial institution must also immediately return to the Federal government all payments received after the 30-day notice period. A financial institution that closes the account without properly terminating the enrollment must make the funds available to the recipient until proper notice is provided.

**K. Call Reports of Unpaid Overdraft Balances.**

*Call Reports do provide that unpaid overdraft balances and over 30-day balances be reported as delinquent loans.* See Federal Financial Institutions Examination Council, Reports of Condition and Income Instructions. After 30 days, the OverdraftHonor® process may have some overdraft balances converted into New Start Repayment Programs (non-interest bearing loans), or the process to write these balances off will be started. If the financial institution and customer agree to convert the overdraft balance into a loan, the institution's loan documentation process will be followed.

**L. State Regulations.**

The foregoing analysis focuses on federal statutes and regulations. State statutes and regulations may impact the ability of a financial institution to implement OverdraftHonor® in a given state. Some potential state law issues are the state's definition of a "loan", the state's method of calculating interest, the state's usury laws and the state's banking regulations. As with other programs, the financial institution must comply with all state and federal statutes and regulations.

**BSG, LLC Disclaimer**

**THIS INFORMATION IS PROVIDED TO ASSIST YOU IN MAKING AN INFORMED DECISION WITH RESPECT TO YOUR POTENTIAL IMPLEMENTATION OF OVERDRAFTHONOR®. WHILE WE HAVE SUCCESSFULLY ASSISTED IN THE IMPLEMENTATION OF THIS PROGRAM AND OBSERVED THE SUCCESSFUL RESOLUTION OF THE COMPLIANCE AND LEGAL CONCERNS OF A NUMBER OF FINANCIAL INSTITUTIONS, BSG, LLC RECOMMENDS THAT YOU PERFORM AN INDEPENDENT LEGAL AND COMPLIANCE REVIEW, AND IMPLEMENT THIS OVERDRAFTHONOR® SERVICE ONLY AFTER REVIEW WITH YOUR LEGAL COUNSEL. WHILE WE PROVIDE AN ANALYSIS OF REGULATIONS, LEGAL ISSUES AND USUAL AND CUSTOMARY PRACTICES, WE EXPRESSLY ACKNOWLEDGE THAT WE ARE NOT ATTORNEYS, DO NOT REPRESENT OUR EFFORTS AS A LEGAL OPINION, AND CANNOT BE RESPONSIBLE FOR THE LEGAL DECISIONS AND CHOICES YOUR INSTITUTION MAKES.**



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## LEGAL RISKS REVIEW FOR CREDIT UNIONS

### **Federal Credit Union Regulations.**

Section 701.21 is promulgated pursuant to the NCUA's Board's exclusive authority as set forth in Section 107(5) of the Federal Credit Union Act (12 U.S.C 1757(5)) to regulate the rates, terms of repayment and other conditions of Federal credit union loans and lines of credit (including credit cards) to members.

Section 701.21(c)(3) Credit applications and overdrafts, states that a credit union may advance money to a member to cover an account deficit without having a credit application from the borrower on file if the credit union has a written overdraft policy. The policy must:

1. Set a cap on the total dollar amount of all overdrafts the credit union will honor consistent with the credit union's ability to absorb losses;
2. Establish a time limit not to exceed forty-five calendar days for a member either to deposit funds or obtain an approved loan from the credit union to cover each overdraft;
3. Limit the dollar amount of overdrafts the credit union will honor per member; and
4. Establish the fee and interest rate, if any, the credit union will charge members for honoring overdrafts.

Under the Truth in Savings Act, deposit account disclosures must include the amount of any fee that may be imposed in connection with the account and the conditions under which the fee may be imposed. The Truth in Savings Act is implemented by NCUA's Truth in Savings Act regulation at 12 CFR Part 707 for federally insured credit unions.

### **Federal Credit Union Advertising Rules (12 CFR § 740.2.)**

Section 740.2 addresses the use of advertisements or other representations that are inaccurate or misrepresent the services or contracts offered which would include making false representations to the public regarding an institution's deposit accounts. The OverdraftHonor® program disclosures clearly inform consumers of all aspects of the overdraft service including the fee charged for each NSF item, and that the institution is not encouraging accountholders to overdraw their accounts or become dependent on the policy to meet short-term cash needs.

### **State Regulations.**

The foregoing analysis focuses on federal credit union regulations. State statutes and regulations may impact the ability of a financial institution to implement OverdraftHonor® in a given state. Some potential state law issues are the state's definition of a "loan", the state's method of calculating interest, the state's usury laws and the state's banking regulations. As with other programs, the financial institution must comply with all state and federal statutes and regulations.

### **BSG, LLC Disclaimer**

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**INDEPENDENT LEGAL AND COMPLIANCE REVIEW, AND IMPLEMENT THIS OVERDRAFTHONOR® SERVICE ONLY AFTER REVIEW WITH YOUR LEGAL COUNSEL. WHILE WE PROVIDE AN ANALYSIS OF REGULATIONS, LEGAL ISSUES AND USUAL AND CUSTOMARY PRACTICES, WE EXPRESSLY ACKNOWLEDGE THAT WE ARE NOT ATTORNEYS, DO NOT REPRESENT OUR EFFORTS AS A LEGAL OPINION, AND CANNOT BE RESPONSIBLE FOR THE LEGAL DECISIONS AND CHOICES YOUR INSTITUTION MAKES.**

**EXHIBIT 5**

**SIDE BY SIDE COMPARISON – PROPOSED AND FINAL JOINT GUIDANCE**

	<b>PROPOSED JOINT GUIDELINES</b>	<b>FINAL JOINT GUIDELINES</b>
<b>SAFETY &amp; SOUNDNESS CONSIDERATIONS</b>		
1. Written Policies		Adopt express account eligibility standards and well defined and properly documented dollar limit decision criteria.
2. Monitor Accounts		Monitor accounts on an ongoing basis and be able to identify consumers who may represent an undue credit.
3. Reports to Management		Reports should be provided to enable management to identify, measure, and manage overdraft volume, profitability, and credit performance on a regular basis.
4. Repayment		Specific Timeframes for when consumers must pay off their overdraft balances should be established.
5. Suspension		There should be established procedures for the suspension of overdraft services when the account holder no longer meets the eligibility criteria as well as for when there is a lack of repayment of an overdraft.
6. Charge-Off Requirements	Overdraft balances should generally be charged off within 30 days from the date first overdrawn. [Revised in the final Guidelines]	Overdraft balances should generally be charged off when considered uncollectible but no later than 60 days from the date first overdrawn.
7. Repayment Plan		Guidelines allow extended repayment plan "in some cases," however the existence of the repayment plan would not extend the charge off determination period beyond 60-days.
8. Recovery		Any payments received after the account is charged off (up to the amount charged off against allowance) should be reported as a recovery.
9. Overdraft Rewritten as Loan Obligations		When overdrafts are rewritten as loan obligations in accordance with an institution's loan policy and supported by a document assessment of that consumer's ability to repay the charge-off timeframes in the FFIEC Uniform Retail Credit Classification and Account Management Policy would apply.
10. Reporting of Income and Loss Recognition		Institutions should follow GAAP and the instruction for the Call Report and NCUA 5300 Call Report
11. Reporting on Regulatory Reports	Overdraft balances should be reported on regulatory reports as loans. Accordingly,	Overdraft balances should be reported on regulatory reports as loans. Accordingly,



	overdraft losses should be charged off against the allowance for loan and lease losses and uncollected overdraft fees should be reversed against overdraft fee income or an associated earned fee loss allowance. [Revised in the final Guidelines]	overdraft losses should be charged off against the allowance for loan and lease losses.
12. Loss Estimation	The Agencies expect all institutions to adopt rigorous loss estimation processes to ensure that any allowances related to earned fees reflect all estimated losses and that earned but uncollected fees are accounted for accurately. [Revised in the final Guidelines]	The Agencies expect all institutions to adopt rigorous loss estimation processes to ensure that overdraft fee income is accurately measured.
13. Unused Commitments		If an institution advises account holders of the available amount of overdraft protection the institution should report the available amount of overdraft protection with legally binding commitments for Call Report, and NCUA 5300 Call Report purposes. These available amounts, therefore, should be reported as "unused commitments" in regulatory reports.
14. Risk-Based Capital		The Agencies also expect proper risk-based capital treatment of outstanding overdrawn balances and unused commitments. Overdraft balances should be risk-weighted according to the obligor.
15. Due Diligence of 3 <sup>rd</sup> Party Vendors		Institutions entering into overdraft protection contracts with third-party vendors must conduct thorough due diligence reviews prior to signing a contract.
<b>LEGAL RISKS</b>		
1. Review by Counsel		Institutions should have their overdraft protection programs reviewed by counsel for compliance with all applicable laws prior to implementation.
2. Monitor Applicable Laws and Regulations	[Not mentioned in initial draft of the Guidelines]	Institutions should monitor applicable laws and regulations for revisions and to ensure that their overdraft protection programs are fully compliant.
3. Federal Trade Commission Act/Advertising Rules		Institutions must avoid engaging in deceptive, inaccurate, misrepresentative, or unfair practices, and closely review all aspects of their overdraft protection programs, especially any material that inform consumers about the programs.
4. Truth in Lending Act/Regulation Z		Currently fees for paying overdraft items are not considered finance charges if the institution has not agreed in writing to pay overdrafts, however, Regulation Z would be triggered if an overdraft repayment loan (usually offered to those who cannot repay their overdrafts) is

		payable by written agreement in more than four installments. Regulation Z will also be triggered where such loans are subject to a finance charge.
5. Equal Credit Opportunity Act		Under the ECOA and Regulation B, creditors are prohibited from discriminating against an applicant on a prohibited basis in any aspect of a credit transaction.
6. Truth in Savings Act	Where the added overdraft protection fees do not exceed previously disclosed NSF fees, a new disclosure may be required if the previous disclosure did not adequately disclose that the fees would be assessed for both paid checks and returned checks. [This sentence did not make it to the final Guidelines.]	When overdraft protection services are added to an existing deposit account, advance notice to the account holder may be required, for example, if the fee for the service exceeds the fee for accounts that do not have the service.
7. Electronic Fund Transfer Act		If, under an overdraft protection program, a consumer could overdraw an account by means of an ATM withdrawal or POS debit card transaction, both are EFTs subject to EFTA and Regulation E. As such, periodic statements must be readily understandable and accurate regarding debits made, current balances, and fees charged. Terminal receipts also must be readily understandable and accurate regarding the amount of the transfer.
<b>BEST PRACTICES</b>		
1. Avoid Promoting Poor Account Management		Institutions should not market the program in a manner that encourage routine or intentional overdrafts. Institutions should instead present that program as a customer service that may cover inadvertent consumer overdrafts.
2. Overdraft Protection Programs vs. Alternatives		Fairly represent overdraft protection programs and alternatives. When informing consumers about an overdraft protection program, inform consumers generally of other overdraft services and credit products, if any, that are available at the institution and how the terms, including fees, for these services and products differ.
3. Staff Training		Train staff to explain program features and other choices. Train customer service or consumer complaint processing staff to explain their overdraft protection program's features, costs, and terms, including how to opt out of the service.
4. Discretionary Nature	If the overdraft payment is discretionary, describe the circumstances in which the institution would refuse to pay an overdraft or otherwise suspend the overdraft protection program.	Clearly explain discretionary nature of program

	Furthermore, if payment of overdrafts is discretionary, information provided to consumers should not contain any representations that would lead a consumer to expect that payment of overdrafts is guaranteed or assured. [These two sentences did not make the final Guidelines]	
5. Overdraft Protection Service vs. "Free" Account Features.		Distinguish overdraft protection services from "Free account features. Institutions should not promote "free" account and overdraft protection programs in the same advertisement in a manner that suggests the overdraft protection program is free of charges.
6. Overdraft Protection Program Fees		In communications about overdraft protection programs, clearly disclose the dollar amount of the fee for each overdraft and any interest rate or other fees that may apply.
7. Overdraft Fees and the Overdraft Protection Dollar Limit		Clarify that fees count against the disclosed overdraft protection dollar limit.
8. Multiple Fees		Demonstrate when multiple fees will be charged.
9. Transaction Clearing Policies	Clearly disclose to consumers the order in which the institution pays checks or processes other transactions (e.g., transactions at the ATM or point of sale terminal). [This sentence did not make the final Guidelines]	Explain impact of transaction clearing policies. Transactions may not be processed in the order in which they occurred and the order in which transactions are received by the institution and processed can affect the total amount of overdraft fees incurred.
10. Type of Transactions Covered		Illustrate the type of transactions covered. Clearly disclose that overdraft fees may be imposed on transactions such as ATM withdrawals, debit card transactions, etc.
11. Election or Opt-Out Service		Provide election or opt-out of service. Obtain affirmative consent of consumers to receive overdraft protection. Alternatively, where overdraft protection is automatically provided, permit consumers to "opt-out" of the program and provide a clear consumer disclosure of this option.
12. Transactions that Trigger Fees		Alert consumers before a transaction triggers any fees. When consumers attempt to withdraw or transfer funds made available through an overdraft protection program, provide a specific consumer notice, where feasible, that completing the withdrawal may trigger the overdraft fees. This notice should be presented in a manner that permits consumers to cancel the attempted withdrawal or transfer after receiving the

		notice. If this is not feasible, then post notices (e.g., on proprietary ATMs) explaining that transactions may be approved that overdraw the account and fees may be incurred.
13. Distinguish Balances from Overdraft Protections Funds		Prominently distinguish balances from overdraft protection funds availability.
14. Notice to Consumers	Institutions should also consider reiterating the terms of the overdraft protection service when the consumer accesses the service for the first time. Where feasible, notify consumers in advance if the institution plans to terminate or suspend the consumer's access to the service. [These two sentences did not make the final Guidelines]	Promptly notify consumers of overdraft protection program usage each time used.
15. Daily Limits	Consider limiting the number of overdrafts or the dollar amount of fees that will be charged against any one account each day while continuing to provide coverage for all overdrafts up to the overdraft limit. [Revised in the final Guidelines]	Consider imposing a cap on consumers' potential daily costs from the overdraft program.
16. Monitor Usage		Monitor excessive consumer usage, which may indicate a need for alternative credit arrangements or other services, and inform consumers of these available options.
17. Fairly Report Program Usage		Institutions should not report negative information to consumer reporting agencies when the overdrafts are paid under the terms of the overdraft protection programs.



**EXHIBIT 6**

**SIDE BY SIDE COMPARISON – OTS GUIDANCE AND FINAL JOINT GUIDANCE**

	<b>FINAL OTS GUIDELINES</b>	<b>FINAL JOINT GUIDELINES</b>
<b>SAFETY &amp; SOUNDNESS CONSIDERATIONS</b>		
1. Written Policies		Adopt express account eligibility standards and well defined and properly documented dollar limit decision criteria.
2. Monitor Accounts		Monitor accounts on an ongoing basis and be able to identify consumers who may represent an undue credit.
3. Reports to Management		Reports should be provided to enable management to identify, measure, and manage overdraft volume, profitability, and credit performance on a regular basis.
4. Repayment		Specific Timeframes for when consumers must pay off their overdraft balances should be established.
5. Suspension		There should be established procedures for the suspension of overdraft services when the account holder no longer meets the eligibility criteria as well as for when there is a lack of repayment of an overdraft.
6. Charge-Off Requirement		Overdraft balances should generally be charged off when considered uncollectible but no later than 60 days from the date first overdrawn.
7. Repayment Plan		Guidelines allow extended repayment plan "in some cases," however the existence of the repayment plan would not extend the charge off determination period beyond 60-days.
8. Recovery		Any payments received after the account is charged off (up to the amount charged off against allowance) should be reported as a recovery.
9. Overdraft Rewritten as Loan Obligations		When overdrafts are rewritten as loan obligations in accordance with an institution's loan policy and supported by a document assessment of that consumer's ability to repay the charge-off timeframes in the FFIEC Uniform Retail Credit Classification and Account Management Policy would apply.
10. Reporting of Income and Loss Recognition	Saving Associations should follow GAAP.	Institutions should follow GAAP and the instruction for the Call Report and NCUA 5300 Call Report
11. Reporting on Regulatory Reports	[The OTS Guidelines do not have a parallel provision]	Overdraft balances should be reported on regulatory reports as loans. Accordingly,

		overdraft losses should be charged off against the allowance for loan and lease losses.
12. Loss Estimation		The Agencies expect all institutions to adopt rigorous loss estimation processes to ensure that overdraft fee income is accurately measured.
13. Unused Commitments	[The OTS Guidelines do not have a parallel provision]	If an institution advises account holders of the available amount of overdraft protection the institution should report the available amount of overdraft protection with legally binding commitments for Call Report, and NCUA 5300 Call Report purposes. These available amounts, therefore, should be reported as "unused commitments" in regulatory reports.
14. Risk-Based Capital	[The OTS Guidelines do not have a parallel provision]	The Agencies also expect proper risk-based capital treatment of outstanding overdrawn balances and unused commitments. Overdraft balances should be risk-weighted according to the obligor.
15. Due Diligence of 3 <sup>rd</sup> Party Vendors		Institutions entering into overdraft protection contracts with third-party vendors must conduct thorough due diligence reviews prior to signing a contract.
<b>LEGAL RISKS</b>		
1. Review by Counsel	[The OTS Guidelines do not have a legal risks section]	Institutions should have their overdraft protection programs reviewed by counsel for compliance with all applicable laws prior to implementation.
2. Monitor Applicable Laws and Regulations	[The OTS Guidelines do not have a legal risks section]	Institutions should monitor applicable laws and regulations for revisions and to ensure that their overdraft protection programs are fully compliant.
3. Federal Trade Commission Act/Advertising Rules	[The OTS Guidelines do not have a legal risks section]	Institutions must avoid engaging in deceptive, inaccurate, misrepresentative, or unfair practices, and closely review all aspects of their overdraft protection programs, especially any material that inform consumers about the programs.
4. Truth in Lending Act/Regulation Z	[The OTS Guidelines do not have a legal risks section]	Currently fees for paying overdraft items are not considered finance charges if the institution has not agreed in writing to pay overdrafts, however, Regulation Z would be triggered if an overdraft repayment loan (usually offered to those who cannot repay their overdrafts) is payable by written agreement in more than four installments. Regulation Z will also be triggered where such loans are subject to a finance charge.
5. Equal Credit Opportunity Act	[The OTS Guidelines do not have a legal risks section]	Under the ECOA and Regulation B, creditors are prohibited from discriminating against an applicant on a

		prohibited basis in any aspect of a credit transaction.
6. Truth in Savings Act	[The OTS Guidelines do not have a legal risks section]	When overdraft protection services are added to an existing deposit account, advance notice to the account holder may be required, for example, if the fee for the service exceeds the fee for accounts that do not have the service.
7. Electronic Fund Transfer Act	[The OTS Guidelines do not have a legal risks section]	If, under an overdraft protection program, a consumer could overdraw an account by means of an ATM withdrawal or POS debit card transaction, both are EFTs subject to EFTA and Regulation E. As such, periodic statements must be readily understandable and accurate regarding debits made, current balances, and fees charged. Terminal receipts also must be readily understandable and accurate regarding the amount of the transfer.
<b>BEST PRACTICES</b>		
1. Avoid Promoting Poor Account Management		Institutions should not market the program in a manner that encourage routine or intentional overdrafts. Institutions should instead present that program as a customer service that may cover inadvertent consumer overdrafts.
2. Overdraft Protection Programs vs. Alternatives		Fairly represent overdraft protection programs and alternatives. When informing consumers about an overdraft protection program, inform consumers generally of other overdraft services and credit products, if any, that are available at the institution and how the terms, including fees, for these services and products differ.
3. Staff Training		Train staff to explain program features and other choices. Train customer service or consumer complaint processing staff to explain their overdraft protection program's features, costs, and terms, including how to opt out of the service.
4. Discretionary Nature		Clearly explain discretionary nature of program
5. Overdraft Protection Service vs. "Free" Account Features		Distinguish overdraft protection services from "Free account features. Institutions should not promote "free" account and overdraft protection programs in the same advertisement in a manner that suggests the overdraft protection program is free of charges.
6. Overdraft Protection Program Fees		In communications about overdraft protection programs, clearly disclose the dollar amount of the fee for each overdraft and any interest rate or other fees that may apply.



7. Overdraft Fees and the Overdraft Protection Dollar Limit		Clarify that fees count against the disclosed overdraft protection dollar limit.
8. Multiple Fees		Demonstrate when multiple fees will be charged.
9. Transaction Clearing Policies	Savings associations should also clearly disclose rules for processing and clearing transactions. [This suggestion in the OTS Guidelines is also found in the Proposed Joint Guidelines but not the Final Joint Guidelines.] [See also Item 18 below]	Explain impact of transaction clearing policies. Transactions may not be processed in the order in which they occurred and the order in which transactions are received by the institution and processed can affect the total amount of overdraft fees incurred.
10. Type of Transactions Covered		Illustrate the type of transactions covered. Clearly disclose that overdraft fees may be imposed on transactions such as ATM withdrawals, debit card transactions, etc.
11. Election or Opt-Out Service		Provide election or opt-out of service. Obtain affirmative consent of consumers to receive overdraft protection. Alternatively, where overdraft protection is automatically provided, permit consumers to "opt-out" of the program and provide a clear consumer disclosure of this option.
12. Transactions that Trigger Fees	If canceling the transaction is not feasible for a particular type of transaction, then savings associations should allow consumers the choice to make access to the overdraft protection program unavailable by transaction type, even if it results in limiting access to the overdraft protection amount only to check transactions. [This sentence is unique to the OTS Guidelines.]	Alert consumers before a transaction triggers any fees. When consumers attempt to withdraw or transfer funds made available through an overdraft protection program, provide a specific consumer notice, where feasible, that completing the withdrawal may trigger the overdraft fees. This notice should be presented in a manner that permits consumers to cancel the attempted withdrawal or transfer after receiving the notice. If this is not feasible, then post notices (e.g., on proprietary ATMs) explaining that transactions may be approved that overdraw the account and fees may be incurred.
13. Distinguish Balances from Overdraft Protection Funds		Prominently distinguish balances from overdraft protection funds availability.
14. Notice to Consumers		Promptly notify consumers of overdraft protection program usage each time used.
15. Daily Limits		Consider imposing a cap on consumers' potential daily costs from the overdraft program.
16. Monitor Usage		Monitor excessive consumer usage, which may indicate a need for alternative credit arrangements or other services, and inform consumers of these available options.
17. Fairly Report Program Usage		Institutions should not report negative information to consumer reporting

		agencies when the overdrafts are paid under the terms of the overdraft protection programs.
18. Manipulation of Transaction Clearing Rules	Do not manipulate transaction-clearing rules. Transaction-clearing rules (including check-clearing and batch debit processing) should not be administered unfairly or manipulated to inflate fees. [This sentence is unique to the OTS Guidelines.]	



**EXHIBIT 7**

**PROPOSED REGULATION DD AMENDMENTS**



# Proposed Rules

Federal Register

Vol. 69, No. 109

Monday, June 7, 2004

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

## FEDERAL RESERVE SYSTEM

### 12 CFR Part 230

[Regulation DD; Docket No. R-1197]

#### Truth in Savings

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Proposed rule.

**SUMMARY:** The Board proposes to amend Regulation DD, which implements the Truth in Savings Act, and the staff commentary to the regulation, to address concerns about the uniformity and adequacy of information provided to consumers when they overdraw their accounts. The proposed amendments, in part, address a specific service offered by depository institutions, commonly referred to as "bounced-check protection" or "courtesy overdraft protection."

Bounced-check protection is an automated service that is sometimes provided to deposit account consumers as an alternative to a traditional line of credit. To address concerns about the marketing of bounced-check protection services, a proposed revision to the regulation would expand the prohibition against misleading advertisements to cover communications with current consumers about existing accounts; the staff commentary would provide examples. Proposed revisions to Regulation DD would require additional fee and other disclosures about automated overdraft services, including in advertisements. The Board also is proposing amendments of general applicability that would require institutions to provide more uniform disclosures about overdraft and returned-item fees.

**DATES:** Comments must be received on or before August 6, 2004.

**ADDRESSES:** You may submit comments, identified by Docket No. R-1197, by any of the following methods:

- **Agency Web site:** <http://www.federalreserve.gov>. Follow the

instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.

- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.

- **E-mail:** [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include docket number in the subject line of the message.

- **FAX:** 202/452-3819 or 202/452-3102.

- **Mail:** Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. All public comments are available from the Board's web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, except as necessary for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

**FOR FURTHER INFORMATION CONTACT:** Elizabeth A. Eurgubian, Attorney, or Ky Tran-Trong or Krista P. DeLargy, Senior Attorneys, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, at (202) 452-3667 or 452-2412; for users of Telecommunications Device for the Deaf ("TDD") only, contact (202) 263-4869.

#### SUPPLEMENTARY INFORMATION:

##### I. The Truth in Savings Act

The Truth in Savings Act (TISA), 12 U.S.C. 4301 *et seq.*, is implemented by the Board's Regulation DD (12 CFR part 230). The purpose of the act and regulation is to assist consumers in comparing deposit accounts offered by depository institutions, principally through the disclosure of fees, the annual percentage yield (APY), the interest rate, and other account terms. An official staff commentary interprets the requirements of Regulation DD (12 CFR part 230 (Supp. I)). Credit unions are governed by a substantially similar regulation issued by the National Credit Union Administration.

Under TISA and Regulation DD, disclosures must be given upon a consumer's request and before an account is opened. Institutions are not required to provide periodic statements;

but if they do, the act requires that fees, yields, and other information be provided on the statements. Notice must be given to accountholders before an adverse change in account terms occurs and prior to the renewal of certificates of deposit (time accounts).

TISA and Regulation DD contain rules for advertising deposit accounts. There is a prohibition against advertisements, announcements, or solicitations that are inaccurate or misleading, or that misrepresent the deposit contract. Institutions are also prohibited from describing an account as free (or using words of similar meaning) if a regular service or transaction fee is imposed, if a minimum balance must be maintained, or if a fee is imposed when a customer exceeds a specified number of transactions. In addition, the act and regulation impose substantive restrictions on institutions' practices regarding the payment of interest on accounts and the calculation of account balances.

##### II. Concerns About Bounced-Check Protection Services

Historically, depository institutions have used their discretion on an ad hoc basis to pay overdrafts for consumers on transaction accounts, usually imposing a fee. Over the years, some institutions automated the process for considering whether to honor overdrafts to reduce the costs of reviewing individual items, but generally institutions did not inform customers of their internal policies for determining whether an item would be paid or returned. More recently, third-party vendors have developed and sold automated programs to institutions, particularly to smaller ones. What generally distinguishes the vendor programs from institutions' in-house automated processes is the addition of marketing plans that appear designed to promote the generation of fee income by stating a dollar amount that consumers would be allowed to overdraw and by encouraging consumers to overdraw their accounts and use the service as a line of credit.

While bounced-check protection services vary among institutions, many programs have the following characteristics:

- Institutions inform consumers that overdraft protection is a feature of their accounts and promote the use of the service. Institutions also inform

consumers of their aggregate dollar limit under the overdraft protection program.

- Coverage is automatic for consumers who meet the institution's criteria (e.g., account has been open a certain number of days, deposits are made regularly). Typically, the institution performs no credit underwriting.

- Overdrafts generally are paid up to the aggregate limit set by the institution for the specific class of accounts, typically \$100 to \$500.

- Many program disclosures state that payment of an overdraft is discretionary on the part of the institution, and may disclaim any legal obligation of the institution to pay any overdraft.

- The service may extend to check transactions as well as other transactions, such as withdrawals at automated teller machines ("ATMs"), transactions using debit cards, pre-authorized automatic debits from a consumer's account, telephone-initiated funds transfers, and on-line banking transactions.

- A flat fee is charged each time the service is triggered and an overdraft item is paid. Commonly, a fee in the same amount would be charged even if the overdraft item were not paid. A daily fee also may apply for each day the account remains overdrawn.

- Some institutions offer closed-end loans to consumers who do not bring their accounts to a positive balance within a specified time period. These repayment plans allow consumers to repay their overdrafts and fees in installments.

In November 2002, when it published the annual proposed update to the staff commentary to Regulation Z, the Board solicited comment and information from the public about how bounced-check protection services are designed and operated, to determine the need for guidance to depository institutions under Regulation Z or other laws (67 FR 72618, December 6, 2002). The Board received approximately 350 comment letters; most were from industry representatives describing how the services work.

Consumer advocates, state agency representatives, and others believed that bounced-check protection services should be subject to TILA and Regulation Z. They noted that in addition to warning consumers about the high cost of the service, Truth in Lending disclosures would apprise consumers about the true nature of the service as a credit transaction. Industry commenters opposed coverage under TILA, stating that the current disclosure requirements under TISA are adequate,

and that coverage under TILA would be burdensome. The Board believes that consumers would benefit from more uniform and complete information about the costs and terms of overdraft services not covered under TILA, including in advertisements.

Improvements in the disclosures provided to consumers could aid them in understanding the costs associated with overdrawing their accounts and promote better account management. The Board is not proposing at this time to cover these services under TILA and Regulation Z, although further consideration of the need for such coverage may be appropriate if concerns about these overdraft programs persist in the future.

Paying consumers' occasional or inadvertent overdrafts is a long-established customer service provided by depository institutions. The Board recognized this longstanding practice when it initially adopted Regulation Z in 1969; the regulation provided that these transactions are generally exempt from coverage under Regulation Z where there is no written agreement between the consumer and institution to pay an overdraft and impose a fee. See § 226.4(c)(3). The exemption was designed to facilitate depository institutions' ability to accommodate consumers on an ad-hoc basis.

The Board's study of bounced-check protection services has identified a number of concerns about some programs. One major concern relates to the adequacy of information provided to consumers whose accounts are eligible for bounced-check protection services. The proposed revisions to Regulation DD and the staff commentary are intended to improve the information provided to consumers about these overdraft services.

Other concerns center on institutions' marketing practices. Although the service is designed to protect consumers against occasional inadvertent overdrafts, some institutions' promotional materials make the service appear to be a line of credit, apparently to promote a consumer's repeated use of the service. Many of the marketing plans include material that informs consumers of the availability of the bounced-check protection service, and also of the maximum aggregate dollar amount of overdrafts the institution will pay. Some marketing plans encourage consumers to use the service to meet short-term credit needs, and not just as protection against inadvertent overdrafts. Some institutions have encouraged consumers specifically to use an overdraft as an advance on their next paycheck. Notwithstanding the marketing

promises, however, qualifying language disclaims any legal obligation by the institution to pay any overdraft. In some cases, deposit accounts that are promoted as being "free" also promote bounced-check protection services that involve substantial fees. In addition, some institutions do not clearly inform consumers that ATM withdrawals, debit card transactions, or other electronic transfers may routinely be authorized under these overdraft services and that fees will be imposed in such cases. Proposed revisions to Regulation DD's advertising rules and disclosure requirements are intended to address these concerns.

In addition to the Board's proposed revisions to Regulation DD and the staff commentary, the member agencies of the Federal Financial Institution Examination Council (FFIEC) have developed proposed supervisory guidance for institutions that offer bounced-check protection services. The proposed interagency guidance, which is being published for comment, would include best practices addressing the marketing and operation of bounced-check protection services. For example, institutions would be encouraged to obtain customers consent to receive overdraft protection or inform customers how they may "opt out" of the service, avoid encouraging routine or intentional overdrafts, and to promptly notify consumers when they access an overdraft protection service.

### III. Concerns About Uniform Disclosure of Overdraft Fees

The Board has concerns about the uniformity and adequacy of cost disclosures provided to consumers regarding overdraft and returned-item fees under Regulation DD. Many institutions already provide timely information to consumers about overdrafts in their accounts and the fees imposed, including notices that are sent at the time the overdraft occurs and on periodic statements. These practices and disclosures are not uniform among institutions, however, and some consumers may not receive adequate information on a timely basis.

Fees for paying overdrafts and for returned items are typically flat fees unrelated to the amount of the item. These amounts may be significant when there are multiple overdrafts although the items may represent relatively small dollar amounts. Even when consumers are aware that an account is or may become overdrawn, they do not necessarily know the number of overdraft items that will result or the total fees that will be imposed, both of which are determined by the order in

which items drawn on the account are presented and the institution's policies regarding the order in which items are paid. Accordingly, some consumers may not be aware of the total amount of fees being imposed and the amount by which the account is overdrawn until the next periodic statement is received. And when the periodic statement is provided, it may intersperse fees among other items rather than providing a total. As a result, the overall cost of obtaining credit through an overdraft service is not clearly presented to consumers.

TISA was enacted, in part, for the purpose of requiring clear and uniform disclosures regarding deposit account terms and fees assessable against these accounts. Such disclosures allow consumers to make meaningful comparisons among different accounts and to make informed judgments about the use of their accounts. To further the purposes of TISA, the Board is proposing uniform requirements for notifying consumers about returned-item fees and overdraft fees (whether the overdraft is created by check, by ATM withdrawal or other electronic transfer, or by other means). These rules will also help ensure that where an overdraft is paid, consumers are uniformly notified about the account's status. Information about overdrafts and returned items that is provided on a regular and timely basis may enable consumers to avoid unnecessary fees; it may assist consumers to better consider their approach to account management and determine whether the account's terms and features are suited to their needs or whether other types of accounts or services would be more appropriate.

#### IV. Summary of Proposed Revisions

Pursuant to its authority under Section 269(a) of TISA, the Board is proposing the following revisions to Regulation DD and the staff commentary to address concerns about the uniformity and adequacy of institutions' disclosure of overdraft fees generally, and to address concerns about advertised automated overdraft services ("bounced-check protection services") in particular:

##### *Disclosures Concerning Overdraft Fees Generally*

**Periodic statements.** Institutions that provide periodic statements would be required to include the total amount of fees imposed for overdrafts and the total amount of fees for returned items for the statement period and for the calendar year to date.

**Account-opening disclosures.** Institutions would be required to

specify in the account-opening disclosures provided under the Truth in Savings Act whether overdraft protection fees may be imposed in connection with checks, automated teller machine (ATM) withdrawals, or other electronic fund transfers.

##### *Additional Protections for Accounts With Certain Overdraft Protection Services (Bounced-Check Protection)*

**Additional advertising disclosures.** To reduce consumer confusion about the nature of the overdraft service and how it differs from a traditional line of credit, institutions that market automated overdraft payment services that are not covered by TILA would have to include in their advertisements about the service: the fee for the payment of each overdraft item, the types of transactions covered, the time period consumers have to repay or cover any overdraft, and the circumstances under which the institution would not pay an overdraft. An exemption in Regulation DD for broadcast media, billboards, and telephone response machines, which applies to other types of advertising disclosures, would also apply here.

**Prohibiting misleading advertisements.** TISA prohibits advertisements, announcements, or solicitations that are misleading or that misrepresent the deposit contract. Currently, Regulation DD applies the prohibition only to advertisements for prospective accounts. To address concerns about overdraft protection services, Regulation DD would be amended to also apply the prohibition to communications with consumers about the terms of their current accounts.

**Examples of misleading advertisements.** The staff commentary would also be revised to provide five examples of advertisements that would ordinarily be deemed misleading: (1) Representing an overdraft protection service as a "line of credit;" (2) representing that the institution will honor all checks or transactions, when the institution retains discretion at any time not to honor any transaction; (3) representing that consumers may overdraw their accounts and maintain a negative balance for an indefinite or extended period when the terms of the service require consumers to promptly return the deposit account to a positive balance; (4) describing a service solely as protection against bounced checks when the overdraft service may be imposed in connection with ATM withdrawals and other electronic fund transfers that permit consumers to overdraw their account; and (5) describing an account as "free" or "no

cost" and also promoting a service for which there is a fee (including a bounced-check protection service), unless the advertisement clearly and conspicuously indicates there is a cost associated with the service.

#### V. Section-by-Section Analysis

##### *Section 230.2 Definitions*

##### *2(b) Advertisements*

TISA prohibits institutions from making any advertisement, announcement, or solicitation relating to a deposit account that is inaccurate or misleading or that misrepresents its deposit contract. 12 U.S.C. 4302(e). Regulation DD defines "advertisement" to include "a commercial message appearing in any medium, that promotes directly or indirectly the availability of, or a deposit in, an account." See § 230.2(b). Under the existing staff commentary, institutions' communications with consumers about existing accounts are not considered "advertisements" under Regulation DD. See comment 2(b)-2.iii. The Board is proposing to revise the definition of an advertisement to cover communications with existing consumers for some purposes. The revised definition does not affect rules for triggering additional disclosures when an advertisement states an APY or bonus; the existing definition of "advertisement," which would continue to apply for this purpose, would be redesignated as § 230.2(b)(1) and would also be modified for stylistic consistency; no substantive change is intended.

Proposed § 230.2(b)(2) applies TISA's prohibition against misleading or inaccurate advertisements or misrepresentations of the deposit contract to communications with consumers about existing accounts. The expanded definition of an advertisement that covers existing accounts would also apply in determining whether a communication is an advertisement that triggers additional disclosures about overdraft protection services.

An advertisement includes a commercial message that invites, offers, or otherwise promotes a deposit or other service in connection with an account or class of accounts. The revision to the definition of "advertisement" does not affect providing required disclosures on an account, such as at account opening, on a periodic statement, or on an electronic terminal receipt (as required by TISA or the Electronic Fund Transfer Act, 15 U.S.C. 1693 *et seq.*), for example. See new comment 2(b)-2. Current comment 2(b)-2 would be redesignated as comment 2(b)-3.



*Section 230.4 Account Disclosures*

## 4(b) Content of Account Disclosures

## 4(b)(4) Fees

Under TISA and Regulation DD, before an account is opened, institutions must provide a schedule describing all fees that may be charged in connection with the account. The schedule must also disclose the amount of the fee and the conditions under which the fee will be imposed. 12 U.S.C. 4303; § 230.4(b)(4). When terms required to be disclosed in the schedule change and adversely affect accountholders, notice of the change must be provided 30 days in advance. 12 U.S.C. 4305; § 2305(a).

Currently the guidance for describing fees is quite general, providing that "naming and describing the fee will typically satisfy these requirements." See comment 4(b)(4)-3. Proposed comment 4(b)(4)-5 would require institutions to state in their account-opening disclosures the types of transactions for which an overdraft protection fee may be imposed. Solely describing an overdraft protection fee as a "fee for overdrafts" or "fee for overdraft items" would not provide sufficient notice to consumers as to whether the fee applies to overdrafts by check only or whether it also applies to overdrafts by other means. The proposed comment would clarify that the disclosure must indicate that a fee may be imposed in connection with checks, ATM withdrawals, or other electronic fund transfers that overdraw the account, if that is the case.

*Section 230.6 Periodic Statement Disclosures*

## 6(a) General Rule

## 6(a)(3) Fees Imposed

Although periodic statements are not required by TISA, an institution that provides such statements must disclose any fees or charges imposed on the account during the statement period. To assist consumers in better understanding the costs associated with overdrawing their accounts, the Board is proposing to revise the requirements for providing cost disclosures on periodic statements.

Under Regulation DD, fees must be itemized on a periodic statement by type, for example, by separately listing the monthly service charge, ATM fees, and returned check fees. When multiple fees of the same type are charged in a single period, comment 6(a)(3)-2 in the current staff commentary to the regulation states that institutions have the option of showing each fee as a separate charge or, alternatively, aggregating all fees of the same type and

disclosing a single dollar amount for that category. For clarity, this guidance would be moved to § 230.6(a)(3)(i) of the regulation.

Under proposed § 230.6(a)(3)(ii), institutions would be required to disclose overdraft fees or returned-item fees on periodic statements on an aggregate basis for the statement period. Institutions that currently disclose each fee as a separate charge on periodic statements could continue to do so as an additional voluntary disclosure. Comment 6(a)(3)-2 provides guidance on itemizing and describing fees on periodic statements. The comment would be revised to reflect the proposed revisions to the regulation concerning overdraft fees and returned-item fees and to clarify that these two types of fees may not be grouped together as fees for insufficient funds.

To highlight the overall cost to consumers of presenting items on an account with insufficient funds on a routine basis, proposed § 230.6(a)(3)(ii) would require institutions' periodic statements to show the total amounts for overdraft fees and returned-item fees for the calendar year to date. The Board believes that disclosure of year-to-date totals would better inform consumers about the cumulative effect of using an overdraft service on a regular basis. An institution's disclosures regarding the total overdraft fees paid by a consumer during the calendar year might also serve as a source of information for financial institutions seeking to monitor consumers' frequency in overdrawing their accounts. The Board requests comment on whether the requirement to disclose cumulative year-to-date fee totals should be limited to institutions that market overdraft payment services, and thereby encourage the routine use of the service.

*Section 230.8 Advertising*

Under the proposal, § 230.8(a) of Regulation DD would be reorganized for clarity. The regulation and staff commentary would be revised to specifically address the promotion of bounced-check protection services.

## 8(a) Misleading or Inaccurate Advertisements

## 8(a)(1)

Some bounced-check protection services, typically those provided under programs developed by third-party vendors, include marketing plans that appear designed to increase customer usage of overdrafts. Some marketing plans include materials that encourage consumers to overdraw their accounts and use the service as a line of credit by

stating that overdrafts up to a specific dollar amount will be paid. Some marketing plans also include statements suggesting that consumers may treat the service as a line of credit, for example, to take an advance on their next paycheck or to cover unexpected expenses.

Notwithstanding the marketing promises, the vendors' programs include qualifying language disclaiming any legal obligation by the institution to pay any individual overdraft, regardless of the amount. The institutions' reservation of the right not to pay overdrafts may not appear prominently or conspicuously in the marketing materials. Moreover, unlike traditional lines of credit, consumers using bounced-check protection services generally are not permitted to carry a credit balance forward at a predetermined and disclosed rate of interest. Instead, consumers using the service are generally charged a flat fee for each overdraft item and are expected to repay the entire overdraft amount within a short period. Under these circumstances, implying that the overdraft service is a traditional line of credit or suggesting that the service can be used like a line of credit may be inconsistent with the actual terms and limitations of the service.

As discussed above, Regulation DD would be revised to apply TISA's prohibition against misrepresentations and misleading advertisements to communications with consumers about their existing accounts, to cover institutions' marketing of deposit-related services, including bounced-check protection services. A new comment 8(a)-10 would be added to provide guidance on the types of advertisements that may violate the rule.

Five new examples would be added to the commentary relating to the promotion of overdraft payment services. The staff commentary would be revised to state that institutions may not mislead consumers by representing an overdraft service as a "line of credit" unless the service is subject to the Board's Regulation Z. An advertisement could also mislead consumers if it represents that the institution will honor all checks or authorize all transactions that overdraw an account, with or without a specified dollar limit, when the institution retains discretion at any time not to honor checks or authorize transactions.

A third example would state that an advertisement could mislead consumers by representing that consumers with overdrawn accounts are allowed to maintain a negative balance when the

terms of the account's overdraft service require consumers to promptly return the deposit account to a positive balance. The fourth example provides that promotional materials describing a service solely as protection against bounced checks could mislead consumers if the service also applies to ATM withdrawals and other debit card transactions and electronic fund transfers.

A fifth new example of misleading advertisements relates to the advertisement of free accounts. Under Regulation DD, an institution may not describe an account as "free" (or use a similar term) if any maintenance or activity fee may be imposed on the account. Examples of fees that trigger the prohibition against advertising an account as free are listed in comment 8(a)-3.

Comment 8(a)-4 lists certain account-related fees that are not considered to be maintenance or activity fees, for example, check-printing fees, stop-payment fees, or fees associated with checks that are returned unpaid. Likewise, fees for bounced-check protection services would not be considered maintenance or activity fees, because the fees relate to the institution's provision of credit as opposed to fees related to the use of the consumer's own funds in the account. Nevertheless, there has been concern that some institutions promote bounced-check protection services as a feature of their free checking accounts, and that consumers may be misled into thinking that overdraft protection on such accounts is without costs.

The commentary would be revised to state that an advertisement would be deemed misleading if the account is described as "free" and also promotes account-related services for which there is a fee, unless the advertisement clearly and conspicuously indicates there is a cost associated with the advertised service. Under proposed comment 8(a)-10, the advertisement may, but need not, state the actual cost of the service, although such a disclosure may be required under proposed § 230.8(f) for certain advertisements. The proposed comment applies to fees for account-related services that are not considered "maintenance or activity fees" (such as fees for bounced-check protection or for specially designed checks). Regulation DD's prohibition against advertising an account as "free" if the institution imposes a "maintenance or activity fee" is unaffected by the proposal.

Comment is also solicited on other types of advertisements of overdraft protection services that would potentially mislead consumers about (i)

the terms, limitations, costs, or nature of the service and (ii) the fact that the service is not a traditional line of credit. For example, where an institution's payment of overdrafts is automated, does advertising to consumers that the institution will pay overdrafts up to a specified dollar amount mislead consumers about the nature of the service? Furthermore, would such an advertisement potentially mislead consumers about whether the bank may not pay an overdraft? Does encouraging consumers to use the service to obtain credit instead of using it to cover inadvertent overdrafts mislead consumers about the actual terms of the service? Do advertisements that encourage the regular or routine use of the service mislead consumers about the cost of the service?

Section 230.8(a)(1) is revised for stylistic consistency, without substantive change.

#### 8(a)(2)

TISA's limitation on advertising an account as free is implemented in § 230.8(a). This provision would be redesignated as § 230.8(a)(2), without any substantive change.

#### 8(f) Additional Disclosures in Connection With Automated Overdraft Services

TISA and Regulation DD require additional information to be provided if an advertisement for a deposit account refers to a specific rate of interest, yield, or rate of earnings. 12 U.S.C. 4302; § 230.8(c). Advertisements for bonuses on deposit accounts also trigger additional information. § 230.8(d). TISA authorizes the Board to exempt "broadcast and electronic media and outdoor advertising from stating some additional information, if the Board finds the disclosures to be unnecessarily burdensome." 12 U.S.C. 4302(b). These limited disclosure rules are implemented in § 230.8(e)(1). The exemptions for broadcast and electronic media do not extend to advertisements posted on the Internet or sent by e-mail.

A principal concern about institutions' promotion of overdraft protection services is that consumers may be led to believe that the service represents a traditional line of credit. Some marketing materials focus on the dollar amount of the overdraft limit, which may lead consumers to believe that a line of credit is being provided. Some advertisements create the impression that the service can be relied upon to obtain short term extensions of credit from time to time (up to a given amount) at minimal cost. These promotions may mislead or confuse

consumers regarding the nature, costs, terms, and limitations of the service. This problem may be magnified somewhat because marketed automated overdraft services are relatively new.

Where consumers are targeted with advertisements about overdraft protection services, additional disclosures could reduce the potential that some consumers would be misled, and generally educate consumers about the nature of the service to enable them to compare the terms offered by different financial institutions. Accordingly, in order to ensure that advertisements promoting overdraft protection services are not misleading, the Board is proposing to revise Regulation DD to require certain disclosures in advertisements for automated overdraft payment services. To reduce consumer confusion about the costs, terms, and limitations of the service and how it differs from a traditional line of credit, advertisements would be required to disclose (1) the fee for the payment of each overdraft item; (2) the types of transactions covered; (3) the amount of time the consumer has to repay or cover any overdraft; and (4) the circumstances under which the institution would not pay an overdraft.

The proposed rule would provide an exemption for certain types of advertisements to mirror exemptions provided for other types of advertising disclosures. Under TISA and Regulation DD, advertisements that state the annual percentage yield for an account must also disclose certain other information. The regulation specifically exempts from these disclosure requirements, advertisements using broadcast media, outdoor billboards, and telephone response machines. These exemptions were based on concerns about the practical limitations of time and space for these types of media; these concerns are not as significant for print advertising or marketing on Internet Web sites. These exemptions would also apply to the advertising rules for automated overdraft payment services under proposed § 230.8(f). Proposed comment 8(f)-1 would clarify that for purposes of the advertising disclosures, institutions may describe the types of transactions covered in the same manner as the disclosures required before account-opening (see proposed comment 4(b)(4)-5).

Comment 8(f)-2 provides that in describing the circumstances under which an institution will not pay an overdraft, a general description will typically satisfy the requirement, for example, statements such as "overdrafts will not be paid if your account is not in good standing, you are not making

regular deposits, or you have too many overdrafts.”

Comment 8(f)–3 clarifies the relationship between the general guidance in comment 8(a)–10.v. (the rules for advertisements that promote free accounts as well as an account-related service for which a fee is charged) and the requirements of § 230.8(f) when the account-related service being advertised is an automated overdraft service.

#### VI. Form of Comment Letters

Comment letters should refer to Docket No. R–1197 and, when possible, should use a standard typeface with a font size of 10 or 12; this will enable the Board to convert text submitted in paper form to machine-readable form through electronic scanning, and will facilitate automated retrieval of comments for review. Comments may be mailed electronically to [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov).

#### VII. Solicitation of Comments Regarding the Use of “Plain Language”

Section 722 of the Gramm-Leach-Bliley Act of 1999 requires the Board to use “plain language” in all proposed and final rules published after January 1, 2000. The Board invites comments on whether the proposed rules are clearly stated and effectively organized, and how the Board might make the proposed text easier to understand.

#### VIII. Initial Regulatory Flexibility Analysis

The Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) requires federal agencies to publish an initial regulatory flexibility analysis to describe the impact of proposed rules on small entities. A final regulatory flexibility analysis will be prepared and will consider comments received during the public comment period.

1. *Statement of the objectives of the proposal.* The Board is proposing revisions to Regulation DD to address the uniformity and adequacy of institutions’ disclosure of overdraft fees generally, and to address concerns about advertised automated overdraft services (“bounced-check protections services”) in particular. As stated more fully above, the existing regulation would be amended to provide that depository institutions offering certain overdraft payment services would be required to provide more complete information regarding those services. Account-opening disclosures and other marketing materials would describe more completely how fees may be triggered. The total dollar amount of overdraft and returned-item fees for the

period and for the calendar year to date would be required on periodic statements. Certain advertising practices would be prohibited, and additional disclosures would be required.

TISA was enacted, in part, for the purpose of requiring clear and uniform disclosures regarding deposit account terms and fees assessable against these accounts. Such disclosures allow consumers to make meaningful comparisons between different accounts and also allow consumers to make informed judgments about the use of their accounts. 12 U.S.C. 4301. TISA authorizes the Board to prescribe regulations to carry out the purpose and provisions of the statute. 12 U.S.C. 4308(a)(1). The act expressly states that the Board’s regulations may contain “such classifications, differentiations, or other provisions, \* \* \* as, in the judgment of the Board, are necessary or proper to carry out the purposes of [the Act], to prevent circumvention or evasion of the requirements of [the Act], or to facilitate compliance with the requirements of [the Act].” 12 U.S.C. 4308(a)(3). The Board believes that the proposed revisions to Regulation DD discussed above are within the Congress’ broad grant of authority to the Board to adopt provisions that carry out the purposes of the statute.

2. *Small entities affected by the proposal.* The number of small entities affected by this proposal is unknown. Approximately 14,580 depository institutions in the United States that must comply with the Truth in Savings Act have assets of \$150 million or less and thus are considered small entities for purposes of the Regulatory Flexibility Act, based on 2003 call report data. Approximately 5,900 are institutions that must comply with the Board’s Regulation DD; approximately 8,860 are credit unions that must comply with National Credit Union Administration regulations, which must be substantially similar to the Board’s Regulation DD. The Board believes small depository institutions that offer accounts where overdraft or returned-item fees are imposed currently send periodic statements on those accounts. Periodic statement disclosures would need to be revised to display aggregate overdraft and aggregate returned-item fees for the statement period and year to date. Account-opening disclosures and marketing materials would have to be reviewed, and perhaps revised.

3. *Other federal rules.* The Board believes no federal rules duplicate, overlap, or conflict with the proposed revisions to Regulation DD.

4. *Significant alternatives to the proposed revisions.* As discussed above,

the Board requests comment on whether the requirement to disclose cumulative year-to-date totals for overdraft and returned-item fees should be limited to institutions that market overdraft payment services, and thereby encourage the routine use of the service.

#### IX. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board reviewed the rule under the authority delegated to the Board by the Office of Management and Budget. The Federal Reserve may not conduct or sponsor, and an organization is not required to respond to, this information collection unless it displays a currently valid OMB control number. The OMB control number is 7100–0271.

The collection of information that is revised by this rulemaking is found in 12 CFR part 230 and in Appendix B. This collection is mandatory (15 U.S.C. 4301 *et seq.*) to evidence compliance with the requirements of Regulation DD and the Truth in Savings Act (TISA). Institutions are required to retain records for twenty-four months. The respondents/recordkeepers are for-profit depository institutions, including small businesses. This regulation applies to all types of depository institutions, not just state member banks. Under Paperwork Reduction Act regulations, however, the Federal Reserve accounts for the burden of the paperwork associated with the regulation only for state member banks. Other agencies account for the paperwork burden on their respective constituencies under this regulation.

The proposed revisions provide that depository institutions offering certain overdraft payment services would be required to provide more complete information regarding those services. Account-opening disclosures and other marketing materials would describe more completely how fees may be triggered. The total dollar amount of overdraft and returned-item fees for the period and for the calendar year to date would be required on periodic statements, and year-to-date totals would be required. Certain advertising practices would be prohibited, and additional disclosures would be required. Although the proposal adds these requirements, it is expected that these revisions would not significantly increase the paperwork burden of depository institutions. With respect to state member banks, it is estimated that there are 976 respondent/recordkeepers. Current annual burden is estimated to be 146,644 hours.

Because the records are maintained at state member banks and the notices are

not provided to the Federal Reserve, no issue of confidentiality arises under the Freedom of Information Act.

The Federal Reserve requests comments from depository institutions, especially state member banks, that will help to estimate burden of the various disclosures that would be made in the first year this proposed regulation would be effective. Comments are invited on: (a) The cost of compliance; (b) ways to enhance the quality, utility, and clarity of the information to be disclosed; and (c) ways to minimize the burden of disclosures on respondents, including through the use of automated disclosure techniques or other forms of information technology. Comments on the collection of information should be sent to the Office of Management and Budget, Paperwork Reduction Project (7100-0271), Washington, DC 20503, with copies of such comments sent to Cynthia Ayouch, Federal Reserve Board Clearance Officer, Division of Research and Statistics, Mail Stop 97, Board of Governors of the Federal Reserve System, Washington, DC 20551.

**Text of Proposed Revisions**

Certain conventions have been used to highlight the proposed revisions. New language is shown inside bold-faced arrows while language that would be deleted is set off with bold-faced brackets.

**List of Subjects in 12 CFR Part 230**

Advertising, Banks, Banking, Consumer protection, Reporting and recordkeeping requirements, Truth in savings.

For the reasons set forth in the preamble, the Board proposes to amend Regulation DD, 12 CFR part 230, as set forth below:

**PART 230—TRUTH IN SAVINGS (REGULATION DD)**

1. The authority citation for part 230 continues to read as follows:

Authority: 12 U.S.C. 4301 *et seq.*

2. Section 230.2 is amended by revising paragraph (b) to read as follows:

**§ 230.2 Definitions.**

\* \* \* \* \*

(b) Advertisement means a commercial message, appearing in any medium, that promotes directly or indirectly:

▶(1)◀ The availability ▶or terms◀ of, or a deposit in, a ▶new◀ account ▶; and

(2) For purposes of § 230.8(a) and (f) of this part, the terms of, or a deposit in, a new or existing account.◀

\* \* \* \* \*

3. Section 230.6 is amended by republishing the introductory text and revising paragraph (a)(3) to read as follows:

**§ 230.6 Periodic statement disclosures.**

(a) *General rule.* If a depository institution mails or delivers a periodic statement, the statement shall include the following disclosures:

\* \* \* \* \*

(3) *Fees imposed.* Fees required to be disclosed under § 230.4(b)(4) of this part that were debited to the account during the statement period. The fees shall be itemized by type and dollar amounts.

▶(i) *General.* Except as provided in paragraph (a)(3)(ii) of this section, when fees of the same type are imposed more than once in a statement period, a depository institution may itemize each fee separately or group the fees together and disclose a total dollar amount for all fees of that type.

(ii) *Overdraft and returned-item fees.* Institutions must disclose a total dollar amount for all overdraft fees and a total dollar amount for all returned-item fees for the statement period and for the calendar year to date. The total dollar amount for overdraft fees shall include all overdrafts on the account, whether created by check, by ATM withdrawal or other electronic transfer, or by other means. Institutions may itemize each overdraft fee or returned-item fee, in addition to providing the disclosures required by this paragraph.◀

\* \* \* \* \*

4. Section 230.8 is amended by revising paragraph (a) and adding a new paragraph (f) to read as follows:

**§ 230.8 Advertising.**

(a) *Misleading or inaccurate advertisements.* An advertisement shall not:

▶(1)◀ Be misleading or inaccurate ▶or◀ [and shall not] misrepresent a depository institution's deposit contract.

▶(2)◀ [An advertisement shall not] Refer to or describe an account as "free" or "no cost" (or contain a similar term) if any maintenance or activity fee may be imposed on the account. The word "profit" shall not be used in referring to interest paid on an account.

\* \* \* \* \*

▶(f) *Additional disclosures in connection with automated overdraft services.* Except for an advertisement subject to paragraph (e)(1) of this section, any announcement, solicitation, or advertisement promoting an automated overdraft service that is not subject to the Board's Regulation Z (12 CFR part 226) shall disclose in a clear and conspicuous manner:

(1) The fee for the payment of each overdraft;

(2) The types of transactions for which a fee for overdrawing an account may be imposed;

(3) The time period by which the consumer must repay or cover any overdraft; and

(4) The circumstances under which the institution would not pay an overdraft.◀

\* \* \* \* \*

5. In Supplement I to part 230:

a. Under Section 230.2 Definitions, under (b) *Advertisement*, existing paragraph 2. is redesignated as paragraph 3.; a new paragraph 2. is added; and newly designated paragraph 3.iii. is revised.

b. Under Section 230.4 Account disclosures, under (b)(4) *Fees*, a new paragraph 5. is added.

c. Under Section 230.6 Periodic statement disclosures, under (a)(3) *Fees imposed*, paragraph 2. is revised.

d. Under Section 230.8 Advertising, under (a) *Misleading or inaccurate advertisements*, a new paragraph 10. is added, a new paragraph title (f) *Additional disclosures in connection with automated overdraft services* is added, and new paragraph (f) 1. through (f) 3. are added.

**Supplement I To Part 230—Official Staff Interpretations**

Section 230.2 Definitions

\* \* \* \* \*

(b) *Advertisement*

\* \* \* \* \*

▶2. *Existing accounts.* For purposes of the prohibition on misleading advertisements in § 230.8(a) of this part and disclosure requirements under § 230.8(f) of this part, an advertisement includes a commercial message in visual, oral, or print media that invites, offers, or otherwise promotes a deposit in, or other service available in connection with, an existing consumer account or class of accounts. An institution is not promoting a deposit or service solely by providing disclosures required by Federal or other applicable law at account opening, on a periodic statement, or on an electronic terminal receipt.◀

▶3.◀ \* \* \* \*

iii. ▶For purposes of § 230.8(b) of this part through § 230.8(e) of this part,◀ information given to consumers about existing accounts, such as current rates recorded on a voice-response machine or notices for automatically renewable time account sent before renewal.

\* \* \* \* \*

## Section 230.4 Account disclosures

\* \* \* \* \*

## (b) Content of account disclosures

\* \* \* \* \*

## (b)(4) Fees

\* \* \* \* \*

## ►5. Fees for overdrawing an account.

Under § 230.4(b)(4) of this part institutions must disclose the conditions under which a fee may be imposed. In satisfying this requirement institutions must specify the types of transactions for which an overdraft fee may be imposed. In describing the conditions, an institution must state whether the fee applies to overdrafts created by check, or by ATM withdrawal or other electronic transfer, as applicable. For example, where a fee may be imposed in such circumstances, disclosing a fee for covering an overdraft "created by check, or by ATM withdrawal or other electronic transfer" would typically satisfy this requirement; disclosing a fee "for overdraft items" would not. ◀

\* \* \* \* \*

## Section 230.6 Periodic statement disclosures

## (a) General rule

\* \* \* \* \*

## (a)(3) Fees imposed

\* \* \* \* \*

2. *Itemizing fees by type.* In itemizing fees imposed more than once in the period, institutions may group fees if they are the same type. ►(But overdraft and returned-item fees each must be separately totaled for the statement period and cumulatively for the calendar year. See § 230.6(a)(3)(ii).) ◀ [But] ► When fees of the same type are grouped together ◀ the description must make clear that the dollar figure represents more than a single fee, for example, "total fees for checks written this period." Examples of fees that may not be grouped together are—

- i. Monthly maintenance and excess-activity fees.
- ii. "Transfer" fees, if different dollar amounts are imposed—such as \$.50 for deposits and \$1.00 for withdrawals.
- iii. Fees for electronic fund transfers and fees for other services, such as balance-inquiry or maintenance fees.
- iv. Fees for transactions that overdraw an account and fees for returning checks or other items unpaid. ◀

\* \* \* \* \*

## Section 230.8 Advertising

## (a) Misleading or inaccurate advertisements

\* \* \* \* \*

►10. *Examples.* Examples of advertisements that would ordinarily be

misleading, inaccurate, or misrepresent the deposit contract are:

- i. Representing an overdraft protection service as a "line of credit," unless the service is subject to the Board's Regulation Z, 12 CFR part 226.
- ii. Representing that the institution will honor all checks or authorize all transactions that overdraw an account, with or without a specified dollar limit, when the institution retains discretion at any time not to honor checks or authorize transactions.
- iii. Representing that consumers with an overdrawn account are allowed to maintain a negative balance when the terms of the account's overdraft service require consumers to promptly return the deposit account to a positive balance.
- iv. Describing a service solely as protection against bounced checks when the service being promoted allows consumers to overdraw their accounts by other means, such as ATM withdrawals, debit card transactions, or other electronic fund transfers.
- v. Advertising an account-related service for which a fee will be charged in an advertisement that also uses the word "free" or "no cost" (or a similar term) to describe the account, unless the advertisement clearly and conspicuously indicates that there is a cost associated with the service. If the fee is a maintenance or activity fee under § 230.8(a)(2) of this part, however, an advertisement may not describe the account as "free" or "no cost" (or contain a similar term) even if the fee is disclosed in the advertisement. ◀

\* \* \* \* \*

►(f) *Additional disclosures in connection with automated overdraft services.*

1. *Types of transactions.* Disclosing that a fee may be imposed for covering overdrafts on an account "created by check, or by ATM withdrawal or other electronic transfer" would typically satisfy the requirements of § 230.8(f)(2) of this part where the fee may be imposed in these circumstances. See comment 4(b)(4)–5.
2. *Circumstances for nonpayment.* In describing the circumstances under which an institution will not pay an overdraft, a general description will typically satisfy the requirement, for example, statements such as "overdrafts will not be paid if your account is not in good standing, or you are not making regular deposits, or you have too many overdrafts."
3. *Advertising an account as "free."* Comment 8(a)–10.v. provides general guidance to institutions that advertise free accounts with an account-related

service for which a fee will be charged, and requires that the advertisement state that a cost is associated with the service. If the advertised account-related service is an overdraft service subject to the requirements of § 230.8(f) of this part, institutions must disclose the fee for the payment of each overdraft, not merely that a cost is associated with the overdraft service, as well as other required information. ◀

\* \* \* \* \*

By order of the Board of Governors of the Federal Reserve System, May 27, 2004.

Jennifer J. Johnson,

Secretary of the Board.

[FR Doc. 04–12521 Filed 6–4–04; 8:45 am]

BILLING CODE 6210–01–P

## FEDERAL RESERVE SYSTEM

## 12 CFR Part 261a

[Docket No. R–1200]

## Privacy Act of 1974 Privacy Act Regulation

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Proposed rule.

**SUMMARY:** The Board of Governors of the Federal Reserve System (Board) proposes to amend its regulation implementing the Privacy Act of 1974. The primary proposed changes concern the waiver of copying fees charged to current or former Board employees for access to records under the Privacy Act, and the special procedures for release of medical records. In addition, the Board is proposing to make minor editorial and technical changes.

**DATES:** Comment must be received on or before July 7, 2004.

**ADDRESSES:** You may submit comments, identified by Docket No. R–1200, by any of the following methods:

- Agency Web Site: <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.
- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.
- E-mail: [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include docket number in the subject line of the message.
- FAX: 202/452–3819 or 202/452–3102.

- Mail: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551.

**BANKRUPTCY LAW UPDATE  
FOR BANK COUNSEL**

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**SECTION D**



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# **BANKRUPTCY LAW UPDATE FOR BANK COUNSEL**

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## **I. INTRODUCTION**

This paper reviews selected bankruptcy decisions during the past year, with a particular emphasis on decisions of interest to lenders in Kentucky and elsewhere in the Sixth Circuit. Selected non-bankruptcy cases which are of interest to lenders are also included.

## **II. NEW BANKRUPTCY CASES**

### **A. Chapter 13 Plan Issues**

#### **Till v. SCS Credit Corp., 541 U.S. 465 (2004)**

In this case, the United States Supreme Court was asked to rule on the appropriate method of determining the cram down interest rate in Chapter 13 -- i.e., the rate that gives the creditor the present value of its claim under a Chapter 13 plan when the claim is paid in installment payments to the creditor in lieu of a lump sum payment. The Court, in a plurality opinion, held that the "formula approach," in which the prime rate was augmented to account for risk of nonpayment by borrowers in the debtors' financial position, was the proper method.

In the underlying matter, the Debtors purchased a truck with financing at an interest rate of 21%. The Debtors later filed for relief under Chapter 13 of the Bankruptcy Code. At the time of filing, the value of the truck was \$4,000, so the creditor's secured claim was limited to that amount. The Debtors' proposed plan also called for an interest rate of 9.5% per year based on a "formula rate" calculation where the prime rate of 8% was increased to account for risk of nonpayment by the debtors. Although the creditor argued that it was entitled to 21% interest, the amount it would have obtained if it could foreclose on the property, collect the proceeds and reinvest them in a similar loan, the bankruptcy court approved the plan as proposed.

The district court reversed, holding that Seventh Circuit precedent required bankruptcy courts to set cram down interest rates at the level the creditor could have obtained if it foreclosed. The district court thus found 21% to be the appropriate rate.

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<sup>1</sup> Many thanks to our associates Kathryn V. Eberle, Angela S. Fetcher, Emily L. Pagorski and Stephen Houston for their excellent research and drafting assistance, without which we would not have these materials.

The Seventh Circuit remanded to the bankruptcy court, agreeing with the district court that, in cram down proceedings, the interest rate should be what the creditor in question could obtain in making a new loan to a similarly situated debtor not in bankruptcy, but stating that the pre-bankruptcy contract rate of 21% did not duplicate the present value of the collateral to the creditor because loans to bankrupt, court-supervised debtors involve risks not incurred in loans to new debtors. The Seventh Circuit held that, to correct this, the original contract rate should serve as a presumptive cram down rate that debtors or creditors could challenge. The court remanded to afford the Debtors or the creditor a chance to rebut the 21% rate. The Supreme Court reversed.

The Supreme Court noted that, as the Bankruptcy Code provides little guidance on which calculations to use, three considerations govern what method should be used to set an interest rate in cram down situations. The first is that the Bankruptcy Code has numerous provisions that require present value calculations. Thus, Congress intended judges to follow the same approach when choosing appropriate interest rates and to use an approach that is familiar in the financial community and that minimizes the need for expensive evidentiary proceedings. The second consideration is that Chapter 13 authorizes a bankruptcy court to modify the rights of any creditor whose claim is secured by anything other than the debtor's residence, and a court can modify the number, timing, and interest rate set forth in the debtor's contract. The third consideration is that the cram down provision mandates an objective rather than subjective approach. In other words, the provision does not require that the terms of the loan match the terms of the contract agreed to prebankruptcy.

Looking at these three considerations, the Court rejected the coerced loan, presumptive contract rate, and cost of funds approaches because they are complicated, impose significant evidentiary costs and have the goal of making a creditor whole rather than to ensure debtor's payments have the required present value. The Court stated that the coerced loan approach overcompensates creditors because the market lending rate covers things not relevant in a cram down situation, such as transaction costs and overall profits. As to the presumptive contract approach, the Court stated that it improperly focuses on the creditor's potential use of the proceeds in a foreclosure sale, requires a debtor to obtain information on the creditor's overhead costs, financial circumstances and lending practices to rebut the presumptive contract rate, and produces results where similarly situated creditors end up with vastly different cram down rates. The Court also stated that the cost of funds approach mistakenly focuses on the creditworthiness of the creditor rather than the debtor.

The Court stated that the formula approach was the preferred approach because it used the national prime rate reflecting the financial market's estimate of the amount a commercial bank should charge a creditworthy customer. And because a bankrupt debtor poses a higher risk of nonpayment, the approach requires the bankruptcy court to adjust the prime rate accordingly. The Court stated that the size of that risk adjustment depends on factors such as the circumstances of the estate, the nature of the security and the duration and feasibility of the reorganization plan. Thus, a bankruptcy court will need to hold a hearing for the creditor and debtors to present evidence on the appropriate risk adjustment. The Court approved this approach in part because starting from a low estimate and adjusting it upward puts the burden on

the creditors, who are likely to have greater access to information not in the debtors' filings. The Court reversed the Seventh Circuit and remanded to the bankruptcy court.

The Court declined to determine "the proper scale for the risk adjustment." The Court acknowledged the lender's argument that a risk adjustment in the range of one to three percent is inadequate to compensate a creditor for the risk that the plan would fail. The Court simply noted that a bankruptcy court should only approve a plan if it is persuaded that the debtor will be able to comply with it. The Court held that this means that a bankruptcy court must "select a rate high enough to compensate the creditor for its risk but not so high as to doom the plan. If the court determines that the likelihood of default is so high as to necessitate an 'eye-popping' interest rate . . . the plan should probably not be confirmed."

Justice Scalia, writing for the dissent, stated that the contract rate is a good indicator of actual risk and provides a quick and reasonably accurate standard. Justice Scalia stated that the contract rate approach makes two reasonable assumptions: (1) The subprime lending markets are competitive and largely efficient, which means that the contract rate reasonably reflects actual risk at the time of borrowing; and (2) The expected costs of default in Chapter 13 are no less than those at the time of lending, which means that the risk persists when the Debtor files for Chapter 13.

**In re Edmondson, 2005 Bankr. LEXIS 136 (E.D. Ky. 2005)**

Here, an assignee of a creditor who did not object to the terms of a Chapter 13 plan was held bound by that plan. The Debtors filed their Chapter 13 plan on April 27, 2000 and listed Fifth Third Bank as a secured creditor on a second mortgage for a particular amount. The plan was then confirmed without objection from the bank. The bank later assigned the mortgage to C & W Asset Acquisition, LLC ("C & W"), which also filed a lien against the property, and a proof of claim. The Debtors sought release of the lien after payment of the amount provided in the plan, but C&W objected on the ground that the amount really owed was higher. The bankruptcy court found that a Chapter 13 plan confirmation order is *res judicata* as to all issues which were decided, or could have been decided, at the confirmation hearing. It further held that a creditor who fails to object to the confirmation of a proposed plan at an appropriate time is deemed to have accepted the plan and is bound by the confirmation order.

**In re Farthing, 2005 Bankr. LEXIS 97 (E.D. Ky. 2005)**

This case deals with lien stripping. On July 3, 2004 the Debtors filed a voluntary petition under Chapter 13. Their schedules indicated that their residence was encumbered by a first mortgage in the amount of \$4,000.00, a second mortgage in the amount of \$54,794.70, and a third mortgage in the amount of \$15,160.00. On July 11, 2004 the Debtors filed a Plan, valuing the secured claim of the third mortgage at zero and providing for repayment at the same rate as other unsecured creditors. At the January 4, 2005 confirmation hearing, counsel for the Debtors informed the court that the first mortgage had been forgiven by the first mortgagees on October 1, 2004. The third mortgagee objected, arguing that its claim now was partially secured and could not be stripped off.

The bankruptcy court held that the Plan did not violate §1322(b)(2) as argued by the third mortgagee, citing authority that debtors may “strip off” mortgages that are totally unsecured. The bankruptcy court held that this determination is to be made as of the date the petition was filed. The court noted that “while it may be appropriate to determine the value of collateral – and, therefore, the *extent* to which a creditor’s claim is secured – as of confirmation or the date of the valuation hearing . . . it is appropriate to determine *if* the creditor holds a secured claim at all as of the date the petition was filed.” (emphasis in original). Accordingly, the bankruptcy court confirmed the Plan because, as of the petition date, the third mortgagee did not have a secured claim.

**In re Wellman, 2004 Bankr. LEXIS 2254 (6<sup>th</sup> Cir. BAP 2004)**

Here, the Bankruptcy Appellate Panel (“Panel”) affirmed the bankruptcy court’s holding that creditor Salt Creek Valley Bank’s motion for relief from stay, which was filed but not heard before confirmation of the Debtors’ Chapter 13 plan, was incompatible with the confirmed plan and therefore denied the bank’s motion.

The bank held a first mortgage on a three-acre parcel of real estate owned by the Debtors. On February 3, 2003, the Debtors filed their Chapter 13 case. On March 12, 2003, the Debtors filed an amended Chapter 13 plan and the bank filed a motion (1) to dismiss the chapter 13 case with prejudice because of repetitive filings; (2) to enjoin the filing of any further petitions by or against the Debtors for a specified period; and (3) for related relief. This was also treated as a confirmation objection. On June 18, 2003, an agreed order was entered in which the parties provided that in the event the case was dismissed prior to February 3, 2006 then, as to the bank, the dismissal would be “with prejudice” and the 180 day time bar would be deemed applicable to it. Also on June 18, the bank filed a motion for relief from the automatic stay. The Chapter 13 plan was confirmed on July 30 and provided for payment of the mortgage. The bankruptcy court subsequently overruled the bank’s motion for relief from stay on the ground that it was not compatible with the confirmed plan.

The Panel affirmed the bankruptcy court’s decision. It noted that an order confirming a Chapter 13 plan is *res judicata* as to all “justifiable issues” which were or could have been decided at the confirmation hearing. “Section 1327 precludes a creditor from asserting, after confirmation, any other interest than that provided for it in the confirmed plan.” Thus, it held that if a motion for relief from stay is filed before confirmation, unless it pertains to a post-confirmation failure to make payments, the motion is untimely in view of the transcendence of the confirmed plan.

**B. Plan Confirmation, Consummation and Other Chapter 11 Issues**

**Pratt v. Ventas, Inc., 365 F.3d 514 (6<sup>th</sup> Cir. 2004)**

This case involves non-debtor releases and the preclusive effect of Chapter 11 plan confirmation. Plaintiffs filed state law claims against Vencor, Inc. ("Old Vencor"). Old Vencor then changed its name to Ventas on May 1, 1998 and spun off its nursing home operations to a new entity named Vencor, Inc. ("New Vencor"). New Vencor, on September 13, 1999, filed for relief under chapter 11 of the Bankruptcy Code. New Vencor sought to enforce the automatic stay in each of the plaintiffs' state court actions. Some of the plaintiffs filed proofs of claim. A Reorganization Plan for New Vencor was proposed, and notice sent to those plaintiffs who filed proofs of claim. The Delaware bankruptcy court confirmed the Plan on March 19, 2001, and it became effective on April 20, 2001.

Pursuant to the Plan, Ventas agreed to contribute \$40 million to the funding of a settlement with the United States and agreed to amendments of certain leases with New Vencor, thereby reducing New Vencor's rental obligations. In exchange, Ventas was given a release of plaintiffs' claims arising from operation of the nursing homes prior to May 1, 1998, and an injunction was imposed proscribing suits against Ventas and New Vencor for alleged conduct prior to the date of confirmation.

Plaintiffs filed suit in the U.S. District Court for the Western District of Kentucky, claiming that Ventas obtained the releases by fraudulent means. They argued that the bankruptcy court lacked jurisdiction over their third-party action against Ventas and, thus, the injunction did not bar plaintiffs' suit. The district court held that plaintiffs could not collaterally attack the confirmation order issued by the Delaware bankruptcy court, and therefore dismissed the complaint for lack of subject matter jurisdiction, stating that the plaintiffs were free to pursue their claim in the Delaware bankruptcy court. The plaintiffs appealed. While the appeal was pending, the plaintiffs again unsuccessfully pursued their claims in the Delaware bankruptcy court, but did not pursue an appeal there.

The Sixth Circuit affirmed, holding that the rule of *Celotex Corp. v. Edwards*, 514 U.S. 300, 115 S. Ct. 1493 (1995), would not allow the plaintiffs to circumvent the bankruptcy court's order by filing the action in the Kentucky district court. Although the court found that it was an error for the district court to dismiss the action without determining if the bankruptcy court had jurisdiction to enter the Confirmation Order, it was harmless error in light of the plaintiffs' subsequent return to the bankruptcy court for the purpose of challenging that court's authority.

The court also stated that because the Delaware bankruptcy court decided that it did have jurisdiction to enter the Confirmation Order with the releases, it could not look at the issue because of the *res judicata* effect of the bankruptcy court's determination.



**In Re Bankvest Capital Corp., Eagle Insurance Company v. Bankvest Capital Corp., 360 F.3d 291 (1<sup>st</sup> Cir. 2004)**

The issue on appeal was whether 11 U.S.C. § 365(b)(2)(D) permits a debtor in possession to assume an unexpired lease without first curing any nonmonetary defaults. The First Circuit held that it does, creating a circuit split. The Debtor Bankvest's business was originating, securitizing, selling and servicing equipment leases. Bankvest was the lessor on two equipment leases at issue here. In its Chapter 11 plan, the Debtor provided that all equipment leases would be assumed by the Estate unless 1) the lease was specifically rejected or 2) any party to the lease filed a claim for cure costs. The lessees here filed claims for cure costs under the Chapter 11 plan. They claimed that the Debtor had failed to replace loaner equipment with permanent equipment. The Bankruptcy Court dismissed the cure claims on the ground that 11 USC § 365(b)(2)(D) permits the Debtor in possession to assume executory contracts or unexpired leases without first curing non-monetary defaults.

Section 365(b) provides that if the Debtor has defaulted on an executory contract prior to assumption, the Debtor may not assume the contract unless it 1) cures the default, 2) compensates the non-debtor party for any actual monetary damages resulting from the default, and 3) provides adequate assurance of future performance under the contract. Section 365(b) provides:

(2) paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to—

\* \* \*

(D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.

The lessees contended that the word "penalty" in paragraph 2(D) modified both "rate" and "provision." Debtor contended that "penalty" modifies only the term "rate." The court found no textual basis requiring that the bankruptcy court's interpretation be overturned, and found the statute to be ambiguous. The court stated that many non-monetary defaults are historical facts that are impossible to cure. "Requiring a debtor to cure such incurable defaults is tantamount to barring the Debtor from assuming any lease or contract in which such default has occurred—no matter how essential that contract might be to the Debtor's reorganization in bankruptcy." *Id* at 299. The court determined that such a result could not be what Congress had intended because it would undermine the successful rehabilitation of the business. The court determined that Congress intended § 365(b)(2)(D) to excuse debtors from the obligation to cure nonmonetary defaults as a condition of assumption. The lessees argued that paragraph (2)(D) could not apply to all non-monetary defaults because such an interpretation would render the *ipso facto* default provisions of § 365(b)(2) superfluous. The court disagreed, finding that *ipso facto* defaults described in subparagraph A through C of § 365(b)(2) need not be non-monetary. Therefore, the court held that the Debtor need not cure the non-monetary default before assuming the equipment leases.

***In Re Heartland Steel, Inc., Siemens Energy and Automation, Inc. v. Good, 389 F. 3d 741 (7<sup>th</sup> Cir. 2004)***

This case deals with the nature of a confirmed plan -- i.e., court order or private contract. The liquidating agent filed objections to three claims made against the Debtor estate. The issue on appeal was whether the liquidating agent's objections were timely filed. The time limit to object to claims was set at 90 days after the effective date of the plan. The 90<sup>th</sup> day fell on a Sunday. The objections were filed the following Monday. The liquidating agent relied on rule 9006(a), which states that the period of time for filing a document includes the last date of that period unless that date is a Saturday, Sunday or a legal holiday, in which case the period runs on the next business day. The claimants alleged that the plan of reorganization should be deemed a private contract between the parties and that its deadlines should not be subject to Rule 9006(a).

The court found that a plan is neither pure contract nor pure court order and that the filing deadlines contained within the plan are subject to the same rules of procedure as any other filing deadlines. The court found that by entering a confirmation order, the court incorporates by reference the entirety of the plan into its judgment. The court found that based on this reasoning, all of the provisions of a plan are "prescribed or allowed" by the court's confirmation of the plan, thus meeting the prerequisite of Bankruptcy Rule 9006(a). The court found that since the language regarding the deadline in the plan referred to the time for filing documents with the court, the reasonable interpretation of that language would be to apply the procedural rules of the court. The court did indicate that it was not suggesting that the parties could not have drafted language that would avoid the automatic rollover provision of Rule 9006(a).

***In Re Russell Cave Co., Inc., The Official Committee of Unsecured Creditors of Russell Cave Co., Inc. v. General Electric Capital Corp., 107 Fed. Appx.449 (6<sup>th</sup> Cir. 2004) (Unpublished)***

This case addresses procedural issues regarding attempts to recharacterize debt to equity. The Official Committee of Unsecured Creditors ("Committee") sought to recharacterize appellee's claims as equity rather than debt and to equitably subordinate those claims. Under the plan that governed the disposition of the remainder of the Debtor's assets and claims, the Debtor and the Committee had the responsibility to make claim objections. The plan defined claim objection as "the rights of the Debtor and the [Committee] to object to allowance and/or payment of any Claim *for any reason*, including, without limitation, the grounds set forth in Sections 502, 503, 506, and 507, . . . but not including the right to seek subordination of any Claim under Sections 509 and 510 . . . or otherwise." The Committee filed an adversary proceeding raising its recharacterization claims after the claims objection deadline. The bankruptcy court dismissed the claims as time-barred.

The Court of Appeals found that the recharacterization claims fell within the plan's definition of claim objections because the Committee was objecting to an allowance of the claim

and payment of the claim. It found that a claim to recharacterize debt to equity is the same as objecting to the claims allowance.

The Court also dismissed the Committee's claim that its recharacterization claims were in fact subordination claims. The Court found that recharacterization and equitable subordination are different: recharacterization focuses on the existence of a debt or a claim whereas equitable subordination focuses on the conduct of the creditor. Further, because the Committee filed its recharacterization claims as separate counts from its equitable subordination claims it could not then argue that its claims fell under the equitable subordination exception of the plan. The Court of Appeals affirmed the order dismissing the Committee's recharacterization claims as untimely.

***In re Horizon Natural Resources Company, 316 B.R. 268 (Bankr. E.D. Ky. 2004)***

In this case, the court was faced with the motions of several subsidiaries of Horizon Natural Resources Company (collectively "Debtors") to terminate collective bargaining agreements and to terminate or modify employee benefit plans. Debtors sought to reject the collective bargaining agreements under 11 U.S.C. § 1113, to modify certain union retiree benefit plans pursuant to 11 U.S.C. § 1114, and to modify Coal Act union retiree benefit plans, also pursuant to 11 U.S.C. § 1114. Each of the collective bargaining agreements contained a "successorship clause," which provided that Debtors agreed not to sell their operations without obtaining agreement of the purchaser to assume Debtors' obligations under the agreement.

In late 2002, the Debtors filed for Chapter 11 relief. The Debtors first attempted to reorganize, but the decision was later made to liquidate substantially all of their assets. The Debtors filed two Chapter 11 plans, both of which sought an order to sell the Debtors' assets free and clear of liens, claims and encumbrances, apparently including successor liability under the collective bargaining agreements. After negotiations between the Debtors and the unions from August 2003 and early 2004 regarding modifications to the collective bargaining agreements and employee benefit plans failed, the Debtors filed the instant motions.

The Debtors offered proof that, without the relief requested in the motions, the Chapter 11 plans would not be confirmable and mine reclamation would be impossible. There was also evidence that the Debtors tried to market their operations with the collective bargaining agreements and employee benefit plans in place, but that there were no offers with these obligations.

The court first looked at whether retiree benefits under the Coal Act could be modified or terminated under § 1114 of the Bankruptcy Code. The court stated that § 1114 permits the modification of retiree benefits, while § 9711 of the Coal Act prohibits modification of retiree benefits in effect at the beginning of 1992 for as long as the employer remains in business. The court also held that Coal Act benefits were "retiree benefits" under § 1114. The court stated that § 1114 deals with the narrow, specific subject of modification of retiree benefits when the employer is in a Chapter 11 bankruptcy, while the Coal Act covers a more general spectrum. The court held that the two statutes were not conflicting and that, if Congress had wanted to exclude Coal Act benefits from the reach of § 1114, it could have done so by limiting the

definition of retiree benefits in the Bankruptcy Code or by stating in the Coal Act that the obligations thereunder are unaffected by the Bankruptcy Code.

The court then looked to the requirements for rejecting collective bargaining agreements and retiree benefits under §§ 1113 and 1114 and used the nine-part test from *In re American Provision Co.*, 44 B.R. 907, 909 (Bankr. D. Minn. 1984), in deciding to grant the motions to reject or modify. The court stated that the facts of the case showed that the relief was necessary to the confirmation of the Chapter 11 plan of the Debtors, that the Debtor's proposals made in 2004 to modify were made in good faith, that the Union's failure to accept the proposals was without good cause, and that the proposed modifications treated all parties fairly and equitably.

***Weingarten Nostat, Inc. v. Service Merchandise Company, Inc.*, 396 F.3d 737(6<sup>th</sup> Cir. 2005)**

Here, a shopping center landlord appealed the decision of the bankruptcy court allowing the assumption and assignment of the Debtor tenant's lease of a retail space. Although the landlord sought a stay of the bankruptcy court's order approving the assumption and assignment, it was not granted. Therefore, the court found the Debtor was entitled to dismissal of the appeal as moot under § 363(m) (the reversal on appeal of an order permitting a sale or lease does not affect the validity of the transaction unless stayed). The court stated that it need not decide whether to apply the *per se* rule of mootness adopted by the majority of the circuits because the relief sought by the landlord would have disturbed the validity of the § 363 sale and assignment at issue in the appeal. The court determined that an assignment of a lease for valuable consideration is a sale of property and therefore 363(m) does apply.

***In re Regal Cinemas, Inc., Capitol Industries, Inc. v. Regal Cinemas, Inc.*, 393 F.3d 647 (6<sup>th</sup> Cir. 2004)**

Capitol Industries was the lessee on a theater lease. It assigned its lease of the theatre to Regal Cinemas. However, Capitol remained guarantor of any rent obligations not paid by Regal. When Regal Cinemas filed for bankruptcy protection, it rejected the lease of the theatre. The Landlord and the Debtor then entered into an agreement whereby the Debtor paid to the Landlord the maximum amount permitted under § 502(b)(6) (capping lease rejection damages). Capitol filed a claim for what apparently was the full amount remaining due on the lease, based on the indemnification provision. The bankruptcy court denied the claim and the district court appealed. The Sixth Circuit reversed.

Capitol's claim was subject to the limitations of § 502(e)(1), which disallows co-debtor claims to the extent that the claim of their creditor is disallowed – i.e., the co-debtor does not get a more favorable result than the underlying creditor. Capitol argued that the lower courts erred because its claim included more than the lease rejection damages. The court disagreed, and found that § 502(e)(1) is broad enough to encompass any liability shared with the Debtor, whatever its basis. Therefore, Capitol's claim was disallowed to the extent that the Landlord's claim against the estate was disallowed. Since Debtor already paid the maximum amount that the Landlord could collect, Capitol's claim was disallowed in its entirety.

**State of Florida v. T.H. Orlando Ltd., 391 F.3d 1287 (11<sup>th</sup> Cir. 2004)**

This case addresses the scope of the exemption from transfer-type taxes given Chapter 11 asset sales. Here, the Chapter 11 Debtors reached agreement with a lender for new financing, but the lender conditioned the credit on a non-debtor company refinancing one of its properties through that lender also. The non-debtor company agreed solely to accommodate the Debtors. The lender issued commitment letters for the loans, pursuant to which the Debtors filed a plan of reorganization treating the non-debtor transaction as exempt from Florida documentary stamp taxes, intangible taxes and other taxes pursuant to 11 U.S.C. § 1146(c). The Florida Department of Revenue (“FDOR”) filed an objection to the confirmation of the plan, stating that the plan did not comply with 11 U.S.C. § 1129(a)(1) because the § 1146(c) exemption was not available to non-debtor entities. The bankruptcy court agreed and confirmed the plan with a provision that stated that the non-debtor transaction was not exempt from Florida documentary stamp taxes. The non-debtor paid the taxes under protest and, with the Debtors, filed suit in state court for a refund of the stamp taxes and for declaratory relief. The FDOR removed the case to federal bankruptcy court, which found that the non-debtor loan agreement was done pursuant to the debtor’s plan, was essential to that plan and was necessary to implement the plan. The bankruptcy court therefore held that the non-debtor loan transaction was “under a plan” within the meaning of § 1146(c), and the non-debtor was entitled to get back the stamp taxes it had paid. The district court reversed, holding that § 1146(c) was inapplicable because the transaction involved two non-debtors.

On appeal, the Eleventh Circuit held that the term “under” in § 1146(c), which exempts from stamp or similar taxes any instrument of transfer “under” a confirmed chapter 11 plan, referred to a transfer authorized by a confirmed Chapter 11 plan, which in turn authorizes any transfer that is necessary to the consummation of the plan. Because the plan authorized the non-debtor transaction, the court found it necessary to the consummation of the plan. The court held that the non-debtor mortgage was exempt from Florida’s stamp tax. The court stated that nothing in the language of § 1146(c) restricted its application to transactions involving the debtor or estate property. The court also rejected the FDOR’s argument that construing § 1146(c) to encompass transactions involving non-estate property would extend the bankruptcy court’s jurisdiction past its statutory limits. The court stated that the issue in the case was whether a non-debtor was entitled to an exemption under federal bankruptcy law, and the adjudication of substantive bankruptcy law was within the core jurisdiction of the bankruptcy court. The court differentiated cases relied upon by the FDOR, because in those cases, the third-party transactions were not necessary to the confirmation of the plan, an element the court found necessary for the transaction to be exempt under § 1146(c).

**C. Discharge and Dischargeability**

**Stamper v. United States (In re Gardner), 360 F.3d 551 (6<sup>th</sup> Cir. 2004)**

In this case, the Debtor was an attorney who failed to pay his tax liabilities for 1990 and 1991. At the request of the IRS, the attorney provided him with certain financial information, but did not list a nominee account in the name of his secretary and her husband, which the attorney used for his personal banking needs. In 1993, he received a \$500,000 distribution from his law firm, which he used to pay taxes, but did not apply to any of the 1990 or 1991 tax liabilities. After several more failed attempts to compromise his tax liabilities, and several other submissions of financial information, the attorney filed a bankruptcy proceeding on October 30, 1995. The attorney did not list any cash or bank accounts and did not list a pending case at his law firm on his bankruptcy schedules. The bankruptcy case closed September 23, 1998.

On March 12, 1999, the United States sought to reopen the attorney's bankruptcy proceeding, which was granted. The government then instituted this adversary proceeding in which it claimed that the attorney's 1990 and 1991 tax liabilities were nondischargeable under 11 U.S.C. § 523(a)(1)(C). The bankruptcy court conducted a trial in which the attorney admitted that he used nominee accounts to hide his assets from the State of Kentucky, that he was aware of his obligations to pay his 1990 and 1991 federal income taxes and that he could have used some of the income he earned to pay those taxes. The government also submitted evidence of the attorney's extravagant lifestyle after he incurred the tax liabilities for 1990 and 1991. Based on this evidence the bankruptcy court held that the attorney had willfully attempted to evade his tax liabilities within Section 523(a)(1)(C), and they were therefore not dischargeable. The district court affirmed.

In affirming both courts, the court of appeals held that Section 523(a)(1)(C) applies to attempts to evade either assessment of tax or payment of it (as here). It held that the government met both the conduct requirement and the mental state requirement in proving that Mr. Gardner willfully attempted to evade payment of the tax liability. The conduct requirement was met by Mr. Gardner hiding money in nominee accounts, failing to disclose the identity of the accounts and failing to apply income to the liabilities. The mental state requirement was met because Mr. Gardner knew of his liabilities and knew that he could have used some of his income to pay the liabilities.

**In re Best (Steier v. Best), 109 Fed Appx. 1 (6<sup>th</sup> Cir. 2004) (Unpublished)**

Here, the Sixth Circuit held that the debtors' effort to thwart the collection of the judgment debt did not render it nondischargeable under §523(a)(6), because the concealment did not cause or give rise to the judgment debt. Also, the bankruptcy court did not err in concluding that the debtors did not invade the unsecured creditor's legal rights by selling assets and using the proceeds to pay other creditors instead of paying him. Finally, the false financial statement provided to the creditor did not render the debt nondischargeable under §523(a)(2)(B) (i.e., incurring debt through a false financial statement), because the creditor did not rely on the statement in deciding to invest.

In 1996 Mr. Best founded Impairment Analysis Centers, Inc. ("IAC") with Mr. Finney. On November 10, 1997, Steier executed an agreement whereby he paid Best and Finney \$300,000 and each gave him fifty shares of IAC stock. Steier was to receive 50 more shares in May 1998, upon payment of \$450,000, reduced to \$300,000 if he found other investors. If Steier failed to do so, he would return his shares and Finney and Best would repay his \$300,000. In the next few months, disagreements arose. In April 1998, Steier demanded that Best and Finney repay his \$300,000. In May 1998, Best and Finney wrote Steier stating that they were unable to reimburse him at that time. Steier sued for breach of contract and won a judgment for \$300,000 plus interest in September 1998. In October 2000, the Bests filed for Chapter 7 bankruptcy. In January 2001, Steier filed an adversary proceeding, seeking a declaration that the Bests' judgment debt was non-dischargeable. Steier alleged that the Bests concealed assets to prevent him from collecting his judgment. The bankruptcy court held the debt was dischargeable under § 523(a)(6) (debt arising from willful and malicious injury to property) and that §523(a)(2)(B) did not apply. The district court affirmed and Steier appealed.

The Sixth Circuit found that it was immaterial whether or not the Bests disposed of or concealed assets in a way that they knew would prevent Steier from collecting the judgment debt because the concealment occurred after the debt arose and did not give rise to the debt. The court further noted that a breach of contract does not constitute a willful and malicious injury under § 523(a)(6). Additionally, while the Bests' actions may have caused Steier a lost opportunity to collect the funds, Steier, an unsecured creditor, did not have a greater right to these funds than any of the Bests' other creditors. The court also affirmed the bankruptcy court's finding that the false financial statement did not render the debt non-dischargeable under §523(a)(2)(B) because Steier did not rely on the financial statement and balance sheets and this finding was amply supported by Steier's own deposition testimony (i.e., that he had relied on the enthusiasm of the principals of the business).

**In re Miller (Miller v. Pa. Higher Education), 377 F. 3d 616 (6<sup>th</sup> Cir. 2004)**

The Sixth Circuit held that any discharge, whole or partial, of student loan debt must be pursuant to 11 U.S.C. Section 523(a)(8), which requires a finding of "undue hardship." Thus, the court reversed the bankruptcy court's partial discharge of student loan debt when the bankruptcy court properly relied on 11 U.S.C. Section 105(a) to discharge a fraction of the student loan debt, but failed to make a finding of "undue hardship" as required under Section 523(a)(8).

The debtor, Patricia Miller, received a B.A. in 1988, a Masters degree in 1992, and pursued a Doctorate of Philosophy at the University of Tennessee-Knoxville until 1997, accumulating approximately \$90,000 in student loans. For several years, she requested and received forbearance and deferments on those loans. In 2001, she filed a Chapter 7 bankruptcy petition and sought to discharge all of her outstanding student loan debt (over 99% remained unpaid at that time).

The bankruptcy court applied the correct test when analyzing whether all of Miller's student loan debt presented an "undue hardship." The Sixth Circuit combines the three-part test enunciated in *Brunner v. New York State Higher Education*, 831 F. 2d 395 (2d. Cir. 1987), plus other relevant factors discussed in *Hornsby v. Tenn. Student Assistance*, 144 F. 3d 433 (6<sup>th</sup> Cir. 1998) to determine if student loan debt presents an "undue hardship" as required by Section 523(a)(8). Upon finding that Miller failed to meet her burden of proof as to the entire loan amount, the bankruptcy court attempted to determine if at least some of the amount was dischargeable. The bankruptcy court turned to Section 105(a), which provides that a court may issue any order that is necessary to "carry out the provisions of this title." The use of Section 105(a), to discharge student loan debt, in part, was approved in *Hornsby*. However, when determining the amount, if any, to discharge, the bankruptcy court failed to apply the same "undue hardship" test. Thus, the Sixth Circuit reversed and remanded the case with instructions for the bankruptcy court to apply the proper "undue hardship" analysis with respect to the portion of the loans that were discharged.

**In Re Michael J. Oyler, Oyler v. Educational Credit Management Corporation, 397 F.3d 382 (6<sup>th</sup> Cir. 2005)**

Here, the bankruptcy court permitted the discharge of student loan debt under 523(a)(8) ("undue hardship" for the debtor and dependents). The creditor successfully appealed on the grounds the debt did not pose an undue hardship because the Debtor had chosen a low paying job. The Debtor was a pastor of a small start-up church, with an annual family income of approximately \$10,000. His only debts listed under his Chapter 13 plan were approximately \$40,000 in student loans. At the time of trial, the Debtor was current on his monthly plan of payments. The Sixth Circuit stated that whether the student loans pose an undue hardship is a legal question and therefore reviewed *de novo*. The Court, for the first time, expressly endorsed the *Brunner v. New York State Higher Educ. Serv. Corp.*, 831 F. 2d 395 (2nd Cir. 1987) factors for analyzing undue hardship. The factors are as follows: "(1) that the Debtor cannot maintain, based on current income and expenses, a minimal standard of living for herself and her dependants if forced to repay the loans; (2) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and (3) that the Debtor has made good faith efforts to repay the loans. *Id.* The Court found that the Debtor failed prong 2 because Debtor's inability to pay the debts was a result of his free choice. "Choosing a low-paying job cannot merit undue hardship relief." *Healy v. Massachusetts Higher Educ. (In Re Healy)*, 161 B.R. 389, 395 (E.D. Mich. 1993) The lower courts erred by not considering that Debtor's decision to accept a low-paying position was voluntary. The court ruled that the debt was not an undue hardship and as such discharge of the debt was unavailable.

**In re Blaszak, 397 F.3d 386 (6th Cir. 2005)**

Here, the Sixth Circuit held that the Debtor's debt for failure to remit trust funds was not dischargeable under §523(a)(4).



James Blaszak started Consumers Land Title Agency, Inc. ("Consumers"), articles of incorporation for which were filed December 27, 1996. On or about December 12, 1996, Consumers had entered into an agency agreement with plaintiff, Commonwealth Land Title Company ("Commonwealth"). The agency agreement appointed and authorized Consumers to be an issuing agent for Commonwealth. The agency agreement was signed by James Blaszak. The bankruptcy court determined that under Ohio law Blaszak was a promoter for Consumers at the time he signed the agency agreement and was therefore liable on the pre-incorporation contract.

The agreement remained in force until January 2, 2001, when it was terminated by Commonwealth because Blaszak failed to report and remit moneys from settlements, closings and premiums collected. Commonwealth claims these "defalcations" constitute breach of contract of the agency agreement and breach of fiduciary duty, resulting in losses in excess of \$99,000. At Commonwealth's request, the bankruptcy court issued an order finding Blaszak's debt non-dischargeable under 11 U.S.C. § 523(a)(4). The Bankruptcy Appellate Panel affirmed, holding the debt non-dischargeable regardless of the capacity in which Blaszak signed the contract.

The Sixth Circuit likewise affirmed, but on the basis of the Debtor's promoter capacity. The Sixth Circuit defines "defalcation" to "encompass embezzlement and misappropriation by a fiduciary, as well as the failure to properly account for such funds." To find that a debt is nondischargeable due to defalcation, the creditor must prove the following by a preponderance of the evidence: (1) a preexisting fiduciary relationship which requires that the debtor hold funds in trust for a third party; (2) breach of that fiduciary relationship; and (3) a resulting loss. Whether a fiduciary relationship exists is determined by looking to federal law which requires that the debtor hold funds in trust for a third party (i.e., it must be more than a principal-agent relationship alone). "The mere failure to meet an obligation while acting in a fiduciary capacity does not rise to the level of defalcation; an express or technical trust must also be present." *In re Garver*, 116 F.3d 176, 179 (6th Cir. 1997). The court found that the agency agreement met all of the requirements of an express or technical trust and therefore affirmed.

#### D. Avoidance Actions

***In Re Simms Construction Services Co., Inc., Corzin v. Decker, Vonau, Sybert and Lackey, Co., L.P.A.*, 311 B.R. 479 (6<sup>th</sup> Cir. B.A.P. 2004)**

Here, the BAP held that an Ohio attorney's charging lien is a lien for all purposes in bankruptcy and can defeat a preference claim to recover fees from a lawyer. A law firm provided prepetition legal services to the Debtor. During the 90 days prior to filing bankruptcy, the firm received payment for those services from the proceeds of an arbitration award. The Trustee sued to recover these payments as preferential transfers. The firm defended on the basis that its lien on the funds made it a secured creditor and the payment not preferential. The bankruptcy court concluded that, because the agreement to recover its fees from the arbitration award was oral, it was not sufficient to create the lien.

The Sixth Circuit reversed. The court found that the Ohio courts had not articulated the level of proof required to establish the existence of an attorney's lien. The court found that the Ohio Supreme Court has suggested that an agreement between the attorney and client is not a prerequisite to the creation of an attorney lien. In addition, the Ohio court of Appeals had recently held that an affidavit from the client is sufficient to establish the attorney charging lien. Therefore, the court found that the law firm did have an enforceable attorney charging lien, based upon the affidavits of the owner of the debtor corporation and an attorney of the law firm. The court found that, once the attorneys charging lien is established, it is treated as a lien for all purposes under the bankruptcy code. The court found that the payment to the law firm could not be a preference because "payments to a creditor who is fully secured are not preferential since the creditor would receive payment up to the full value of his collateral in Chapter 7 liquidation." (Quoting *In Re C-L Cartage Co.*, 899 F. 2d 1490, 1493. (6<sup>th</sup> Cir. 1990)).

***In Re Thrush, Byron Center State Bank v. Tibble*, 388 F. 3d 195 (6<sup>th</sup> Cir. 2004)**

Debtor purchased a mobile home from an individual who had financed his purchase of the mobile home through a bank. That same bank also financed the Debtor's transaction. The bank executed a release of lien on the previous owner's certificate of title and simultaneously entered its name on the certificate of title as the new lien holder. Just weeks later, the Debtor filed for bankruptcy, but had not yet applied for a title in his own name. Debtor filed for a title in his own name post-petition, and the new title listed the bank as the first and only lien holder. The Trustee initiated an adversary proceeding to avoid the bank's security interest in the mobile home. The bankruptcy court found that the bank had not perfected its interest in the mobile home because it failed to file its security interest with the Department of Commerce, as required by state law, prior to the filing of the bankruptcy petition. The district court reversed the bankruptcy court on the ground that the prior security interest remained valid until a new title application is delivered. However, the Sixth Circuit agreed with the reasoning of the bankruptcy court.

***In Re Vance, Rogan v. America's Wholesale Lender*, 99 Fed. Appx. 25 (6<sup>th</sup> Cir. 2004) (Unpublished)**

Here, the Trustee successfully avoided a defective mortgage. The Trustee sought to avoid a mortgage based on the assertion that the mortgage was invalid against a *bona fide* purchaser lacking notice of the mortgage, and therefore invalid against the Trustee, because of various defects. The defects included omissions in the notary's acknowledgement, such as the name of the county where the acknowledgement was taken, the identity and/or names of those who signed the mortgage and the date of the acknowledgement. The bankruptcy court determined that this acknowledgment failed to comply with KRS §§ 423.130 and 423.160. Kentucky law has uniformly held that defective acknowledgement of the security interest, though recorded, does not provide protection against a good faith purchaser without notice. The court determined that, based on the strong arm provision of bankruptcy law, the Trustee cannot be deemed to have actual knowledge of the mortgage. As an improperly executed security interest does not provide constructive notice under Kentucky law, the Trustee could not be

deemed to have notice of the mortgage, permitting it to be avoided. The district court reversed but the Sixth Circuit affirmed the bankruptcy court.

**In re Biggs, 377 F.3d 515 (6th Cir. 2004)**

Here, the Sixth Circuit affirmed the decisions of the bankruptcy and district courts, holding a deed of trust invalid where the required acknowledgment omitted the names of the individuals purporting to acknowledge their signatures on the deed.

On November 6, 1997, Richard and Kathy Biggs executed a deed of trust on their Tennessee home securing a \$65,000 loan and naming Seacoast Equities, Inc. as the beneficiary. The acknowledgment on the last page of the deed of trust omitted the names of the Biggs as the individuals purporting to acknowledge their signatures on the deed. On January 12, 1998, Seacoast Equities recorded the deed of trust and sold its interest in the deed to Ocwen Federal Bank. On April 9, 2001, the Biggs filed a bankruptcy petition under Chapter 7. The Trustee then filed a complaint in the bankruptcy court to avoid the deed of trust held by Ocwen under §544(a)'s strong arm clause on the ground that the acknowledgment was defective and that her status as a bona fide purchaser gave her a superior interest in the Debtors' home. The bankruptcy court ruled for the Trustee. It held that, in order for the acknowledgment to be in substantial compliance with Tennessee law, it must include the names of the people who appeared before the notary. Ocwen appealed the decision to the district court, which affirmed.

The Sixth Circuit affirmed. It noted that Tennessee law specifically forgives defective acknowledgments that either in "substance" or "intent" comply with the statutory requirements for a proper acknowledgement. However, the substantial compliance test could not save the deed of trust held by Ocwen because the savings provision addresses the unintentional omission of words by the officer taking the acknowledgment, not the unintentional omission of the names of the acknowledging individuals. Further, the deed of trust held by Ocwen failed the intent test because in this case the notary named no one in the certificate of acknowledgment and the court could not determine who, if anyone, intended to acknowledge the signatures on the deed of trust.

**In Re Huffman, Kovacs v. National Lending Center, Inc., 369 F. 3d 972 (6<sup>th</sup> Cir. 2004)**

This case encompassed three consolidated appeals of judgments by the district court allowing the bankruptcy Trustee to avoid mortgages held by creditors First Union Home Equity Bank and ContiMortgage Corporation under 11 U.S.C. § 544. The district court and court of appeals held that an Ohio statute stating that a recorded mortgage was irrebuttably presumed to be properly executed regardless of any actual or allegedly defect in the witnessing was unconstitutional because it also pertained to a wide variety of additional subjects, in violation of Article 2 § 15d of the Ohio constitution, which provides that no bill shall contain more than one subject. The court stated that the pivotal question was whether the various topics shared a common purpose or relationship. The court found that there was none. The court determined that, while the mortgages could have been saved by a recent amendment to the law, the amended statute could not be applied retroactively to impair the Trustee's vested rights.

**Johnson v. Altegra Credit Co. (In re Coleman), Case No. 01-53130, Adv. No. 02-5167, 2004 Bankr. LEXIS 967 (Bankr. E.D. Ky. July 21, 2004)**

This is another decision involving avoidance of a mortgage. The Debtors, before filing a Chapter 7 bankruptcy, refinanced a loan with CIT Group on their mobile home and real property. The note was assigned to Altegra Credit Co. ("Creditor"). The Trustee claimed that, because Creditor's lien did not appear on the mobile home's certificate of title and because the mortgage did not comply with the notarial acknowledgement requirements of KRS 423.130, her interest was superior to the creditor's interest, and she could therefore avoid the lien as a hypothetical lien creditor under 11 U.S.C. § 544(a)(1).

The court stated that, because the creditor's security interest did not appear on the mobile home's certificate of title, as required by Kentucky law, it was unperfected on the date of the filing of the Debtors' petition. Thus, the Trustee's lien pursuant to § 544(a)(1) was prior and superior, and the Trustee could avoid the mortgage on that basis.

The Trustee argued that she also had priority as a bona fide purchaser pursuant to 11 U.S.C. § 544(a)(3) because the mortgage did not meet the requirements in KRS 423.130 for proper notarization. The court agreed based upon *Rogan v. America's Wholesale Lender (In re Vance)*, 99 Fed. Appx. 25, 2004 WL 771484, at \*2 (6<sup>th</sup> Cir. 2004).

**Gardner v. Century Bank of Kentucky, Inc. (In re Dennis), Case No. 04-3037, Adv. No. 04-3022, 2004 Bankr. LEXIS 1469 (Bankr. E.D. Ky. Sept. 29, 2004)**

Here, the Trustee sought to avoid the creditor's mortgage on the basis that the mortgage did not recite the maturity date of the indebtedness secured as required under KRS 382.330.

The court stated that KRS 382.330 says that a mortgage may not be recorded unless it states the date and maturity of the obligation secured. The creditor responded by arguing that the mortgage was in fact recorded. The court said that, although an improperly recorded mortgage may give actual notice to those searching the title, a bankruptcy trustee has the rights and avoidance powers of a judicial lien creditor and bona fide purchaser "without regard to any knowledge of the Trustee or of any other creditor" under 11 U.S.C. § 544(a). Also, Sixth Circuit law held that a "defectively acknowledged security interest that is recorded does not provide protection from a subsequent party who lacks notice of the interest." *Rogan v. America's Wholesale Lender (In re Vance)*, 99 Fed. Appx. 25, 27 (6<sup>th</sup> Cir. 2004). Because the mortgage did not give third parties constructive notice of the mortgage, it was improperly recorded and the Trustee cannot have actual notice or knowledge of the mortgage. The court held that the Trustee could avoid the mortgage.

**Spradlin v. Stump (In re Charles), Case No. 04-70204, Adv. No. 04-7017, 2004 Bankr. LEXIS 1741 (Bankr. E.D. Ky. Oct. 19, 2004)**

Here, the court declined to invalidate a lien based on alleged drafting errors. The Stumps executed a "General Warranty Deed with Lien" to one of the Debtors and a third party "for and

in consideration of the sum of \$180,000, secured by a promissory note of even date hereof, payable pursuant to said note, the last payment being due and payable on or before October 1, 2009, and other good and valuable consideration, receipt for which is hereby acknowledged." A paragraph in the deed stated that a lien is retained on the property to secure the unpaid purchase price. With the deed was a Certificate of Consideration which stated, "We, the undersigned, hereby certify pursuant to KRS Chapter 382, . . . that the above stated consideration in the amount of \$ 180,000 is true, correct and full consideration paid for the property conveyed," and it is signed by the sellers and purchasers, followed by notary entries stating that the deed was acknowledged by the Stumps and that the Certificate of Consideration was subscribed and sworn to by the Stumps and by the Debtor and the third party.

Dated the same day was a promissory note signed by the Debtor and the third party that stated that they promised to pay the Stumps \$150,000 plus interest in monthly installments with the last payment due on September 1, 2009. The Stumps and Phelps BP Mart, Inc., as sellers, and the Debtor, the third party and their wives, as purchasers, entered into a "Contract of Sale and Purchase of Business Assets" for the purchase of the personalty and real estate described in the deed. One of the paragraphs of that contract, designated PAYMENT OF PURCHASE PRICE, stated that the purchasers were to pay \$150,000 in monthly installments with the final payment due on September 1, 2009.

When the Debtors filed their chapter 7 petition, they listed the transaction on schedule G as an executory contract or unexpired lease. The Stumps filed a proof of claim, alleging a secured claim of \$100,483.73 based on the note and lien in the above transaction. The Trustee filed the instant action seeking to avoid the Stumps' lien as unperfected as against the Trustee as a hypothetical bona fide purchaser or judicial lien creditor under 11 U.S.C. § 544. She argued that the deed failed to properly retain a lien on the property and that the acknowledgement was deficient.

The court, after considering Kentucky law on the requirements for signatures, attestation and filing of deeds, held that the deed in question complied with the law and gave adequate notice of the Stumps' lien. The court stated that the deed's title clearly reflects that a lien is being retained to secure the unpaid purchase price. The court stated that, although the stated amount of indebtedness is incorrect, it is less than the actual amount of the indebtedness, which is the secured amount, and although the maturity date was incorrect, it was off by only one payment. Thus, the court dismissed the Trustee's suit with prejudice.

**Baker v. Hodge (In re Hodge), Case No. 04-20357, Adv. No. 04-2034, 2004 Bankr. LEXIS 1477 (Bankr. E.D. Ky. Sept. 28, 2004)**

This case deals with the positions of the Trustee and junior lienholders when an otherwise first lien has been mistakenly released pre-petition. Here, Fifth Third Bank of Northern Kentucky, Inc. ("Fifth Third") recorded a mortgage on the Debtors' residence on June 11, 1999, but mistakenly released the mortgage on February 7, 2001. On April 25, 2003, Legal Recoveries, Inc. ("Legal Recoveries") recorded a judgment lien against each Debtor, as did Huntington National Bank ("Huntington") on January 8, 2004. On February 19, 2004, the

Debtors filed a voluntary chapter 7 petition and, in their schedules, valued the property at \$71,000. The Debtors also, in amended Schedule C, claimed an exemption on the property. Fifth Third filed a proof of claim. Legal Recoveries also filed a proof of claim, asserting that the claim was secured by a judgment lien. Huntington filed a proof of claim, but filed it as an unsecured claim.

The Trustee filed a complaint seeking to avoid Fifth Third's mortgage under 11 U.S.C. § 544(a) and preserve it for the estate, to avoid Huntington's judgment lien as a preference, for a determination that the judgment lien of Legal Recoveries was subordinate to the estate and to the Debtors' exemptions, for a determination that the Debtors' interests are subordinate to the estate and for authority to sell the property free of clear of the mortgage, judgment liens and exemptions. The Debtors filed a motion to avoid the judgment lien of Legal Recoveries as impairing their exemption. The Trustee admitted subsequently that the lien of Legal Recoveries was superior to Fifth Third's mortgage and thus, the Trustee's rights as successor to that mortgage.

The court stated that, under Kentucky law, the release of a mortgage reinstates title in the mortgagor or grantor, although a mortgagee who mistakenly releases a mortgage is entitled to have the mortgage reinstated as long as later claimants did not rely to their detriment on the release in acquiring their rights. However, the court noted that, based on Sixth Circuit authority, the equitable right to have the mortgage reinstated does not rise to the level of a present security interest for the purpose of federal tax lien statutes. Thus, a competing claimant will prevail over an unrecorded, equitable mortgage so long as the claimant did not have notice that the release was erroneous. Thus, Fifth Third retained no interest in the property following the recordation of the release, and the Trustee has no authority under § 544(a) to avoid any interest. Even though § 544(a) gives the Trustee the right of a judicial lien creditor or bona fide purchaser without knowledge, the court stated that these rights would be subject to the rights of other judicial lien creditors that were perfected prior to the commencement of the case. Thus, the Trustee's rights by virtue of § 544(a) are subordinate to the judicial lien rights of Legal Recoveries and Huntington.

The Trustee was permitted to avoid Huntington's lien as a preference under 11 U.S.C. § 547. However, the liens of Legal Recoveries were not permitted to be avoided by the Debtors because they did not impair the Debtors' exemption. The remaining liens and exemption totaled only approximately \$32,000, which was much less than the value of the property.

***In Re Ulinski, Ulinski v. Huntington National Bank, 317 B.R. 716 (Bankr. E.D. Ky. 2004)***

Here, the court held invalid a vehicle lien when the final act to perfect the lien took place post-petition. The Debtor financed the purchase of a truck through a lender from whom he had been leasing that vehicle. The Trustee sought to avoid the bank's loan as a preferential transfer or a post-petition transfer, and as a violation of the automatic stay. The bank claimed that, because it had taken all steps necessary to have its lien noted on the certificate of title and because the certificate of title still noted it as the owner of the truck and not the lienholder, its interest was perfected prior to filing of the bankruptcy petition. However, Kentucky law

provides that the sole means of perfecting the lien on a vehicle is by notation on its certificate of title. Perfection of this lien did not occur until after the petition had been filed. The Court determined that, if the lien was invalid under § 362, the Trustee would not need to avoid it. Any act in violation of the automatic stay is considered to be invalid and has no effect. Despite the bank's notation on the certificate of title, the truck was deemed to be property of the estate at commencement of the case.

As the perfection of the bank's lien was in violation of the automatic stay, the Court deemed it invalid.

**In re Lewis, 398 F.3d 735 (6th Cir. 2005)**

Here, the Sixth Circuit affirmed the avoidance of a late-filed mortgage as a preferential transfer pursuant to § 547, notwithstanding the appointment of a receiver for the lender under FIRREA.

On September 9, 1999, Ms. Lewis executed a note to Superior Bank and, with two family members, executed a mortgage on her real property to secure the note. Superior did not record the mortgage until April 17, 2000. On May 4, 2000, Ms. Lewis filed under Chapter 7. On November 11, 2000, the Trustee filed an adversary proceeding seeking to avoid Superior's mortgage. On July 27, 2001, Superior was placed in receivership pursuant to the provisions of the Financial Institutions Reform, Recovery and Enforcement Act ("FIRREA"). On November 15, 2001, the bankruptcy court granted partial summary judgment in favor of the Trustee and avoided Superior's mortgage. The district court affirmed, as did the Sixth Circuit. The FDIC, as receiver, appealed and challenged the bankruptcy court's subject matter jurisdiction under FIRREA.

The question of whether FIRREA applies to an action pending at the time a receiver was appointed was an issue of first impression in the Sixth Circuit. The Court found that Congress did not intend for § 1821(d)(13)(D) to strip the bankruptcy court of its jurisdiction in a pre-receivership context and that the bankruptcy court had jurisdiction to decide the avoidance issue at the time the adversary complaint was filed. The Sixth Circuit further found that, if the receiver does not request a stay, FIRREA does not prevent a court that acquired jurisdiction before the receiver was appointed from deciding the issues before it. § 1821(d)(13)(D) only precludes a court from acquiring jurisdiction *after* a receiver is appointed. Therefore, the bankruptcy court retained jurisdiction to decide the adversary action because the FDIC did not intervene and request a stay of the pre-receivership case after it was appointed receiver of Superior.

**E. Exemptions/Property of the Estate**

**In re Medex Regional Laboratories, LLC, 314 B.R. 716 (Bankr. E.D. Tenn. 2004)**

Here, the bankruptcy court found that the proceeds of a directors' and officers' liability policy were not property of the Debtor's bankruptcy estate because any indemnification to be provided to the Debtor under the policy was hypothetical and/or speculative.

The Debtor was organized as a Tennessee limited liability company. Each of individuals at issue here ("Officers") was a governor and/or manager of the Debtor. In 2002, the Debtor obtained a Directors' and Officers' liability insurance policy. Each Officer was an "Insured Person," the Debtor was an "Insured Entity," and the Officers and the Debtor were "Insureds" as defined in the policy. On April 8, 2003, the Debtor filed a voluntary petition commencing its Chapter 11 bankruptcy case. A committee later filed an adversary proceeding against the Officers in their capacities as officers and/or directors alleging breach of fiduciary duty and related claims. Each of the Officers asserted indemnification by the Debtor as an affirmative defense. Additionally, five of the Officers filed proofs of claim in the Debtor's bankruptcy case for an undetermined amount based upon possible indemnification claims against the Debtor (with the adversary proceeding constituting a "Claim" as defined in the policy). The insurer conditioned payment of the costs of defense on the court (1) finding that the policy proceeds were not property of the Debtor's estate, or (2) granting relief from the automatic stay as to the policy proceeds.

The bankruptcy court noted that, while there is general agreement that Directors' and Officers' policies are property of the estate, there is disagreement regarding the status of policy proceeds. It concluded that, because the Debtor had not provided any indemnification to the movants and because any indemnification was hypothetical and/or speculative, the policy proceeds were not the property of the Debtor's bankruptcy estate. The insurer was therefore not precluded by the automatic stay from disbursing the costs of defense directly to the Officers. The bankruptcy court stated the rule as follows:

"When a debtor's liability insurance policy provides direct coverage to the debtor the proceeds are property of the estate, because the proceeds are payable to the debtor. Further, when the liability insurance policy only provides direct coverage to the directors and officers the proceeds are not property of the estate. However, when there is coverage for the directors and officers and the debtor, the proceeds will be property of the estate if depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate's other assets from diminution. Lastly, when the liability policy provides the debtor with indemnification coverage but indemnification either has not occurred, is hypothetical or speculative, the proceeds are not property of the bankruptcy estate."



**Yates v. Hendon, 541 U.S. 1 (2004)**

Here, the U.S. Supreme Court resolved a circuit split and held that the working owner of a business may qualify as a “participant” in an ERISA pension plan.

Dr. Raymond B. Yates was the sole shareholder and president of Raymond B. Yates, M.D., P.C., a professional corporation, which maintained a profit sharing plan (“Profit Sharing Plan”). At least one other person besides Dr. Yates and his wife were participants in the Profit Sharing Plan. The Profit Sharing Plan contained a spendthrift clause, which precluded the alienation or assignment of any benefit or interest in the plan except for loans to participants. Dr. Yates, in December 1998, borrowed \$20,000 from the Raymond B. Yates, M.D., P.C. Money Purchase Pension Plan, which was later merged into the Profit Sharing Plan. Dr. Yates originally defaulted on the terms of the loan but finally did repay to the Profit Sharing Plan the approximately \$50,000 in principal and interest due. Three weeks after the repayment, Dr. Yates’s creditors filed an involuntary bankruptcy petition against him. The Trustee filed an adversary complaint against the Profit Sharing Plan and Dr. Yates as its Trustee asking the bankruptcy court to avoid the preferential transfer of the \$50,000 by Dr. Yates to the Profit Sharing Plan.

The bankruptcy court, relying on existing Sixth Circuit precedent, granted summary judgment to the Trustee, holding that, as the self-employed owner of the professional corporation that sponsored the Profit Sharing Plan, Dr. Yates could not participate in the plan as an employee under ERISA and could therefore not use the anti-alienation spendthrift clause to enforce the restriction of his interest. Therefore, the money Dr. Yates put into the Profit Sharing Plan was not protected by ERISA. The district court and Sixth Circuit affirmed.

The Court reversed. It considered the text of ERISA, which contained multiple indications that Congress intended working owners to qualify as plan participants, and an amicus curiae brief filed by the Department of Labor in which it stated that it believed owners were included in the definition of “participant.” The Court held that a working owner may be a participant under ERISA on equal terms with other plan participants as long as the plan covers one or more employees other than the business owner and his or her spouse, and that the owner qualifies for all the protections of ERISA.

**United States v. Wagner, 382F. 3d 598 (6<sup>th</sup> Cir. 2004)**

This case addresses the criminal concealment of assets in a bankruptcy context. Appellant appeals his conviction for fraudulently concealing property from a bankruptcy Trustee and filing a false document in a bankruptcy proceeding. The Debtor filed a pro se Chapter 11 bankruptcy proceeding to stay approximately 75 foreclosure actions. He refused to attend the customary meeting with the U.S. Trustee’s office, and filed a “plan” that simply criticized the judge. He also further “encumbered” several of his properties with bogus mortgages based on forged documents purporting to evidence a loan to the Debtor from the Small Business Administration. The United States Trustee’s office filed a motion to convert Debtor’s

bankruptcy petition to a Chapter 7 petition, which was granted. The Debtor then ordered tenants not to pay rent to the Trustee and changed property locks to thwart the Trustee's efforts to sell the properties. The Debtor was indicted for fraudulently presenting the SBA mortgage and note and the plan, fraudulently ordering his tenants to pay rent to him as opposed to the Chapter 7 Trustee and for concealing assets by changing the locks on the houses that were assets of the Estate. The Debtor was found guilty on the first and third counts, however, the jury was unable to reach a unanimous verdict on count 2.

On appeal, the Debtor argued that he did not "conceal" property by changing the locks. The court determined that Debtor concealed property within the meaning of 18 U.S.C. § 152(1), by depriving the Trustee of access to the houses and withholding the values of the properties. As there is no materiality requirement in § 152(1), the Court determined that such issues as the minimal inconvenience caused by the changing of locks were irrelevant.

The Debtor also argued that his conviction for bankruptcy fraud should be reversed because his actions had not been proven to have an affect on the bankruptcy court. The court analyzed his conviction under the three-part test for § 157(2): (1) the existence of a scheme to defraud or intent to later formulate a scheme to defraud; (2) the filing of a document and a proceeding under Title 11; (3) for the purpose of executing or attempting to execute the scheme. The court found that there was no requirement that the fraudulent filing have its intended effect. The court affirmed based on its finding that a reasonable trier of fact could conclude that Wagner devised a scheme to defraud the court and filed the plan of arrangements in furtherance of that scheme.

#### F. Good Faith/Dismissal

#### *In Re Integrated Telecom Express, Inc., NMSBPCSLDHB, LP. v. Integrated Telecom Express, Inc., 384 F. 3d 108 (3<sup>rd</sup> Cir. 2004)*

Here, the Third Circuit dismissed a Chapter 11 proceeding for lack of good faith where a non-operating debtor filed a Chapter 11 petition in order to force the reduction of a lease termination liability, so that more value could be distributed to shareholders. The Debtor had been a supplier of software and equipment to broadband communications industries. It leased real property in Silicon Valley from the Landlord in early 2001. The lease was for a period of 10 years with escalating rent. The tenant then encountered various legal and financial difficulties and formed a plan to liquidate, but needed to deal with its liability under the lease. The Debtor's Board of Directors authorized a Chapter 11 filing in order to take advantage of the post-petition lease termination damages cap set forth in § 502(b)(6) (the greater of one year's rent or 15% not to exceed three years' rent) if the Landlord would not accept \$8 million for the obligations under the lease, and a letter to that effect went to the Landlord. The Debtor and the Landlord were unable to reach an agreement, and the Debtor filed the bankruptcy proceeding. At the time of filing, the Debtor listed over \$106 million in assets. The Landlord filed proof of claim for \$26 million. The Debtor also listed miscellaneous liabilities of approximately \$430,000. The Debtor moved to reject the lease and the Landlord moved to dismiss for lack of good faith. The bankruptcy court denied the motion to dismiss. It noted several factors supporting the filing,

including a desire to stem losses and return some remaining value to investors. However, it also held that the desire to take advantage of § 502(b)(6) was enough to support the filing. The district court affirmed.

The court of appeals noted that the burden is on the Debtor to establish that the petition was filed in good faith. The court of appeals reviewed the bankruptcy court's decision for abuse of discretion. The court focused on whether the petition served a valid bankruptcy purpose or was filed merely to obtain a tactical litigation advantage. The court found that filing a bankruptcy petition merely to obtain tactical litigation advantage is not within the legitimate scope of the bankruptcy law. Because the Debtor was out of business, the court determined that the main issue on appeal was whether the petition might reasonably have maximized the value of the bankruptcy estate. The court did note that the Debtor need not be insolvent before filing for bankruptcy protection. However, here, there was no value for the Debtor's assets that was threatened outside of bankruptcy, but that could be preserved or maximized in a bankruptcy proceeding. The court found that the collapse of the Debtor's business model did not support a finding of good faith. The Debtor was not suffering from financial distress when it filed its petition and the lower court's findings to the contrary constituted legal error.

The court also found that there was not sufficient evidence to support a finding of good faith based on the Debtor's stated purpose to provide a framework for resolving a class action against it. The court noted that the Debtor would have remained solvent even had the class and the Landlord been able to recover their full claims.

The court stated that it appeared that the Debtor had filed for Chapter 11 protection to gain a litigation advantage. The court noted that prior cases rejected this as a good faith reason for filing for bankruptcy protection. The court also found that dissolution and distribution were not valid purposes for filing a bankruptcy petition. The court also determined that the sale of the Debtor's intellectual property rights through the bankruptcy court did not justify the filing. The court found that the only increase in value for these assets was as a result of the Committee's challenge to the Debtor's proposed sale and auction. The court stated that bankruptcy protection was not necessary to alert the Debtor to the fact that it could achieve a higher price for its assets in an open auction.

The court then addressed whether the Debtor's desire to take advantage of the cap on Landlord claims established good faith in and of itself. The bankruptcy court determined that the Debtor's desire to take advantage of the § 502(b)(6) cap does not establish bad faith. The court of appeals agreed, stating that it is not bad faith to seek to avail oneself of a particular protection of the Bankruptcy Code. However, the court found that such a desire, standing alone, cannot establish good faith. The court found that good faith must be determined prior to the operation of § 502(b)(6). The court stated that although the Code allows redistribution of value from one interest to another, the redistributions are merely the means to effectuate the purpose of preserving going concerns and maximizing the value of the estate. To be filed in good faith, a petition must seek to create or preserve value that would be lost but for the protections of bankruptcy. The court held that the bankruptcy court and the district court erred as a matter of

law in concluding that the Debtor suffered financial distress. Because the Debtor was not in financial distress, the petition was not filed in good faith.

**In re Behlke, 358 F.3d 429 (6th Cir. 2004)**

Here, the Sixth Circuit affirmed the bankruptcy court's ruling that to grant the Debtors a Chapter 7 discharge would constitute a substantial abuse of the bankruptcy system because the Debtors had disposable income with which to pay their creditors.

In 2001 the Debtors voluntarily filed under Chapter 7. At the time of the filing, the Debtors owed approximately \$160,000 in unsecured non-priority debt that was consumer in nature. The Debtors' net monthly income totaled \$4,923 and their net monthly expenses totaled \$4,749. The Debtors' Schedule 1 showed a voluntary monthly contribution of \$460 to the Debtor's employer-sponsored 401K program. The Trustee filed a motion to dismiss the case under § 707(b) as a "substantial abuse" of the chapter. The bankruptcy court noted that substantial abuse can be predicated on a lack of honesty or a lack of need and concluded the Debtors were not needy. It granted the motion and the Sixth Circuit BAP affirmed on that ground. The Sixth Circuit affirmed.

The court held that that the bankruptcy court did not abuse its discretion in including 401K contributions as disposable income for purposes of determining the Debtors' ability to pay under § 707(b), on the ground that the 401K contributions were not reasonably necessary to the maintenance and support of the Debtors or their dependant.

The court held that the bankruptcy court also did not abuse its discretion in concluding that the Debtors' ability to repay 14% over three years or 23% over five years meant they did not satisfy the need prong of the test. The court acknowledged there is not a bright line test for determining the extent of ability to repay that will support a substantial abuse finding.

**Copper v. Copper (In re Copper), 314 B.R. 628 (B.A.P. 6<sup>th</sup> Cir. 2004)**

In this case, the Debtor, a distinguished university professor, had filed his sixth bankruptcy petition in an attempt to avoid paying his ex-wife the amounts she was awarded under the divorce decree. Each of the prior petitions was dismissed because of the Debtor's failure to comply with basic bankruptcy requirements. During this sixth bankruptcy matter, the former wife filed an adversary proceeding against the Debtor, asserting that the debts owed to her were nondischargeable and that the Debtor's discharge should be denied. Just before trial, the Debtor filed a motion to convert his chapter 7 bankruptcy into a chapter 13 pursuant to 11 U.S.C. § 706(a).

The bankruptcy court noted that there were a number of serious false statements in the Debtor's schedules and statement of financial affairs. In fact, the Debtor's attorney stated that his client was the most sanctioned debtor in the district and that his client had told "egregious lies" during the trial. The judge then held that it would be futile to convert the Debtor's case into a chapter 13, because a chapter 13 plan must be proposed in good faith, and the Debtor was not

capable of making such a proposal. Thus, the motion to convert was denied, and this appeal followed.

The Debtor argued that, no matter how reprehensible his conduct, he had an absolute, one-time right to convert his chapter 7 case to a chapter 13 case. The court, although recognizing that there is a line of cases holding differently, held that the right to convert is not absolute and, in extreme circumstances, such as bad faith or an attempt to abuse the bankruptcy process, it could be denied. The court thus affirmed the bankruptcy court's finding that the motion to convert was motivated solely by a desire to avoid a determination that the Debtor was not entitled to a discharge, and affirmed the denial of the motion for conversion.

#### G. Attorneys

##### **Rubin v. Pringle (In re Focus Media, Inc.), 387 F.3d 1077 (9<sup>th</sup> Cir. 2004)**

Here, the attorney for a party in a bankruptcy proceeding was deemed to be the agent for service of process on that party in a later adversary proceeding. An involuntary bankruptcy case was filed against Focus Media, Inc. Over a year later, the Trustee brought an adversary proceeding against the sole shareholder of the Debtor, alleging that the Debtor transferred millions to the shareholder. The Trustee also sought to freeze the shareholder's assets by a temporary restraining order ("TRO") and a motion for a preliminary injunction. The court issued the TRO and scheduled a hearing on the preliminary injunction. The Trustee served the attorney who represented the shareholder in the underlying bankruptcy action. The shareholder appeared by counsel only and challenged service of process.

The court tentatively granted the preliminary injunction motion, stating that the question really came down to whether the attorney was impliedly designated as the agent for service of process for the shareholder. The bankruptcy court found that the attorney, as counsel for the shareholder in the underlying bankruptcy action, was impliedly authorized to receive service of process on his behalf in the adversary case. The shareholder appealed, and the district court affirmed, stating that service on the shareholder was proper under Bankruptcy Rule 7004(b) and adopted the ruling of the bankruptcy court that implied authority to accept service of process was proper under the bankruptcy rules.

The court of appeals affirmed, holding that the attorney was impliedly authorized to accept service on the shareholder's behalf because the attorney was extensively involved in the underlying bankruptcy on the shareholder's behalf and because the shareholder had been served with papers in the bankruptcy proceeding in the care of the attorney with no objection. The court held that Rule 7004(b)(8) allowed the agent for service of process to be an agent impliedly authorized to accept service on a client's behalf.

The court also held that *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308 (1999), which held that asset-freezing injunctions are impermissible where a creditor seeking money damages lacks any interest in the debtor's assets, was inapplicable

because that case did not bar the issuance of preliminary injunctions freezing assets where a party in a bankruptcy alleges fraudulent conveyance or other equitable causes of action.

#### H. Credit Facility and Collateral Disputes

##### *Pressman v. Franklin National Bank and Gordon E. Inman*, 384 F.3d 182 (6<sup>th</sup> Cir. 2004)

The bank in this case prevailed on allegations that it improperly declined to make a loan. A partnership was formed to purchase several tracts and develop them as a residential subdivision. One of the parties spoke to a loan officer at Franklin National Bank ("Bank"), concerning an acquisition loan for a certain piece of property. The officer asserted that the Bank would need to obtain a participating bank to finance a portion of the loan. He then told the partner that the loan had been approved but that the Bank still needed to locate a participating bank in order to provide the loan. The Bank approached a Georgia lender who required approval of the rezoning before agreeing to participate in the loan. There was conflicting evidence on whether the partner was told this was the only impediment to the loan. The Bank subsequently executed a Commitment Letter, dated July 31, 1996, stating that it intended to make a loan to the partnership but that it was contingent on the Bank's ability to find a participating bank. The rezoning of the property was officially approved on August 12, but the Georgia lender decided not to participate in the loan. The partnership later obtained a loan elsewhere but on less favorable terms than those originally proposed by Bank. Two years later the partnership filed for bankruptcy. Another partner purchased all the partnership's claims and filed suit against the Bank and one of its principals alleging that the Bank was liable for breach of contract, fraud and civil conspiracy. The district court entered judgment in favor of the Bank defendants on all claims.

The Sixth Circuit rejected the partner's argument that the Bank waived the participating-bank condition with a representation that the participating Georgia lender was ready to close subject only to final rezoning approval. The court found that: (1) there was no evidence that the Bank officer possessed the requisite intent to waive; (2) at the time of his alleged representation, the Bank had no rights under the participating-bank condition that could be waived; (3) a merger and integration clause contained in the Commitment Letter precluded the partnership from relying upon the alleged representations made prior to the execution of the letter; and (4) the commitment letter required that any waiver had to be in writing and executed by both parties, which was not done. The court also affirmed the district court's finding that the Bank acted in good faith and used commercially reasonable standards.

The court affirmed the district court's finding that the evidence did not establish that the Bank defendants intended to defraud the partnership.

**Huntington National Bank v. Porter, Nos. 2001-CA-000505-MR, 2001-CA-000509-MR & 2003-CA-001022-MR, 2004 WL 1909295 (Ky. App. Aug. 27, 2004) (Unpublished)**

In this case, DDR Rental and Leasing, Inc., d/b/a Dollar Rent-A-Car of Kentucky (“DDR”) received floorplan financing from Huntington for \$8.6 million. DDR purchased cars from local dealers, and had repurchase agreements for the dealers to buy back the cars at an agreed amount of money. Huntington had a security interest in the cars purchased from the dealers, and the buy back amounts were to be paid to Huntington toward the floorplan debt. However, because the dealers repurchasing the cars required Huntington to release its lien on them and the money from the repurchases was paid directly to DDR, Huntington was left unsecured. To protect itself, Huntington asked the shareholders of DDR to sign an indemnification agreement promising to reimburse Huntington for any losses it might suffer from DDR’s failure to abide by the repurchase agreements with the dealers. DDR claimed that Huntington also promised to extend overline financing of \$5 million to DDR for DDR to purchase new cars before receiving payment for the repurchased cars, which claim the bank disputed.

The trial court held that the agreement between the DDR shareholders and Huntington was actually a guaranty agreement and was unenforceable under KRS 371.065 for failure to comply with the terms of the statute. The trial court also directed a verdict in favor of Huntington on the claim of fraud by one of the DDR shareholders. A jury determined that DDR was liable on the floorplan note for over \$3.8 million.

Huntington appealed the determination that the indemnity agreement with the DDR shareholders was actually a guaranty agreement subject to KRS 371.065. The court of appeals stated that, despite its label as an indemnity agreement, the agreement was a guaranty because it was a “promise to protect the promisee (Huntington) against loss or damage through the failure of DDR to fulfill its obligations to Huntington.” Thus, it stated, KRS 371.065 applied, and the guaranty did not comply with the statute because it did not state “the amount of the maximum aggregate liability of the guarantor thereunder, and the date on which the guaranty terminates.” The court affirmed the trial court’s ruling that the guaranty agreement was unenforceable.

The court of appeals did, however, reverse the directed verdict in favor of Huntington on the shareholder’s fraud claim, stating that the shareholder had presented enough evidence that Huntington, through its representative, had made material representations to him (through DDR) regarding overline financing.

**Eubanks v. CBSK Financial Group, Inc., 385 F.3d 894 (6th Cir. 2004)**

This case involved Debtors who prosecuted a lender liability claim after omitting it from their schedule of assets, and discusses the concept of judicial estoppel.

Although this case has a somewhat complicated procedural history, reduced to the basics, the Debtors claimed to have filed their Chapter 7 bankruptcy proceeding as a result of a dispute with a lender over the cancellation of a loan previously approved. The Debtors did not initially

identify the lender as a creditor or identify the lender liability claim as an asset. However, they did later make the Trustee aware of the claim and provided documents to him concerning it. The plaintiffs at one point sought to substitute the Trustee as a plaintiff in the action, but the bankruptcy court ultimately entered the Trustee's final report which declared the lender liability claim "fully administered and fully abandoned." After a number of procedural steps, they eventually attempted to amend their original petition to add the claim as an asset, which amendment the lender sought to block. During the course of the case, the Debtors did bring the lender liability claim. The district court eventually dismissed it on grounds of judicial estoppel, and the plaintiffs appealed.

The court noted that the doctrine of judicial estoppel barred the party from asserting a position that is contrary one the party has asserted under oath in a prior proceeding where the prior court adopted the contrary position. The lender argued that the plaintiffs' failure to include the potential claim as an asset in its initial bankruptcy adjudication warranted judicial estoppel. The court declined to apply that doctrine here, noting that the plaintiffs' disclosures to the Trustee through correspondence, motions and status conference requests supported their argument that the claim's omission on the schedules was inadvertent and that all parties knew they intended to pursue the claim. The court found there was no evidence of any fraudulent intent to conceal the claim.

**Layne v. Bank One, Kentucky, N.A., 395 F.3d 271 (6<sup>th</sup> Cir. 2005)**

This case deals with a lender's duty to preserve collateral value where the collateral is shares of stock. Plaintiffs Charles E. Johnson, Jr. and Geoff Layne entered into two loan transactions with Bank One, Kentucky, N.A. ("Bank One"), borrowing a total amount of approximately \$6 million secured by their shares of stock in the company PurchasePro.com, Inc., of which Johnson was founder and CEO and Layne was national marketing director. The loan agreements included a Loan-to-Value ("LTV") ratio for each debtor that had to meet specified percentages or the debtors had five days to cure by increasing the collateral or reducing the outstanding balance, after which the loan would be in default and Bank One could exercise the right to sell the stock with ten days notice to Johnson. In February 2001, the stock price fell, and both loans exceeded their LTV ratios. Bank One entered into discussions with Johnson and Layne to pledge more collateral. After Layne went back and forth several times on whether he wanted the bank to sell the shares, Bank One had final discussions with the two debtors regarding pledging additional collateral. The proposed deal fell through, and Bank One notified Johnson of his continued default on the loans. Bank One finally sold Johnson's shares in July, recovering approximately \$525,000, and leaving a \$2.2 million unpaid balance. Layne and Johnson separately filed suit against Bank One, and the cases were consolidated. Layne subsequently settled. Bank One filed counterclaims seeking payment of the loan deficiencies and then filed a motion for summary judgment on all claims and counterclaims. The district court granted Bank One's motion, and Johnson appealed.



Johnson argued that Bank One violated a duty under Kentucky law to preserve the value of the collateral it had in its possession under the U.C.C. as adopted in Kentucky. *See* KRS 355.9-207. The court stated that whether a secured party's duty to preserve collateral applies to pledged shares was an issue of first impression in Kentucky. The court held that, under Kentucky law, a lender has no obligation to sell pledged stock held as collateral merely because of market decline, regardless of whether the loan is over-collateralized. The court held that it is the duty of the borrower, if he is concerned about the decline in the share value, to substitute the pledged stock with other valuable assets or sell the pledged stock himself and pay off the loan. The decision suggests that, had the borrower requested the sale of the stock, and the bank refused, the result could have been different.

Johnson also argued that Bank One violated Kentucky law by failing to dispose of the pledged stock in a commercially reasonable manner. The court recognized that KRS 355.9-627(2) allows as commercially reasonable sales of collateral on a recognized market such as the New York Stock Exchange. It held that the sale of the stock by Bank One on NASDAQ was commercially reasonable.

Johnson's final argument was that Bank One breached its fiduciary duty by failing to sell the pledged stock when the LTV ratio exceeded the required percentage. The court held that there was no fiduciary relationship created between Bank One and Johnson pursuant to the loan agreements, as precedent recognized that "banks do not generally have fiduciary relationships with their debtors." The court affirmed the district court.

## I. Miscellaneous

### *Georgia Higher Education Assistance Corp. v. Crow (In re Crow)*, 394 F.3d 918 (11<sup>th</sup> Cir. 2004)

In this case, the Eleventh Circuit affirmed in part and reversed in part the bankruptcy court's denial of a motion to dismiss filed by the government entities, which claimed that the debtors' adversary proceeding was barred by Eleventh Amendment immunity.

The court affirmed the denial of the government's motion to dismiss as to the count seeking to discharge student loans, as the Supreme Court, in *Tennessee Student Assistance Corporation v. Hood*, 124 S. Ct. 1905 (2004), had already decided that the bankruptcy rule requiring a debtor to file an adversary proceeding against a state agency to discharge student loan debt did not implicate the Eleventh Amendment because the bankruptcy court's jurisdiction is derived from the jurisdiction over the debtor's property and does not infringe state sovereignty.

The court vacated the bankruptcy court's denial of the motion to dismiss on the second count, which sought damages for the government agencies' attempts to collect from the Debtors after receiving notice of the Chapter 7 filing. The court stated that count two sought affirmative relief from the state through judicial process, and therefore jurisdiction was *in personam*. This meant that *Hood* did not apply. The court stated that it was joining the Seventh, Ninth, Third,

Fifth and Fourth Circuits which held that Congress's attempts under 11 U.S.C. § 106(a) to abrogate Eleventh Amendment immunity in bankruptcy proceedings were invalid in light of the Supreme Court's decision in *Seminole Tribe of Florida v. Florida*, 517 U.S. 44, 116 S. Ct. 1114 (1996). *Seminole Tribe* held that Congress cannot abrogate state sovereign immunity by legislation passed pursuant to its Article I powers, which the court here concluded Congress used to adopt § 106(a). The court also held that neither § 5, nor § 4 of the Fourteenth Amendment were routes under which Congress did, or could validly, abrogate state sovereign immunity for bankruptcy matters.

**United States v. Collins, 97 Fed. Appx. 629 (6<sup>th</sup> Cir. 2004) (Unpublished)**

Here, the Debtor appealed a conviction of bankruptcy fraud. The conviction came after the Debtor filed for bankruptcy protection in 1996. Her petition did not list her one-half interest in a house or the mortgage on the property. The Debtor also testified that she did not own any property. After that testimony, but before the discharge, she retained counsel to sell the property and her counsel sent letters to her brother, the other one-half owner, negotiating the terms of the sale. The property was sold and the proceeds distributed between the Debtor and her brother.

The Debtor was indicted under 18 U.S.C. § 152 for knowingly and fraudulently concealing a property interest from the Trustee. At trial, the Debtor stated that she did not know she was the real owner of the property, but rather thought she was holding it with her brother until her mother returned from prison. She also claimed that she gave her brother a quitclaim deed to give the property back to their parents, but she later discovered that her brother had never signed or recorded it. The Debtor's brother refuted these allegations. A jury found the Debtor guilty under an instruction of deliberate ignorance.

The Debtor argued on appeal that the introduction of letters from her attorneys to her brother was improper because the attorneys were not subject to cross-examination and because they were not properly authenticated. The court held that the letters were admissible non-hearsay because they were admissions of a party opponent as a statement by a party's agent or as a statement by a person authorized to make a statement concerning the subject, and that the letters were properly authenticated by the person who received them, the Debtor's brother.

The Debtor also argued that the jury instruction for "deliberate ignorance" violated her right to a fair trial because, she claimed, the evidence did not support the instruction. The court disagreed, holding that there was ample evidence for the instruction. The Debtor's conviction was thus affirmed.

**Wachovia Bank, National Association v. Schmidt, 388 F.3d 414 (4th Cir. 2004)**

Here, the Fourth Circuit held that, for federal diversity jurisdiction purposes, a national bank is located where it operates its branch offices.

Wachovia Bank is a national banking association with its principal place of business in Charlotte, North Carolina. Wachovia operates branch offices in a number of states, including

South Carolina. David Schmidt is a citizen of South Carolina, and on April 10, 2003, he and other plaintiffs filed a complaint in South Carolina state court naming Wachovia and others as defendants. The complaint alleged that the defendants fraudulently induced the plaintiffs to engage in a risky tax-motivated investment scheme. Wachovia filed a petition in the United States District Court in South Carolina seeking an order compelling arbitration and a motion to compel arbitration of the state claims, naming Schmidt and related business entities as defendants. The sole basis of jurisdiction for Wachovia's petition was diversity jurisdiction. The district court denied Wachovia's petition and it appealed. For the first time, Schmidt then argued that diversity was lacking because Wachovia is "located" in South Carolina within the meaning of 28 U.S.C. § 1348 (national banking associations are deemed citizens of the states in which they are respectively "located").

The court looked to three traditional tools of statutory interpretation in reaching its conclusion that Wachovia was "located" in South Carolina. First, in construing the plain meaning of the statute the court found that the "located" referred to "physical presence in a place" and that a national banking association becomes physically present in a state when it "operates branch offices in that state and conducts business there." Thus, under the plain meaning of the statute, a national banking association is "located" wherever it operates branch offices.

Second, to give independent meaning to the terms used to refer to the presence of a banking association in §1348, the Court found that where a national bank is "established" refers to a bank's charter location and that a bank is "located" where it has a physical presence. In so holding, the Fourth Circuit found controlling the Supreme Court's decision in *Citizens and Southern National Bank v. Bouslog*, 434 U.S. 35 (1977), which interpreted "located" in the former venue statute to include branch offices. *Bouslog* found that different statutory terms in the same section should be given different meanings. Thus, the Fourth Circuit rejected the Seventh Circuit's interpretation that "established" referred to a bank's charter location while "located" referred to a bank's principal place of business because, as a practical matter, this interpretation failed to give independent meanings to the terms "established" and "located."

Third, the Fourth Circuit concluded that venue and jurisdiction statutes should be treated as *in pari material*, so that the Supreme Court's construction of a term in one statute must control the meaning of the identical term in the other.

**United States v. Abel Cosmo Galetti, 541 U.S. 114 (2004)**

The Court held that the United States was authorized to collect a partnership's unpaid federal employment taxes from individuals who had been general partners where the taxes had been timely assessed against the partnership. If a tax is properly assessed within three years the statute of limitations for collection of that tax is extended by 10 years from the date of the assessment. The issue presented was whether the United States must assess the taxes not only against the partnership but also against each individual partner to avail itself of the extended statute of limitations. Generally, a partnership has a separate identity from its partners and the partners are only secondarily liable for tax debts of the partnership. The Debtors claimed that the

timely assessment of the partnership could only extend the statute of limitations against the partnership. Therefore, the debtors claimed that the IRS could no longer collect the debt from them. The government claimed that as the Debtors conceded that they were liable for the partnership's debt, the government had a right to payment. The Court held that the tax code contained no requirement that the government make separate assessments of a single tax against persons or entities secondarily liable therefore. The Court stated that it is the tax, not the taxpayer, which is assessed. The statute of limitations attaches to the debt as a whole.

**White v. Kentuckiana Livestock Market, 397 F.3d 420 (6th Cir. 2005)**

Here, the Debtors sued their former employer for relief under 11 U.S.C. § 525(b) (which prohibits private employers from discharging employees solely because they have invoked bankruptcy protection). The Sixth Circuit affirmed the bankruptcy court's dismissal of the adversary proceeding because the evidence supported the bankruptcy court's finding that the Debtors had not been fired by their mutual employer "solely because" of their Chapter 7 filing.

On March 16, 2001, the Debtors filed for protection under Chapter 7. Their employment was terminated three days after the filing was reported in a local newspaper. The Debtors commenced an adversary proceeding against the employer in the bankruptcy case. Their case was principally supported by testimony concerning the employer's statements that the bankruptcy and failure to pay investors in a prior business deal were factors in the firing, including a sworn statement to the Kentucky unemployment insurance authorities that the Debtors were fired because they filed for bankruptcy protection and this reflected poorly on the business. The employer defended by contending that there were additional reasons to terminate the Debtors' employment. These included Mr. White's offer to help his bosses cheat on their income taxes in exchange for a company car, and Mrs. White's sloppy bookkeeping. The employer acknowledged that one of the additional reasons that Mrs. White was fired was that she was married to Mr. White and he was being fired. The bankruptcy court dismissed the adversary proceeding.

The Sixth Circuit affirmed. It rejected the Debtors' argument that a termination is prohibited if the bankruptcy filing is a "substantial factor" in the termination (i.e., that bankruptcy discrimination should be analyzed like that based on race, sex or age). The court held that the language "solely because" is unambiguous and acknowledged the likelihood that this would make bankruptcy discrimination more difficult to prove than discrimination based upon the factors referred to above.

**In Re Calumet Farm, Inc., First National Bank & Trust v. Brant, 2005 U.S. App. LEXIS 2767 (6<sup>th</sup> Cir. 2005)**

This case deals with liability for return of mistaken wire transfers. Here, the former Calumet Farm authorized its bank to transfer \$77,301 to White Birch Farm to pay interest on the Debtor's \$1 million debt to White Birch for the purchase of a one-half interest in the Stallion Mogambo. The bank mistakenly wired \$770,301 to White Birch's account at CitiBank. White Birch refused to return the overpayment and Calumet eventually entered Chapter 11. The Debtor

and the bank reached a partial settlement with each other under which the Debtor assigned to the bank any right to recovery that it had against White Birch.

After various interim appeals, the bankruptcy court granted summary judgment for White Birch, after finding that there was not sufficient evidence to support a finding that White Birch had notice of the transfer error before the funds were credited to its account at CitiBank, and White Birch thus satisfied the required element of its “discharge for value” defense to the bank’s restitution claim. The district court affirmed, but the Sixth Circuit reversed.

The court reviewed Uniform Commercial Code and Federal Reserve Regulation provisions and noted that a bank is entitled to recover from the beneficiary of an erroneous transfer the excess payment received to the extent allowed by law governing mistake and restitution. The Court noted that this provision authorizes the bank to seek restitution from the beneficiary if the bank committed an error in executing the payment order, and that this concept incorporates the “discharge for value” defense.

“A creditor of another or one having a lien on property who has received from a third person any benefit in discharge of the debt or lien is under no duty to make restitution therefore, although the discharge was given by mistake of the transferor as to his interests or duties, if the transferee made no misrepresentation and did not have notice of the transferor’s mistake.”

Thus, a key issue here was the timing of the notice of the mistake in a wire transfer context. The court noted that prior decisions had erroneously focused on when White Birch received the funds, rather than on when it credited Calumet’s account, which the court criticized as eviscerating the concept of “discharge” from the “discharge for value” defense. The court noted that, while there was some dispute about when White Birch received notice of the error, there was no dispute that it had notice of the error before it credited Calumet’s account. The court noted that White Birch’s behavior also established that it was aware of the error as soon as it learned of the wire transfer because it immediately transferred the overage into a third account so that “everything could be sorted out.” The court concluded that White Birch had prior notice of the mistake for purposes of the discharge for value rule and could not use that defense.

### **III. BANKRUPTCY LEGISLATION UPDATE**

- The U.S. Senate passed S.B. 256, the “Bankruptcy Abuse Prevention and Consumer Protection Act of 2005” on March 10, 2005. As of this date, passage by the House of Representatives is expected.
- A copy of the CRS Report for Congress is attached.

# CRS Report for Congress

Received through the CRS Web

## **The “Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,” S. 256, in the 109<sup>th</sup> Congress**

**February 9, 2005**

Robin Jeweler  
Legislative Attorney  
American Law Division

# The “Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,” S. 256, in the 109<sup>th</sup> Congress

## Summary

On February 1, 2005, Senator Grassley introduced S. 256, the “Bankruptcy Abuse Prevention and Consumer Protection Act of 2005” (BAPCA), in the 109<sup>th</sup> Congress, 1<sup>st</sup> Session. The bill is similar to that passed by the House in the 108<sup>th</sup> Congress. S. 256 addresses many areas of bankruptcy practice, including consumer filings, small business bankruptcy, tax bankruptcy, ancillary and cross-border cases, financial contract provisions, amendments to chapter 12 governing family farmer reorganization, and health care and employee benefits. This report surveys selected provisions that have been of interest to past Congresses that have considered comparable legislation.

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# The “Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,” S. 256, in the 109<sup>th</sup> Congress

**Introduction.** On February 1, 2005, Senator Grassley introduced S. 256, the “Bankruptcy Abuse Prevention and Consumer Protection Act of 2005” (BAPCA), in the 109<sup>th</sup> Congress, 1<sup>st</sup> Session.<sup>1</sup> The bill is similar to that passed by the House in the 108<sup>th</sup> Congress.<sup>2</sup> Like the House-passed bill from the 108<sup>th</sup> Congress, S. 256 omits the provision making nondischargeable liability for violation of protective orders and violent protests against providers of “lawful services,” including reproductive health services.

The U.S. Bankruptcy Code, 11 U.S.C. § 101 *et seq.*, is divided into eight chapters — chapters 1, 3, 5, 7, 9, 11, 12, and 13. Chapters 1, 3, and 5 govern general procedures involving management and administration of the bankruptcy estate which are applicable, as specified, to the operative chapters. Chapters 7 through 13, the operative chapters, address the different forms of bankruptcy relief. Chapter 7 governs liquidation; chapter 11 governs business reorganization; chapter 12, family farmer reorganization; and, chapter 13, consumer reorganization.

Also codified under Title 11 of the United States Code are the Rules of Bankruptcy Court and officially authorized bankruptcy forms.

**Survey of Selected Provisions.** S. 256 addresses many areas of bankruptcy practice, including consumer filings, small business bankruptcy, tax bankruptcy, ancillary and cross-border cases, financial contract provisions, amendments to chapter 12 governing family farmer reorganization, and health care and employee benefits.

The chart below surveys selected provisions that have been of interest to past Congresses that have considered comparable legislation.

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<sup>1</sup> 151 CONG. REC. S768 (daily ed. Feb. 1, 2005).

<sup>2</sup> H.R. 975, 108<sup>th</sup> Cong., 1<sup>st</sup> Sess. 2003. See H.R. Rept. 108-40, 108<sup>th</sup> Cong., 1<sup>st</sup> Sess. (2003).

<b>Selected Provisions</b>	<b>S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 109<sup>th</sup> Congress, 1<sup>st</sup> Session.</b>
<b>Means test, 11 U.S.C. § § 704, 707:</b>	
<i>Implementation</i>	Would amend 11 U.S.C. § 707 to permit creditors, the trustee, or any party in interest to challenge a debtor's eligibility to file under chapter 7. If indicated, the U.S. trustee must file a statement that the debtor's case is a presumed abuse of chapter 7. § 102.
<i>Definition of "current monthly income"</i>	Excludes Social Security benefits; payments to victims of war crimes or crimes against humanity; and payments to victims of international terrorism. § 102.
<i>Presumed abuse</i>	Debtor presumed to be abusing chapter 7 if current monthly income, excluding allowed deductions, secured debt payments, and priority unsecured debt payments, multiplied by 60, would permit a debtor to pay not less than the lesser of (a) 25% of nonpriority unsecured debt or \$6,000 (or \$100 a month), whichever is greater, or (b) \$10,000.  In addition to the means test, the court may find that the debtor's filing was in bad faith or that the totality of the circumstances demonstrates abuse. § 102.

Selected Provisions	S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 109 <sup>th</sup> Congress, 1 <sup>st</sup> Session.
<p><i>Calculation of permissible monthly living expenses</i></p>	<p>Expenses to be calculated as specified under the National Standards and Local Standards, and the debtor's actual monthly expenses for the categories specified as Other Necessary Expenses issued by the Internal Revenue Service for the area in which the debtor resides. A debtor may also subtract, if reasonably necessary, an allowance of up to 5% of the IRS food and clothing categories.</p> <p>Individualized expenses may include debts incurred to protect the debtor's family from domestic violence; actual expenses for the care and support of nondependent, elderly, ill or disabled household or family members; private or public school tuition of up to \$1,500 per year; administrative expenses for chapter 13 candidates; average monthly expenses for secured and priority debts; actual expenses for housing and utilities, if reasonably necessary; and, charitable contributions of up to 15% of gross income.<sup>3</sup></p> <p>Dollar amounts will be adjusted at three-year intervals in accordance with the Consumer Price Index. § 102.</p>
<p><i>To rebut the presumption of abuse</i></p>	<p>A debtor must demonstrate and justify "special circumstances" in order to adjust current monthly income determination. § 102.</p>

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<sup>3</sup> Charitable contributions are permissible under current law, 11 U.S.C. § 707(b), and would not be altered by the bill.

Selected Provisions	S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 109 <sup>th</sup> Congress, 1 <sup>st</sup> Session.
<i>Safe harbor exemption from the means test</i>	<p>Only the judge, U.S. trustee or bankruptcy administrator may bring a substantial abuse motion if the debtor's current monthly income is less than the highest national or the applicable State median family income.</p> <p>No party may make a motion to convert the debtor to chapter 13 if the debtor (and spouse combined) have a monthly income equal to or less than the state median household income reported by the Bureau of the Census.</p> <p>The U.S. trustee may also decline to file a motion to convert if the debtor's monthly income is between 100% and 150% of the national or applicable State median income, and would permit a debtor to pay the lesser of (a) 25% of nonpriority unsecured debt or \$6,000, whichever is greater, or (b) \$10,000. § 102.</p>
<i>IRS Living Standards applicable to chapter 13 reorganization plan</i>	<p>A chapter 13 debtor's "disposable income" which may be directed to the repayment plan will be calculated in accordance with IRS Living Standards if the debtor meets the applicable means test for state median family income.</p> <p>A chapter 13 debtor may deduct from plan payments the costs of health insurance; domestic support obligations; charitable contributions of up to 15% of gross income; and expenses necessary to operate a business. § 102.</p>

<b>Selected Provisions</b>	<b>S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 109<sup>th</sup> Congress, 1<sup>st</sup> Session.</b>
<i>Attorney sanctions for improper motion</i>	<p>If a panel trustee brings a successful motion for dismissal or conversion, counsel for the debtor may be liable to reimburse the trustee for costs, attorneys' fees, and payment of a civil penalty if the court finds a violation of Bankruptcy Rule 9011.</p> <p>An attorney's signature on the bankruptcy petition certifies that the attorney has performed an investigation into the circumstances that gave rise to the petition; that the attorney has determined that the petition is well grounded in fact and is warranted by existing law; and that the attorney has no knowledge after an inquiry that the information in accompanying schedules is incorrect. § 102.</p>
<i>Creditor sanctions for an improper motion</i>	<p>The court may award the debtor costs for contesting an unsuccessful motion to convert if the court finds that the motion violated Rule 9011, or was intended to coerce the debtor into waiving rights under the Bankruptcy Code. A small business creditor whose claim is less than \$1000 is not liable for sanctions. § 102.</p>
<i>Dismissal of filings by persons convicted of violent crimes or drug trafficking</i>	<p>A crime victim or party in interest may request dismissal of the voluntary bankruptcy case of the convicted debtor. The court must grant the dismissal unless the filing is necessary to satisfy a domestic support obligation. § 102.</p>
<b>Selected consumer provisions</b>	
<i>Mandatory credit counseling</i>	<p>Debtor must undergo credit counseling within 180 days of filing, and may not obtain a discharge until completion of a personal financial management instructional course.</p> <p>The jurisdictional filing requirement may be waived for 30 to 45 days if the debtor certifies exigent circumstances or was denied service from an approved counseling agency.</p> <p>The U.S. trustee or bankruptcy administrator for the judicial district is directed to oversee and approve nonprofit budget and credit counseling agencies. § 106.</p>

<b>Selected Provisions</b>	<b>S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 109<sup>th</sup> Congress, 1<sup>st</sup> Session.</b>
<i>Promotion of alternative dispute resolution</i>	A creditor's allowable claim may be reduced by 20% if a court finds that the creditor "unreasonably refused to negotiate a reasonable alternative repayment schedule proposed by an approved credit counseling agency that provides repayment of at least 60% of the debt, and the debtor can prove by "clear and convincing" evidence that a creditor unreasonably refused to consider the offer." § 201.
<i>Reaffirmation agreements</i>	Imposes enhanced requirements for approval of a reaffirmation agreement when the debtor is not represented by counsel but exempts credit unions from creditor disclosure requirements; requires U.S. Attorney and FBI to investigate abusive reaffirmation practices. § 203.
<i>Preserving defenses against predatory lenders</i>	Amends 11 U.S.C. § 363 to add a new subsection preserving defenses that a party to a consumer credit transaction may have if the contract is sold by a debtor in bankruptcy. § 204.
<i>GAO reaffirmation study</i>	Requires a study of reaffirmation practices and a report to Congress. § 205.
<i>Domestic support owed to individuals and government units made first priority</i>	<p>Would move domestic support obligations to first priority, which is currently allocated to administrative expenses of the bankruptcy estate. Administrative expenses would become second priority.</p> <p>However, if a trustee is appointed under chapter 7, 11, 12, or 13, the trustee's expenses may be paid before domestic support. § 212.</p>
<i>Trustee notification of child support claim holders</i>	Would direct the trustee to notify a priority child support recipient of the existence of a state child support enforcement agency, and, upon discharge, the existence of nondischargeable and reaffirmed debt. § 219.
<i>Priority assigned to claims for liability incurred by the debtor DUI</i>	A new § 507 tenth priority is created for unsecured claims for liability incurred by a debtor from operating a vessel while under the influence of alcohol or drugs. Claims of this nature are also nondischargeable. § 223.

<b>Selected Provisions</b>	<b>S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 109<sup>th</sup> Congress, 1<sup>st</sup> Session.</b>
<i>Retirement savings exemption broadened</i>	Would clarify and expand the law to provide that retirement accounts that are tax exempt under the Internal Revenue Code are exempted from the debtor's estate up to a \$1,000,000 cap, which may be increased if "the interests of justice so require." § 224.
<i>Exemption for saving for postsecondary education</i>	Subject to certain IRS requirements, excludes funds up to \$5000 per specified beneficiary made within a year of filing in an education individual retirement account and/or any funds used to purchase a tuition credit or certificate under a qualified state tuition program. §225.
<i>Protection of nonpublic personal information and consumer privacy ombudsman</i>	Prohibits the transfer by the debtor of personal customer information unless approved by the court. Provides for the appointment of a consumer privacy ombudsman if a debtor wishes to sell or lease such information. §§ 231,232.
<i>Prohibition on disclosure of identify of minor children</i>	Debtor may not be required to disclose the name of a minor child in public records. U.S. trustee or auditor may have access to nonpublic records maintained by the court. § 233.
<i>Lien stripping on security interests in consumer goods (cramdown)</i>	Chapter 13 debtors would not be permitted to bifurcate security interests in an automobile purchased within 910 days (2½ years) before the filing; or in other consumer goods purchased within 1 year of the filing. § 306.

Selected Provisions	S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 109 <sup>th</sup> Congress, 1 <sup>st</sup> Session.
<i>Homestead exemption</i>	<p>Definition of “debtor’s residence” includes mobile homes or trailers. § 306.</p> <p>Imposes lengthened residency requirements to qualify for state exemption. § 307.</p> <p>Reduces the value of the exemption if the value is attributable to property that the debtor disposed of within 10 years of bankruptcy with the intent to hinder, delay or defraud a creditor. § 308.</p> <p>Debtors’ electing a state homestead exemption may not exempt any interest acquired within 1215 days (3.3 years) of filing which exceeds in the aggregate \$125,000, unless the value in excess of that amount occurs from a transfer of residences within the same state. Exempts family farmers from the limit. Limitations may not apply to amounts reasonably necessary to support the debtor and any dependents.</p> <p>Imposes a firm \$125,000 cap on an individual who is convicted of specified felonies (including violations of federal securities laws) or who commits criminal acts, intentional torts, or willful or reckless misconduct that caused serious physical injury or death within 5 years preceding the bankruptcy filing. § 322.</p>
<i>Residential lease excepted from the automatic stay</i>	<p>Adds new provisions permitting a landlord/lessor to bypass the automatic stay to continue with a residential eviction of a tenant/lessee. § 311.</p>
<i>Restrictions on chapter 7 and chapter 13 filings.</i>	<p>Extends time within which a debtor who has received a chapter 7 discharge may not receive another from 6 to 8 years.</p> <p>Amends chapter 13 to disallow discharge if the debtor filed under chapters 7, 11, or 12 within 4 years prior to the 13 filing, or under chapter 13, within 2 years of the subsequent filing. § 312.</p>



<b>Selected Provisions</b>	<b>S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 109<sup>th</sup> Congress, 1<sup>st</sup> Session.</b>
<i>Definition of "household goods"</i>	Defines household goods to include clothing, furniture, appliances, 1 radio, 1 television, 1 VCR, other electronic entertainment equipment with a market value of under \$500, linens, china, crockery, kitchenware, educational materials used by minor dependent children, medical equipment and supplies, furniture used exclusively by minors and disabled or elderly dependents, personal effects, 1 personal computer and antiques and jewelry with a value less than \$500. § 313.
<i>Debtor's duty to disclose tax filings.</i>	Modifies debtor filing requirements under 11 U.S.C. § 521 to include federal tax returns. § 315.
<i>Plan duration</i>	Chapter 13 plans to have 5 year duration for families whose monthly income is not less than the highest state median family income. Families below the highest state median income would have 3 year plans. § 318.
<i>Wages withheld by an employer for contributions to employee benefit plans</i>	Withheld wages for contributions to employee benefit plans would be excluded from the debtor (employer's) estate. § 323.
<i>Valuation of collateral</i>	A secured creditor's allowable claim would be the retail cost to replace the item without deduction for costs of sale or marketing. Personal property's replacement value would be the price a retail merchant would charge for like items. § 327.
<i>Wages and benefits awarded as back pay</i>	Makes specified prepetition and postpetition wages and benefits awarded as back pay in a judicial proceeding a high-priority administrative expense. § 329.
<i>Audits</i>	The Attorney General is directed to establish a procedure to ensure random audits of no less than 1 out of every 250 individual filings; the U.S. trustee is authorized to enter into contracts with auditors, and to take action when misstatements in the debtor's petition and schedules are identified. § 603.

<b>Selected Provisions</b>	<b>S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 109<sup>th</sup> Congress, 1<sup>st</sup> Session.</b>
<b>Nondischargeable consumer debts</b>	
<i>Debts to government units for domestic support</i>	Defines “domestic support obligation” to include debts owed to or recoverable by a governmental unit. §§ 211, 215.
<i>Expanded definition of student loan</i>	Adds qualified educational loans as defined under § 221 of the IRC to those educational loans that are currently nondischargeable. § 220.
<i>Loan repayments to debtor’s retirement savings or thrift plan</i>	Makes nondischargeable, i.e., allows an employer to continue to withhold, loan repayments to debtor’s savings/retirement plan from debtor’s wages. § 224(c).
<i>Consumer debts presumed fraudulent</i>	Consumer debts owed to a single creditor for more than \$550 for “luxury goods” incurred within 90 days of filing; and cash advances for more than \$750 under an open end credit plan within 70 days of filing are presumed to be nondischargeable. § 310.
<i>Debts incurred to pay nondischargeable debts are nondischargeable</i>	Debts incurred to a third party to pay a tax to a state or local government unit become nondischargeable. § 314.
<i>Expanded definition of nondischargeable condominium and homeowners association fees</i>	Expands the types of post-petition condo and homeowners association fees that are nondischargeable by omitting requirement that in order to be nondischargeable the debtor must reside in the residence postpetition. § 412.
<i>FEC penalties nondischargeable</i>	Fines and penalties under federal election law are made nondischargeable. § 1235.

<b>Selected Provisions</b>	<b>S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 109<sup>th</sup> Congress, 1<sup>st</sup> Session.</b>
<b>Consumer credit disclosure</b>	
<i>Amendments to the Truth in Lending Act (TILA)</i>	TILA amended to require enhanced minimum payment disclosures under an open end credit plan; enhanced disclosures regarding the tax deductibility of credit extensions which exceed the fair market value of a dwelling for credit transactions secured by the consumer's dwelling; disclosures related to introductory "teaser" rates; disclosures related to Internet-based open end credit solicitations; and disclosures related to late payment deadlines and penalties. TILA would be amended to prohibit termination of a credit account because the consumer has not incurred finance charges. §§ 1301-1306.
<i>Study of bankruptcy impact of credit extended to dependent students</i>	The Board of Governors of the Federal Reserve is directed to study bankruptcy impact of credit extensions to students in postsecondary school. § 1308.
<i>Consumer credit studies</i>	The Board of Governors of the Federal Reserve is directed to study existing protections for consumers for unauthorized use of a dual use debit card. § 1307.
<b>Business bankruptcy</b>	
<i>Increased employee wage and benefit priority</i>	Increases the high-priority categories for employee wages and benefits from \$4925 earned within 90 days of filing to \$10,000 earned within 180 days of filing. § 1401.
<i>Trustee to appoint retiree committees</i>	Amends 11 U.S.C. § 1114 to provide that in the event that a retiree committee is appointed, the appointment of members will be made by the U.S. Trustee, not the court. § 447.
<i>Retiree insurance benefits</i>	Amends 11 U.S.C. § 1114 to allow the court to reinstate retiree benefits that are modified by a debtor within 180 days <i>prior</i> to the bankruptcy filing unless the court finds that the balance of equities supports such modifications. § 1404.
<i>Avoidable preferences</i>	Amends 11 U.S.C. § 547 to liberalize the rules for defending against an avoidable transfer in the ordinary course of business; creates a new preference exception to aggregate transfers of less than \$5,000. § 409.

<b>Selected Provisions</b>	<b>S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 109<sup>th</sup> Congress, 1<sup>st</sup> Session.</b>
<i>Fraudulent transfers</i>	Amends 11 U.S.C. § 548 to increase the time period for setting aside certain fraudulent transactions from one year to two and expressly includes certain transfers made pursuant to an employment contract. § 1402.
<i>Small business bankruptcy</i>	<p>Subtitle B of Title IV has provisions defining a “small business” for chapter 11 purposes as one with debts under \$2,000,000. The debtor’s period of exclusivity to file a reorganization plan is 180 days. A plan and disclosure statement must be filed within 300 days of the initial filing.</p> <p>A plan must be confirmed within 45 days of filing in bankruptcy. § 438.</p> <p>Provisions require establishment of uniform accounting and reporting standards for small businesses. Grounds for appointment of a trustee and the trustee’s general supervisory duties are expanded, as are grounds for dismissal or conversion of the case. §§ 431-442.</p>
<i>Health care business bankruptcy</i>	<p>Defines a broad variety of service-providing health care business, including skilled nursing facilities, assisted-living facilities and homes for the aged.</p> <p>Provides for the disposition and disposal of patient records and for the costs of closing the facility, including the transfer of patients. Permits the court to appoint a patient care ombudsman to monitor patient care and represent the interest of patients. Excludes participation in medicare from the automatic stay. §§ 1101- 1106.</p>
<i>Trustee to appoint retiree committees</i>	Amends 11 U.S.C. § 1114 to provide that in the event that a retiree committee is appointed, the appointment of members will be made by the U.S. Trustee, not the court. § 447.

Selected Provisions	S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 109 <sup>th</sup> Congress, 1 <sup>st</sup> Session.
<i>Chapter 11 corporate nondischargeability</i>	Confirmation of a plan under chapter 11 would not discharge a corporate debtor from debts under 11 U.S.C. § 523(a)(2) that are owed to a domestic governmental unit for property obtained by false pretenses or representations; or owed to an individual under subchapter III of chapter 37 of Title 31, U.S.C.; or any debt for taxes for which the debtor willfully attempted to evade or made a fraudulent return. § 708.
<i>Title X dealing with chapter 12 family farmers</i>	<p>Makes chapter 12 permanent. Measure to be effective upon enactment; includes jurisdictional debt limit in amount subject to readjustment in accordance with CPI; subordinates certain high priority unsecured claims owed to the government to nonpriority claims. Measure to take effect upon enactment, but will not apply to pending cases. §§ 1001-1003.</p> <p>Raises jurisdictional debt limit of family farmers to \$3,237,000 and lowers percentage requirement of income derived from farming and expands the time frame for measuring farm income from one to three years. §§ 1004, 1005.</p> <p>Prohibits retroactive assessment of disposable income. § 1006</p> <p>Amends chapter 12 to include “family fishermen.” § 1007.</p>

<b>Selected Provisions</b>	<b>S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 109<sup>th</sup> Congress, 1<sup>st</sup> Session.</b>
<b>General provisions</b>	
<i>In forma pauperis filings</i>	Directs the Judicial Conference to prescribe procedures for waiving bankruptcy fees for an individual debtor under chapter 7 whose income is less than 150% of the official poverty line and who is unable to pay the fee in installments. § 418.
<i>Bankruptcy judgeships</i>	Creates new temporary bankruptcy judgeships for designated districts. § 1223.
<i>Procedure to certify appeals from a bankruptcy court to a court of appeals</i>	Establishes procedures to permit direct appeals from a bankruptcy court to a court of appeals if the decision involves a substantial question of law for which there is no controlling decision; a question requiring resolution of conflicting decisions; or, a matter of public importance. §1233.
<i>Involuntary Bankruptcy</i>	Makes technical corrections made to 11 U.S.C. § 303 dealing with involuntary bankruptcy. Measure applies upon enactment, but not to pending cases. § 1234.
<i>General effective date</i>	Subject to express provisions otherwise in specified titles, the new law will take effect 180 days after enactment and will not apply to cases commenced before the effective date. § 1501.



**UPDATE FROM THE CHICAGO REGIONAL  
OFFICE OF THE FDIC**

*Timothy E. Divis  
Regional Counsel  
Federal Deposit Insurance Corporation  
Chicago, Illinois*

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**SECTION E**





**UPDATE FROM THE CHICAGO REGIONAL OFFICE OF THE FDIC**

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## 2000 - FDIC RULES AND REGULATIONS

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{{2-29-96 p.2965}}

### PART 353—SUSPICIOUS ACTIVITY REPORTS

#### Sec.

[353.1 Purpose and scope.](#)

[353.2 Definitions.](#)

[353.3 Reports and records.](#)

**AUTHORITY:** 12 U.S.C. 1818, 1819; 31 U.S.C. 5318.

**SOURCE:** The provisions of Part 353 appear at 61 Fed. Reg. 6099, February 16, 1996, effective April 1, 1996, except as otherwise noted.

#### § 353.1 Purpose and scope.

The purpose of this part is to ensure that an insured state nonmember bank files a Suspicious Activity Report when it detects a known or suspected criminal violation of federal law or a suspicious transaction related to a money laundering activity or a violation of the Bank Secrecy Act. This part applies to all insured state nonmember banks as well as any insured, state-licensed branches of foreign banks.

[Codified to 12 C.F.R. § 353.1]

#### § 353.2 Definitions.

For the purposes of this part:

- (a) *FinCEN* means the Financial Crimes Enforcement Network of the Department of the Treasury.
- (b) *Institution-affiliated party* means any institution-affiliated party as that term is defined in sections 3 (u) and 8(b)(5) of the Federal Deposit Insurance Act (12 U.S.C. 1813(u) and 1818(b)(5)).

[Codified to 12 C.F.R. § 353.2]

#### § 353.3 Reports and records.

(a) *Suspicious activity reports required.* A bank shall file a suspicious activity report with the appropriate federal law enforcement agencies and the Department of the Treasury, in accordance with the form's instructions, by sending a completed suspicious activity report to FinCEN in the following circumstances:

- (1) *Insider abuse involving any amount.* Whenever the bank detects any known or suspected

federal criminal violation, or pattern of criminal violations, committed or attempted against the bank or involving a transaction or transactions conducted through the bank, where the bank believes it was either an actual or potential victim of a criminal violation or series of criminal violations, or that the bank was used to facilitate a criminal transaction, and the bank has a substantial basis for identifying one of the bank's directors, officers, employees, agents, or other institution-affiliated parties as having committed or aided in the commission of the criminal violation, regardless of the amount involved in the violation;

(2) *Transactions aggregating \$5,000 or more where a suspect can be identified.* Whenever the bank detects any known or suspected federal criminal violation, or pattern of criminal violations, committed or attempted against the bank or involving a transaction or transactions conducted through the bank, and involving or aggregating \$5,000 or more in funds or other assets, where the bank believes it was either an actual or potential victim of a criminal violation, or series of criminal violations, or that the bank was used to facilitate a criminal transaction, and the bank has a substantial basis for identifying a possible suspect or group of suspects. If it is determined prior to filing this report that the identified suspect or group of suspects has used an "alias", then information regarding the true identity of the suspect or group of suspects, as well as alias identifiers, such as driver's license or social security numbers, addresses and telephone numbers, must be reported; {{2-29-96 p.2966}}

(3) *Transactions aggregating \$25,000 or more regardless of potential suspects.* Whenever the bank detects any known or suspected federal criminal violation or pattern of criminal violations, committed or attempted against the bank or involving a transaction or transactions conducted through the bank, involving or aggregating \$25,000 or more in funds or other assets, where the bank believes it was either an actual or potential victim of a criminal violation, or series of criminal violations, or that the bank was used to facilitate a criminal transaction, even though the bank has no substantial basis for identifying a possible suspect or group of suspects; or

(4) *Transactions aggregating \$5,000 or more that involve potential money laundering or violations of the Bank Secrecy Act.* Any transaction (which for purposes of this paragraph (a)(4) means a deposit, withdrawal, transfer between accounts, exchange of currency, loan, extension of credit, purchase or sale of any stock, bond, certificate of deposit, or other monetary instrument or investment security, or any other payment, transfer, or delivery by, through, or to a financial institution, by whatever means effected) conducted or attempted by, at or through the bank and involving or aggregating \$5,000 or more in funds or other assets, if the bank knows, suspects, or has reason to suspect that:

(i) The transaction involves funds derived from illegal activities or is intended or conducted in order to hide or disguise funds or assets derived from illegal activities (including, without limitation, the ownership, nature, source, location, or control of such funds or assets) as part of a plan to violate or evade any federal law or regulation or to avoid any transaction reporting requirement under federal law;

(ii) The transaction is designed to evade any regulations promulgated under the Bank Secrecy Act; or

(iii) The transaction has no business or apparent lawful purpose or is not the sort of transaction in which the particular customer would normally be expected to engage, and the bank knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

(b) *Time for reporting.* (1) A bank shall file the suspicious activity report no later than 30 calendar days after the date of initial detection of facts that may constitute a basis for filing a suspicious activity report. If no suspect was identified on the date of detection of the incident requiring the filing, a bank may delay filing a suspicious activity report for an additional 30 calendar days to identify a suspect. In no case shall reporting be delayed more than 60 calendar days after the date of initial detection of a reportable transaction.

(2) In situations involving violations requiring immediate attention, such as when a reportable violation is ongoing, the bank shall immediately notify, by telephone, an appropriate law enforcement authority and the appropriate FDIC regional office (Division of Supervision) in addition to filing a timely report.

(c) *Reports to state and local authorities.* A bank is encouraged to file a copy of the suspicious activity report with state and local law enforcement agencies where appropriate.

(d) *Exemptions.* (1) A bank need not file a suspicious activity report for a robbery or burglary committed or attempted, that is reported to appropriate law enforcement authorities.

(2) A bank need not file a suspicious activity report for lost, missing, counterfeit, or stolen securities if it files a report pursuant to the reporting requirements of 17 CFR 240.17f-1.

(e) *Retention of records.* A bank shall maintain a copy of any suspicious activity report filed and the original or business record equivalent of any supporting documentation for a period of five years from the date of filing the suspicious activity report. Supporting documentation shall be identified and maintained by the bank as such, and shall be deemed to have been filed with the suspicious activity report. A bank must make all supporting documentation available to appropriate law enforcement authorities upon request.

(f) *Notification to board of directors.* The management of a bank shall promptly notify its board of directors, or a committee thereof, of any report filed pursuant to this section.

{{2-29-96 p.2967}}The term "board of directors" includes the managing official of an insured state-licensed branch of a foreign bank for purposes of this part.

(g) *Confidentiality of suspicious activity reports.* Suspicious activity reports are confidential. Any bank subpoenaed or otherwise requested to disclose a suspicious activity report or the information contained in a suspicious activity report shall decline to produce the suspicious activity report or to provide any information that would disclose that a suspicious activity report has been prepared or filed citing this part, applicable law (e.g., 31 U.S.C. 5318(g)), or both, and notify the appropriate FDIC regional office (Division of Supervision).

(h) *Safe Harbor.* The safe harbor provisions of 31 U.S.C. 5318(g), which exempts any bank that makes a disclosure of any possible violation of law or regulation from liability under any law or regulation of the United States, or any constitution, law or regulation of any state or political subdivision, cover all reports of suspected or known criminal violations and suspicious activities to law enforcement and financial institution supervisory authorities, including supporting documentation, regardless of whether such reports are filed pursuant to this part or are filed on a voluntary basis.

[Codified to 12 C.F.R. § 353.3]

[The page following this is 3077.]

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Financial Institution Letters  
FIL-16-2005  
March 15, 2005

## **Deposit Insurance Coverage Video-Overview on Deposit Insurance Coverage for Bank Employees and Customers**

The FDIC has produced a video on CD-ROM for bank employees and bank customers about the FDIC's rules and requirements for deposit insurance coverage. The 27-minute video – *FDIC's Video-Overview on Deposit Insurance Coverage* – provides an overview of how deposit insurance works, focusing on the most common account ownership categories used by individuals and families. The video on CD-ROM was first released on DVD (*FDIC's Video on Deposit Insurance Coverage*) on November 10, 2004.

The Federal Deposit Insurance Corporation (FDIC) has produced a digital video on CD-ROM for bank employees and customers that explains federal deposit insurance coverage. The video was first released on DVD on November 10, 2004 (*FDIC's Video on Deposit Insurance Coverage*). The new CD-ROM version – *FDIC's Video-Overview on Deposit Insurance Coverage* – is also available for viewing through the FDIC's Web site.

The video, which is 27 minutes long, provides an overview of deposit insurance coverage rules and requirements, with specific emphasis on the most common account ownership categories used by individuals and families. The video was designed as an informational and training tool for bank employees. The video can be seen in English or Spanish.

The video is divided into four parts:

- Part I, "Introduction," presents the basics of deposit insurance coverage and is intended to reinforce the viewer's confidence in the stability of the banking system.
- Part II, "Personal Accounts," and Part III, "Business Accounts," are designed to inform and educate viewers on how FDIC deposit insurance coverage works in a variety of situations for the eight different ownership account categories.
- Part IV, "Resources," explains the various ways to contact the FDIC to obtain more information on deposit insurance coverage.

### **Viewing the Video from the FDIC Web Page**

Financial institutions may view *FDIC's Video-Overview on Deposit Insurance Coverage* on the FDIC's Web site. To view the video, go to Videos on Deposit Insurance Coverage at <http://www.fdic.gov/deposit/deposits/video/index.html>. This page identifies the videos available for viewing, as well as system requirements and system test options.

### **Obtaining Copies from the FDIC**

The FDIC will provide insured banks and savings associations with limited copies of the video on CD-ROM at no charge. To place an order for the video on CD-ROM or DVD, complete and submit the order form located on the FDIC's Web site at <http://www2.fdic.gov/depositinsuranceregister/index.asp>. Please allow four to six weeks for delivery.

Using the order form on the FDIC's Web site will ensure the fastest delivery of your order. If your institution does not have access to the Internet, orders may be faxed or mailed to the FDIC:

FAX: FDIC Public Information Center  
202-416-2111  
Or write to: 801 17th Street, N.W., Room 100  
Washington, D.C. 20434



Orders submitted by FAX or mail should be written on your institution's letterhead and include a contact name, a telephone number where the contact may be reached, the title of the video requested, and the number of copies requested.

**Reproduction of the Video**

Financial institutions and consumers may reproduce *FDIC's Video-Overview on Deposit Insurance Coverage* without permission from the FDIC, provided it is reproduced in its entirety.

For more information about the FDIC's new deposit insurance video, please contact the FDIC's Call Center toll-free at 1-877-275-3342.

Michael J. Zamorski  
Director  
Division of Supervision and Consumer Protection

Last Updated 03/14/2005

[communications@fdic.gov](mailto:communications@fdic.gov)

# Proposed Rules

Federal Register

Vol. 70, No. 22

Thursday, February 3, 2005

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

## DEPARTMENT OF THE TREASURY

### Office of the Comptroller of the Currency

#### 12 CFR Chap. I

[Docket No. 05-01]

## FEDERAL RESERVE SYSTEM

#### 12 CFR Chap. II

[Docket No. OP-1220]

## FEDERAL DEPOSIT INSURANCE CORPORATION

#### 12 CFR Chap. III

## DEPARTMENT OF THE TREASURY

### Office of Thrift Supervision

#### 12 CFR Chap. V

[No. 2005-02]

### Request for Burden Reduction Recommendations; Money Laundering, Safety and Soundness, and Securities Rules; Economic Growth and Regulatory Paperwork Reduction Act of 1996 Review

**AGENCIES:** Office of the Comptroller of the Currency (OCC), Treasury; Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and Office of Thrift Supervision (OTS), Treasury.

**ACTION:** Notice of regulatory review; request for comments.

**SUMMARY:** The OCC, Board, FDIC, and OTS ("we" or "the Agencies") are reviewing our regulations to identify outdated, unnecessary, or unduly burdensome regulatory requirements pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). Today, we request your comments and suggestions on ways to reduce burden in rules we have categorized as Money Laundering, Safety and Soundness, and Securities.

All comments are welcome. We specifically invite comment on the following issues: Whether statutory changes are needed; whether the regulations contain requirements that are not needed to serve the purposes of the statutes they implement; the extent to which the regulations may adversely affect competition; whether the cost of compliance associated with reporting, recordkeeping, and disclosure requirements, particularly on small institutions, is justified; whether any regulatory requirements are inconsistent or redundant; and whether any regulations are unclear.

We will analyze the comments received and propose burden-reducing changes to our regulations where appropriate. Some of your suggestions for burden reduction might require legislative changes. Where legislative changes would be required, we will consider your suggestions in recommending appropriate changes to Congress.

**DATES:** Written comments must be received no later than May 4, 2005.

**ADDRESSES:** You may submit comments by any of the following methods:

*EGRPRA Web site:* <http://www.EGRPRA.gov>.

- Comments submitted at the Agencies' joint Web site will automatically be distributed to all the Agencies. Comments received at the EGRPRA Web site and by other means will be posted on the Web site to the extent possible.

*Individual agency addresses:* You are also welcome to submit comments to the Agencies at the following contact points (due to delays in paper mail delivery in the Washington area, commenters may prefer to submit their comments by alternative means):

*OCC:* You may submit comments, identified by [docket 05-01], by any of the following methods:

- *E-mail:* [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov). Include [docket 05-01] in the subject line of the message.

- *Fax:* (202) 874-4448.
- *Mail:* Public Information Room, Office of the Comptroller of the Currency, 250 E Street, SW., Mailstop 1-5, Washington, DC 20219; Attention: Docket ##.

*Public Inspection:* You may inspect and photocopy comments at the Public Information Room. You can make an

appointment to inspect the comments by calling (202) 874-5043.

*Board:* You may submit comments, identified by Docket Number OP-1220, by any of the following methods:

- *Agency Web site:* <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.

- *E-mail:* [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include docket number in the subject line of the message.

- *Fax:* (202) 452-3819 or (202) 452-3102.

- *Mail:* Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments are available from the Board's Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>, as submitted, except as necessary for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

*FDIC:* You may submit comments, identified as EGRPRA burden reduction comments, by any of the following methods:

- <http://www.fdic.gov/regulations/laws/federal/propose.html>.

- *E-mail:* [comments@fdic.gov](mailto:comments@fdic.gov). Include "EGRPRA burden reduction comment" in the subject line of the message.

- *Mail:* Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

- *Hand Delivery:* Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m.

*Public Inspection:* You may inspect comments at the FDIC Public Information Center, Room 100, 801 17th Street, NW., between 9 a.m. and 4:30 p.m. on business days.

**OTS:** You may submit comments, identified by "No. 2005-02." by any of the following methods:

- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.

- **E-Mail:** [regs.comments@ots.treas.gov](mailto:regs.comments@ots.treas.gov). Include "No. 2005-02" in the subject line of the message, and provide your name and telephone number.

- **Fax:** (202) 906-6518.

- **Mail:** Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

- **Hand Delivery:** Comments may be hand delivered to the Guard's Desk, East Lobby Entrance, 1700 G Street, NW., from 9 a.m. to 4 p.m. on business days, Attention: Regulation Comments, Chief Counsel's Office.

**Public Inspection:** OTS will post comments and the related index on the OTS Internet site at <http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1>. In addition, you may inspect comments at the Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment for access, call (202) 906-5922, send an e-mail to [public.info@ots.treas.gov](mailto:public.info@ots.treas.gov), or send a fax to (202) 906-7755. (Please identify the material you would like to inspect to assist us in serving you.) OTS schedules appointments on business days between 10 a.m. and 4 p.m. In most cases, appointments will be available the next business day following the date OTS receives a request.

**FOR FURTHER INFORMATION CONTACT:**

**OCC:**

- **Stuart Feldstein**, Assistant Director, Legislative and Regulatory Activities Division, (202) 874-5090.

- **Heidi Thomas**, Special Counsel, Legislative and Regulatory Activities Division, (202) 874-5090.

- **Lee Walzer**, Counsel, Legislative and Regulatory Activities Division, (202) 874-5090.

**Board:**

- **Patricia A. Robinson**, Managing Senior Counsel, Legal Division, (202) 452-3005.

- **Michael J. O'Rourke**, Counsel, Legal Division, (202) 452-3288.

- **John C. Wood**, Counsel, Division of Consumer and Community Affairs, (202) 452-2412.

- **Kevin H. Wilson**, Supervisory Financial Analyst, Division of Banking Supervision and Regulation, (202) 452-2362.

- For users of Telecommunications Device for the Deaf (TDD) only, contact (202) 263-4869.

**FDIC:**

- **Claude A. Rollin**, Special Assistant to the Vice Chairman, (202) 898-8741.

- **Steven D. Fritts**, Associate Director, Division of Supervision and Consumer Protection, (202) 898-3723.

- **Ruth R. Amberg**, Senior Counsel, Legal Division, (202) 898-3736.

- **Thomas Nixon**, Counsel, Legal Division, (202) 898-8766.

**OTS:**

- **Glenn Gimble**, Senior Project Manager, Thrift Policy, Supervision Policy, (202) 906-7158.

- **Josephine Battle**, Program Analyst, Thrift Policy, Supervision Policy, (202) 906-6870.

- **Karen Osterloh**, Special Counsel, Regulations and Legislation Division, Chief Counsel's Office, (202) 906-6639.

**SUPPLEMENTARY INFORMATION:**

**I. Overview of the EGRPRA Review and the Steps Taken so Far**

The Agencies<sup>1</sup> are asking for your comments and suggestions on ways in which we can reduce regulatory burdens consistent with our statutory obligations. Today, we request your input to help us identify which regulatory requirements in three categories—Money Laundering, Safety and Soundness, and Securities—are outdated, unnecessary, or unduly burdensome. We list the rules in these categories in a chart at the end of this notice. Please send us your recommendations at our Web site, <http://www.EGRPRA.gov>, or to one of the listed addresses.

Today's request for comment is the fourth notice in our multi-year review of regulations for burden reduction required by section 2222 of EGRPRA.<sup>2</sup> We described the EGRPRA review's requirements in our first EGRPRA notice. In summary, EGRPRA requires us to:

- Categorize our regulations by type.
- Publish the regulations by category to request comments on which regulations contain requirements that are: outdated, unnecessary, or unduly burdensome.
- Publish a summary of those comments.
- Eliminate unnecessary regulations to the extent appropriate.

<sup>1</sup>The National Credit Union Administration has participated in planning the EGRPRA review but has issued, and will issue, requests for comment separately.

<sup>2</sup>Public Law 104-208, Sept. 30, 1996, 12 U.S.C. 3311. We published our first notice in the *Federal Register* on June 16, 2003, at 68 FR 35589; our second notice on January 21, 2004, at 69 FR 2852; and our third notice on July 20, 2004, at 69 FR 43347. You may view the notices at our Web site, <http://www.EGRPRA.gov>.

- Report to Congress: summarizing the significant issues raised and their relative merits, and analyzing whether legislative change is required to reduce burden.

The first publication cycle must be complete by September 2006.

We have identified 13 categories of rules to implement our EGRPRA review. The categories are: Applications and Reporting; Banking Operations; Capital; Community Reinvestment Act; Consumer Protection: Lending Related Rules; Consumer Protection: Account/Deposit Relationships and Miscellaneous Consumer Rules; Directors, Officers and Employees; International Operations; Money Laundering; Powers and Activities; Rules of Procedure; Safety and Soundness; and Securities. You may see the categories and the rules placed within them at our Web site, <http://www.EGRPRA.gov>.

We previously requested public comment about possible burden reduction in five categories of rules. Our June 16, 2003, notice requested comment on three categories: Applications and Reporting, Powers and Activities, and International Operations. Our January 21, 2004, notice requested comment on Consumer Protection: Lending Related Rules. Our July 20, 2004, notice requested comment on Consumer Protection: Account/Deposit Relationships and Miscellaneous Consumer Rules. Today, we request comment on rules related to Money Laundering, Safety and Soundness, and Securities.

We plan to continue to publish one or more categories of rules approximately every six months between 2003 and 2006 and provide a 90-day comment period for each publication. As noted earlier, we must publish all our covered categories of rules for comment and review them by the end of September 2006.

In addition to soliciting written comments, we held banker outreach meetings in Orlando, St. Louis, Denver, San Francisco, New York City, Nashville, Seattle, and Chicago to hear directly from the industry about ways the Agencies could reduce regulatory burden. More than 400 representatives from the industry have attended the outreach meetings. The Agencies have also held three outreach meetings with over 100 participants for representatives of consumer and community groups to obtain their input on regulatory burden reduction. The consumer meetings were held in Arlington, Virginia; San Francisco; and Chicago. These meetings have helped focus our regulatory burden reduction efforts. We anticipate holding

additional outreach events this year. You may learn more about the meetings and related recommendations at our EGRPRA Web site, <http://www.EGRPRA.gov>.

We received 19 comments in response to the first notice, about 560 to the second notice, and over 100 to the third notice. The Agencies appreciate the response to our notices and the outreach meetings. The written comments and remarks at the meetings came from individuals, banks, savings associations, holding companies, industry trade groups, and consumer and community groups. You may view the comments at our EGRPRA Web site, <http://www.EGRPRA>. We are actively reviewing the feedback received about specific ways to reduce regulatory burden, as well as conducting our own analyses.

In addition, Congress considered various legislative proposals to reduce burden on the financial services industry in 2004. Representatives of the Agencies and industry leaders testified before congressional committees about these legislative reform proposals and other ideas for reducing burden on the financial services industry.<sup>3</sup> We will continue to post information about legislative and regulatory reform efforts on our Web site.

## II. Request for Comment on Money Laundering, Safety and Soundness, and Securities Rules

Today, we are asking the public to identify ways in which the rules related

<sup>3</sup> On May 12, 2004, FDIC Vice Chairman John M. Reich testified about burden reduction before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services. On June 22, agency and industry leaders testified about regulatory reform before the Senate Committee on Banking, Housing and Urban Affairs. Agency leaders included: Federal Reserve Board Governor Donald Kohn, FDIC Vice Chairman John M. Reich, NCUA Chairman JoAnn Johnson, OCC First Senior Deputy Comptroller and Chief Counsel Julie L. Williams, and OTS Chief Counsel John E. Bowman. On August 27, Senator Mike Crapo, who is leading a financial services regulatory reform effort for the Senate Banking Committee, released a matrix detailing more than 130 burden reduction proposals that were made in the June 2004 hearing.

to Money Laundering, Safety and Soundness, and Securities may be outdated, unnecessary, or unduly burdensome. As shown on the chart at the end of this notice, there are 28 regulations in these categories. The Agencies note that other non-banking agencies, such as the Department of Treasury under the Bank Secrecy Act, have issued rules within these three categories that apply to our regulated institutions. Some of the rules of these other agencies are beyond our jurisdiction. However, to the extent that we receive comments raising significant issues about these related rules, we will identify the issues in our Report to Congress and make those comments available to the appropriate agencies.

We encourage comments that address not only individual rules or requirements but also pertain to certain product lines. For example, in the case of an institution's securities activities, are any of the reporting, recordkeeping or other requirements of one regulation inconsistent with or duplicative of the requirements under another regulation? A product line approach is consistent with EGRPRA's focus on how rules interact, and may be especially helpful in exposing redundant or potentially inconsistent regulatory requirements. We recognize that commenters using a product line approach may want to make recommendations about rules that are not in our current request for comment. They should do so since we designed the EGRPRA categories to stimulate creative approaches rather than limiting them.

*Specific issues to consider.* While all comments are welcome, we specifically invite comment on the following issues:

*A. Need for Statutory Change.* (1) Do any statutory requirements underlying the rules impose unnecessary, redundant, conflicting or unduly burdensome requirements? (2) Are there less burdensome alternatives?

*B. Need and Purpose of the Regulations.* (1) Are the regulations consistent with the purposes of the statutes that they implement? (2) Have circumstances changed so that a rule is

no longer necessary? (3) Do changes in the financial products and services offered to consumers suggest a need to revise certain regulations (or statutes)? (4) Do any of the regulations impose compliance burdens not required by the statutes they implement?

*C. General Approach/Flexibility.* (1) Would a different general approach to regulating achieve statutory goals with less burden? (2) Do any of these rules impose unnecessarily inflexible requirements?

*D. Effect of the Regulations on Competition.* Do any of the regulations or statutes create competitive disadvantages for insured depository institutions compared to the rest of the financial services industry or competitive disadvantages for one type of insured depository institution over another?

*E. Reporting, Recordkeeping, and Disclosure Requirements.* (1) Which reporting, recordkeeping, or disclosure requirements impose the most compliance burdens? (2) Are any of the reporting or recordkeeping requirements unnecessary to demonstrate compliance with the law?

*F. Consistency and Redundancy.* (1) Are any of the requirements under one regulation inconsistent with or duplicative of requirements under another regulation? (2) If so, are the inconsistencies not warranted by the purposes of the regulations?

*G. Clarity.* Are any of the regulations drafted unclearly?

*H. Burden on Small Insured Institutions.* We have particular interest in minimizing burden on small insured institutions (those with assets of \$150 million or less). Are there appropriate ways to amend these rules to minimize adverse economic impact on small insured institutions?

The Agencies appreciate the efforts of all interested parties to help us eliminate outdated, unnecessary, or unduly burdensome regulatory requirements.

BILLING CODE 4810-33-P; 6210-01-P; 6714-01-P; 6720-01-P

**Rules for which we are requesting comment now:  
Money Laundering, Safety and Soundness, and Securities**

Subject	National Banks	State Member Banks	State Non-Member Banks	Thriffs	Holding Companies  Bank <sup>4</sup> ----- Thrift
<b>Money Laundering</b>					
<b>Interagency Regulations</b>					
Bank Secrecy Act Compliance	12 CFR Part 21, Subpart C	12 CFR 208.63 [Reg. H]	12 CFR Part 326, Subpart B	12 CFR 563.177	
Reports of Crimes or Suspected Crimes	12 CFR Part 21, Subpart B	12 CFR 208.62 [Reg. H]	12 CFR Part 353	12 CFR 563.180(d)	12 CFR 225.4(f) -----
<b>Safety and Soundness</b>					
<b>Interagency Regulations</b>					
Appraisal Standards for Federally Related Transactions	12 CFR Part 34, Subpart C	12 CFR 208.50 [Reg. H]; 12 CFR Part 225, Subpart G [Reg. Y]	12 CFR Part 323	12 CFR Part 564	12 CFR Part 225, Subpart G [Reg. Y] -----
Frequency of Safety and Soundness Examination	12 CFR 4.6-.7	12 CFR 208.64	12 CFR 337.12	12 CFR 563.171; See also 12 CFR 563.170	
Lending Limits	12 CFR Part 32			12 CFR 560.93	
Real Estate Lending Standards	12 CFR Part 34, Subpart D	12 CFR Part 208, Subpart E and App. C [Reg. H]	12 CFR Part 365	12 CFR 560.100; 12 CFR 563.101	
Security Devices and Procedures	12 CFR Part 21, Subpart A	12 CFR 208.61 [Reg. H]	12 CFR Part 326, Subpart A	12 CFR Part 568	

<sup>4</sup> Foreign banking organizations that conduct banking operations in the U.S., either directly through branches and agencies or indirectly through U.S. bank subsidiaries or commercial lending company subsidiaries, generally are subject to the same regulatory regime as domestic bank holding companies.

Subject	National Banks	State Member Banks	State Non-Member Banks	Thrifts	Holding Companies Bank <sup>4</sup> ----- Thrift
<b>Safety and Soundness (continued)</b>					
<b>Interagency Regulations (continued)</b>					
Standards for Safety and Soundness	12 CFR Part 30	12 CFR Part 208, App. D-1 [Reg. H]	12 CFR Part 364	12 CFR Part 570	
Transactions with Affiliates	12 CFR Part 223 [Reg. W]; 12 CFR Part 31	12 CFR Part 223 [Reg. W]		12 CFR 563.41	
<b>OCC Regulations</b>					
Other Real Estate Owned	12 CFR Part 34, Subpart E				
<b>Board Regulations</b>					
Extensions of Credit by Federal Reserve Banks	12 CFR Part 201 [Reg. A]	12 CFR Part 201 [Reg. A]	12 CFR Part 201 [Reg. A]	12 CFR Part 201 [Reg. A]	
Limitations on Interbank Liabilities	12 CFR Part 206 [Reg. F]	12 CFR Part 206 [Reg. F]	12 CFR Part 206 [Reg. F]	12 CFR Part 206 [Reg. F]	
<b>FDIC Regulations</b>					
Annual Independent Audits and Reporting Requirements	12 CFR Part 363	12 CFR Part 363	12 CFR Part 363	12 CFR Part 363; <u>See also</u> OTS: 12 CFR 562.4	
Unsafe and Unsound Banking Practices (Standby Letters of Credit and Brokered Deposits)			12 CFR 337.2; 12 CFR 337.6		
<b>OTS Regulations</b>					
Audits of Savings Associations and Savings Association Holding Companies				12 CFR 562.4; <u>See also</u> FDIC: 12 CFR Part 363	----- 12 CFR 562.4
Financial Management Policies				12 CFR Part 563, Subpart F	----- 12 CFR 563.170

Subject	National Banks	State Member Banks	State Non-Member Banks	Thrifts	Holding Companies Bank <sup>4</sup> ----- Thrift
<b>Safety and Soundness (continued)</b>					
<b>OTS Regulations (continued)</b>					
Lending and Investment – Additional Safety and Soundness Limitations				12 CFR Part 560	
<b>Securities</b>					
<b>Interagency Regulations</b>					
Banks as Registered Clearing Agencies	12 CFR 19.135	12 CFR 208.32-33 [Reg. H]	12 CFR Part 308, Subpart S		
Banks as Securities Transfer Agents	12 CFR 9.20	12 CFR 208.31 [Reg. H]	12 CFR Part 341		
Government Securities Sales Practices	12 CFR Part 13	12 CFR 208.37 [Reg. H]	12 CFR Part 368		
Recordkeeping and Confirmation of Securities Transactions Effected by Banks	12 CFR Part 12	12 CFR 208.34 [Reg. H]	12 CFR Part 344	12 CFR Part 551	
Reporting Requirements for Reported Securities Under the Securities Exchange Act of 1934	12 CFR Part 11	12 CFR 208.36 [Reg. H]	12 CFR Part 335	12 CFR Part 563d	
Securities Offerings	12 CFR Part 16			12 CFR Part 563g	
<b>OCC Regulations</b>					
Municipal Securities Dealer Activities of Banks	12 CFR Part 10				
<b>Board Regulations</b>					
Credit by Banks and Persons Other than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stock	12 CFR Part 221 [Reg. U]	12 CFR Part 221 [Reg. U]	12 CFR Part 221 [Reg. U]	12 CFR Part 221 [Reg. U]	12 CFR Part 221 [Reg. U] ----- 12 CFR Part 221 [Reg. U]

Subject	National Banks	State Member Banks	State Non-Member Banks	Thriffs	Holding Companies Bank <sup>4</sup> ----- Thrift
<b>Securities (continued)</b>					
<b>OTS Regulations</b>					
Accounting Requirements/Financial Statements				12 CFR Part 563c	
Proxies				12 CFR Part 569	
Rules on the Issuance and Sale of Institution Securities				12 CFR 563.5; 12 CFR Part 563, Subpart C	

Dated: January 13, 2005.

**Julie L. Williams,**  
*Acting Comptroller of the Currency.*

By order of the Board of Governors of the Federal Reserve System on January 26, 2005.

**Jennifer J. Johnson,**  
*Secretary of the Board.*

Federal Deposit Insurance Corporation.

By order of the Board of Directors.

Dated at Washington, DC, this 18th day of January, 2005.

**Robert E. Feldman,**  
*Executive Secretary.*

Dated: January 25, 2005.

**James E. Gilleran,**  
*Director, Office of Thrift Supervision.*

[FR Doc. 05-2079 Filed 2-2-05; 8:45 am]

BILLING CODE 4810-33-C; 6210-01-C; 6714-01-C; 6720-01-C

## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Part 1

RIN 3038-AC15

### Investment of Customer Funds and Record of Investments

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Commodity Futures Trading Commission ("Commission") is proposing to amend its regulations regarding investment of customer funds and related recordkeeping requirements. The proposed amendments address

standards for investing in instruments with embedded derivatives, requirements for adjustable rate securities (including auction rate securities), concentration limits on reverse repurchase agreements ("reverse repos"), transactions by futures commission merchants ("FCMs") that are also registered as securities broker-dealers ("FCM/BDs"), rating standards and registration requirement for money market mutual funds ("MMMFs"), auditability standard for investment records, and certain technical changes. Among those technical changes is an amendment to the Commission's recordkeeping rules in connection with repurchase agreements ("repos") and proposed transactions by FCM/BDs.

**DATES:** Comments must be received on or before March 7, 2005.

**ADDRESSES:** Comments on the proposed amendments should be sent to Jean A. Webb, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581. Comments may be sent by facsimile transmission to (202) 418-5521, by e-mail to [secretary@cftc.gov](mailto:secretary@cftc.gov), or electronically by accessing <http://www.regulations.gov>. Reference should be made to "Proposed Amendments to Rule 1.25."

**FOR FURTHER INFORMATION CONTACT:** Phyllis P. Dietz, Special Counsel, Division of Clearing and Intermediary Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581. Telephone (202) 418-5430.

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# Proposed Rules

Federal Register

Vol. 70, No. 47

Friday, March 11, 2005

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

## DEPARTMENT OF THE TREASURY

### Office of the Comptroller of the Currency

#### 12 CFR Part 25

[Docket No. 05-04]

RIN 1557-AB98

### FEDERAL RESERVE SYSTEM

#### 12 CFR Part 228

[Regulation BB; Docket No. R-1225]

### FEDERAL DEPOSIT INSURANCE CORPORATION

#### 12 CFR Part 345

RIN 3064-AC89

### Community Reinvestment Act Regulations

**AGENCIES:** Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); and Federal Deposit Insurance Corporation (FDIC).

**ACTION:** Joint notice of proposed rulemaking.

**SUMMARY:** The OCC, Board, and FDIC (collectively, "federal banking agencies" or "the Agencies") are issuing this notice of proposed rulemaking that would revise certain provisions of our rules implementing the Community Reinvestment Act (CRA). We plan to take this action in response to public comments received by the federal banking agencies and the Office of Thrift Supervision (OTS) on a February 2004 inter-agency CRA proposal and by the FDIC on its August 2004 CRA proposal. The current proposal would address regulatory burden imposed on some smaller banks by revising the eligibility requirements for CRA evaluation under the lending, investment, and service tests. Specifically, the proposal would provide a simplified lending test and a flexible new community development

test for small banks with an asset size between \$250 million and \$1 billion. Holding company affiliation would not be a factor in determining which CRA evaluation standards applied to a bank. In addition, the proposal would revise the term "community development" to include certain community development activities, including affordable housing, in underserved rural areas and designated disaster areas.

**DATES:** Comments must be received by May 10, 2005.

**ADDRESSES:** Comments should be directed to:

**OCC:** You should include OCC and Docket Number 05-04 in your comment. You may submit comments by any of the following methods:

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.

- *OCC Web Site:* <http://www.occ.treas.gov>. Click on "Contact the OCC," scroll down and click on "Comments on Proposed Regulations."

- *E-mail Address:* [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).

- *Fax:* (202) 874-4448.

- *Mail:* Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 1-5, Washington, DC 20219.

- *Hand Delivery/Courier:* 250 E Street, SW., Attn: Public Information Room, Mail Stop 1-5, Washington, DC 20219.

**Instructions:** All submissions received must include the agency name (OCC) and docket number or Regulatory Information Number (RIN) for this notice of proposed rulemaking. In general, the OCC will enter all comments received into the docket without change, including any business or personal information that you provide. You may review comments and other related materials by any of the following methods:

- *Viewing Comments Personally:* You may personally inspect and photocopy comments at the OCC's Public Information Room, 250 E Street, SW., Washington, DC. You can make an appointment to inspect comments by calling (202) 874-5043.

- *Viewing Comments Electronically:* You may request e-mail or CD-ROM copies of comments that the OCC has received by contacting the OCC's Public Information Room at [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).

- *Docket:* You may also request available background documents and

project summaries using the methods described above.

**Board:** You may submit comments, identified by Docket No. R-1225, by any of the following methods:

- *Agency Web Site:* <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.

- *Federal eRulemaking Portal:* <http://www.regulations.gov>. Follow the instructions for submitting comments.

- *E-mail:*

[regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include docket number in the subject line of the message.

- *Fax:* 202/452-3819 or 202/452-3102.

- *Mail:* Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments are available from the Board's Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, except as necessary for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20th and C Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

**FDIC:** You may submit comments, identified by RIN number by any of the following methods:

- *Agency Web site:* <http://www.fdic.gov/regulations/laws/federal/propose.html>. Follow instructions for submitting comments on the Agency Web Site.

- *E-mail:* [Comments@FDIC.gov](mailto:Comments@FDIC.gov). Include the RIN number in the subject line of the message.

- *Mail:* Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

- *Hand Delivery/Courier:* Guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m.

- *Instructions:* All submissions received must include the agency name and RIN for this rulemaking. All comments received will be posted without change to <http://www.fdic.gov/regulations/laws/federal/propose.html>

including any personal information provided.

**FOR FURTHER INFORMATION CONTACT:**

OCC: Michael Bylsma, Director, or Margaret Hesse, Special Counsel, Community and Consumer Law Division, (202) 874-5750; Karen Tucker, National Bank Examiner, Compliance Division, (202) 874-4428; or Patrick T. Tierney, Attorney, Legislative and Regulatory Activities (202) 874-5090, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219.

Board: William T. Coffey, Senior Review Examiner, (202) 452-3946; Catherine M.J. Gates, Oversight Team Leader, (202) 452-3946; Kathleen C. Ryan, Counsel, (202) 452-3667; or Dan S. Sokolov, Senior Attorney, (202) 452-2412, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

FDIC: Richard M. Schwartz, Counsel, Legal Division, (202) 898-7424; Susan van den Toorn, Counsel, Legal Division, (202) 898-8707; or Robert W. Mooney, Chief, CRA and Fair Lending Policy Section, Division of Supervision and Consumer Protection, (202) 898-3911; Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

**SUPPLEMENTARY INFORMATION:**

**Background**

*Advance Notice of Proposed Rulemaking.* In 1995, when the OCC, the Board, the OTS, and the FDIC (collectively, "federal banking and thrift agencies" or "four agencies") adopted major amendments to regulations implementing the Community Reinvestment Act, they committed to reviewing the amended regulations in 2002 for their effectiveness in placing performance over process, promoting consistency in evaluations, and eliminating unnecessary burden. (60 FR 22156, 22177, May 4, 1995). The review was initiated in July 2001 with the publication in the *Federal Register* of an advance notice of proposed rulemaking (66 FR 37602, July 19, 2001). The federal banking and thrift agencies indicated that they would determine whether and, if so, how the regulations should be amended to better evaluate financial institutions' performance under CRA, consistent with the Act's authority, mandate, and intent. The four agencies solicited comment on the fundamental issue of whether any change to the regulations would be beneficial or warranted, and on eight discrete aspects of the regulations.

About 400 comment letters were received, most from banks and thrifts of varying sizes and their trade associations ("financial institutions") and local and national nonprofit community advocacy and community development organizations ("community organizations").

The comments reflected a consensus that certain fundamental elements of the regulations are sound, but demonstrated a disagreement over the need and reasons for change. Community organizations advocated that the regulations needed to be changed to reflect developments in the industry and marketplace; financial institutions were concerned principally with reducing burden consistent with maintaining or improving the regulations' effectiveness. In reviewing these comments, the federal banking and thrift agencies were particularly mindful of the need to balance the desire to make changes that might "fine tune" the regulations, with the need to avoid unnecessary and costly disruption to reasonable CRA policies and procedures that the industry has put into place under the current rules.

*Joint Agency Regulatory Proposal to Address Small Institution Regulatory Burden and Illegal or Predatory Lending Practices.* In February 2004, the federal banking and thrift agencies issued identical proposals to amend their respective CRA regulations to increase the limit on the asset size of institutions classified as "small institutions" that are eligible for streamlined CRA evaluations and exempt from CRA data reporting obligations. (69 FR 5729, Feb. 6, 2004). Under the current rule, a "small institution" is an institution that has less than \$250 million in assets and is either independent or a member of a holding company with less than \$1 billion in assets. The four agencies proposed to re-define a "small institution" as one with fewer than \$500 million in assets. The holding company criterion would have been eliminated under the proposal.

The commenters were deeply split on the proposal. A majority of over 250 community bank commenters, and all of the trade associations commenting on behalf of community banks, urged the federal banking and thrift agencies to extend the proposed burden relief to all institutions with assets under \$2 billion, or at least to all institutions with assets under \$1 billion; a few favored the proposed \$500 million threshold. Virtually every one of over 250 community group commenters strongly opposed changing the definition of "small institution" or exempting any more institutions from

the three-part test (lending, services, and investments). These commenters urged that the threshold not be changed so that community development activities continue to be evaluated, as they are today, in banks with \$250 million or more in assets.

The federal banking and thrift agencies also proposed to revise and clarify the regulations to provide that evidence of certain abusive and illegal credit practices will adversely affect an agency's evaluation of a bank's CRA performance, including evidence of a pattern or practice of extending home mortgage or consumer loans based predominantly on the foreclosure or liquidation value of the collateral by the institution, where the borrower cannot be expected to be able to make the payments required under the terms of the loan. The proposal clarified that a bank's evaluation will be adversely affected by such abusive or illegal credit practices regardless of whether the practices involve loans in the bank's assessment area(s) or in any other location or geography. It also provided that a bank's CRA evaluation can be adversely affected by evidence of such practices by any affiliate, if any loans of that affiliate have been considered in the institution's CRA evaluation.

While commenters differed in their reaction to many aspects of the proposal, many commenters, including community organizations and financial institutions, opposed—as either inadequate or inappropriate—the provision that evidence of collateral-based mortgage lending would adversely affect a bank's CRA evaluation.

*Recent OTS Rulemaking.* On August 18, 2004, the OTS published a final rule that expanded the category of "small savings associations" subject to OTS CRA regulations to those under \$1 billion, regardless of holding-company affiliation. The OTS announced that it was taking this action on July 16, 2004, and that same day, the OCC and the Board announced separately that they would not proceed with their respective proposals. The Board formally withdrew its proposal. The OCC did not formally withdraw its proposal, but did not adopt it.

On November 24, 2004, the OTS issued another proposed rulemaking to revise the definition of "community development" to permit consideration of such activities in underserved non-metropolitan areas, and to solicit comment on the appropriate consideration of such community development activities in any areas affected by natural disasters or major community disruptions. The OTS

further solicited comment on providing substantial flexibility in the way that CRA ratings are assigned for institutions subject to the lending, investment, and service tests (savings associations with assets of \$1 billion or more). Under the OTS proposal, 50% or more of a large savings association's CRA rating would be based on lending, and the remaining percentage would be based on any other type or types of CRA activity (services or investments) that the association elects to have evaluated. The OTS also asked for comment on whether it should eliminate the Investment Test entirely.

**FDIC Proposal.** On August 20, 2004, the FDIC issued a new proposal on the CRA evaluation of banks defined as "small." (69 FR 51611, Aug. 20, 2004) The FDIC's new proposal would expand the category of "small banks" to those under \$1 billion, regardless of any holding-company size or affiliation. For small banks with assets between \$250 million and \$1 billion, the FDIC proposal would add to the five performance criteria of the current streamlined small bank test a new sixth criterion taking into account a bank's record of community development lending, investments, or services "based on the opportunities in the market and the bank's own strategic strengths." While these community development activities would not be a separately rated test, the FDIC requested comment on whether it should apply a separate community development test in addition to the existing streamlined performance criteria and on what weighting the community development test would have in assigning an overall performance rating. The FDIC also proposed to expand the definition of "community development" to include activities that benefit rural areas and individuals in rural areas.

The FDIC's proposal generated approximately 11,500 comment letters. These comments were sent by a wide spectrum of commenters, including over 4,000 from community bankers, over 1,500 from various community organizations, and over 5,000 from individuals. As with the February 2004 interagency proposal, the commenters were deeply divided on the issues presented in the August proposal. Nearly all of the comments received from bankers and banking organizations supported a change in the small bank dollar threshold, primarily as a way to reduce administrative burden. Bankers were mixed on the community development performance criterion. Some supported a community development criterion as an effective compromise, while others opposed the criterion altogether on one of two

grounds: (1) Community development lending and investments are already part of the loan-to-deposit performance criterion assessing the level of lending activity<sup>1</sup> or (2) community development activities should be based on an overall subjective assessment, not an artificial test. Most of the banking commenters opposed making the community development test a separate test.

Community groups almost universally opposed any increase in the small bank threshold. These commenters asserted that the burden argument made by banks did not justify a change. This group also uniformly opposed the community development performance criterion on the ground that permitting banks to choose one or more lending, investment, and service activities would lead to cut backs in investments and services currently required under the large bank test. The community group commenters generally supported a separate community development test.

Commenters were mixed on the addition of "rural" to the definition of "community development." Some supported the proposal because it would permit CRA credit for such rural-based activities as funding local water projects, school construction, or rehabilitation of a Main Street retail district in rural areas lacking sufficient financial resources. Many commenters were concerned that the mere inclusion of the phrase "individuals who reside in rural areas" would permit banks to get CRA credit for loans, investments, or services to middle-class or wealthy individuals.

#### Discussion

The CRA requires the federal banking and thrift agencies to assess the record of each insured depository institution in meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound operation of the institution and to take that record into account when the agency evaluates an application by the institution for a deposit facility.<sup>2</sup>

The federal banking agencies continue to believe that it is both worthwhile and possible to improve the CRA rules in ways that reduce unnecessary burden while at the same time maintaining and improving the effective implementation of the CRA. Moreover, we believe that it is important to take steps at this time to develop and propose rules to achieve these goals, and to work toward

<sup>1</sup> Some commenters also noted that, under existing regulations, small banks can elect to be evaluated under the large bank lending, investment, and service tests.

<sup>2</sup> 12 U.S.C. 2903.

achieving standards that ultimately can apply on a uniform basis to all banks subject to the CRA. Therefore, the federal banking agencies request comment on proposed regulatory revisions that balance the objective of providing meaningful regulatory relief for additional community banks with the objectives of preserving and encouraging meaningful CRA activities by those same banks.

As noted above, commenters were divided on the merits of that portion of the February 2004 and August 2004 proposals that would have increased the limit on the size of banks that would be eligible for treatment as a "small bank." The comments in favor of the proposal focused on the potential regulatory relief for insured institutions, while those opposed expressed concern that the proposal would result in decreased community development activities in areas that are particularly in need of credit and investment, notably rural areas.

In light of these comments, the federal banking agencies request comment on this revised proposal. The new proposal addresses both the comments from community banks and comments from community organizations. It responds to community banks concerned about the reduction of undue regulatory burden by extending eligibility for streamlined lending evaluations and the exemption from data reporting to banks under \$1 billion without regard to holding company assets. It addresses the concerns of community organizations that urged the federal banking and thrift agencies to continue to evaluate community development participation, by providing that the community development records of banks between \$250 million and \$1 billion would be separately evaluated and rated, but provides a more streamlined basis than the current rule for doing so. It responds to suggestions from both community banks and community organizations that the definition of "community development" is too confined by proposing a more flexible approach to the types of community development activities that would be considered, and by expanding the definition of community development activities in underserved rural areas and designated disaster areas. In short, the new proposal tries to strike a balance between burden reduction for community banks and effective evaluation of community development by those banks.

The key differences between this proposal and the February 2004 interagency proposal are three-fold. First, as with the FDIC's August 2004

proposal, the new proposal would raise the threshold for a "small bank" to banks with assets of less than \$1 billion, not \$500 million, regardless of any holding company size or affiliation. Unlike the prior proposals, the new proposal would provide an adjustment of the threshold for inflation, based on changes to the Consumer Price Index.

Second, the new proposal would add a flexible new community development test that would be separately rated in CRA examinations for banks with at least \$250 million and less than \$1 billion in assets (these banks will be referred to as "intermediate small banks"). Ratings for intermediate small banks would be based on a rating on this community development test and on a separate rating for the streamlined small bank lending test. An intermediate small bank would not be eligible for an overall rating of "satisfactory" unless it received ratings of "satisfactory" on both the lending and community development tests.

Third, the definition of "community development" would be expanded to encompass: (1) Affordable housing for individuals in underserved rural areas and designated disaster areas (in addition to low- or moderate-income individuals) and (2) community development activities that revitalize or stabilize underserved rural areas and designated disaster areas (in addition to low- or moderate-income areas).<sup>3</sup> The current definition of "community development," which hinges on targeting low- or moderate-income people or census tracts, has been criticized by community banks and community organizations alike for needlessly excluding rural areas that often do not have census tracts that meet the definition of "low- or moderate-income." Indeed, about 60% of non-metropolitan counties lack such low- and moderate-income tracts. As a result, many rural areas in need of community development activities are not in low- or moderate-income tracts.

The current definition of "community development" also does not explicitly provide that it encompasses activities in areas affected by disasters. For example, there has been unnecessary uncertainty about the CRA treatment of bank revitalization activities in areas affected by natural disasters such as hurricanes or in, for example, the commercial and residential areas surrounding the site of the World Trade Center. Affordable housing for individuals in underserved

rural areas and in designated disaster areas, and activities that promote the revitalization and stabilization of such areas, such as for infrastructure improvements, community services, and small business development, are fully consistent with the goals and objectives of the CRA because these projects can benefit the entire community, including, but not limited to, low- or moderate-income individuals or neighborhoods.

#### *Size Threshold*

Under the proposal, intermediate small banks would no longer have to report originations and purchases of small business, small farm, and community development loans. This change would account for most of the cost savings and paperwork burden reduction for intermediate small banks.

The proposal also would annually adjust the asset size for small and intermediate small banks based on changes to the Consumer Price Index. Using an index to adjust dollar figures for the effects of inflation is commonplace, and is used in other federal lending regulations, such as the Home Mortgage Disclosure Act. 12 U.S.C. 2801 *et seq.*

#### *Community Development Test for Intermediate Small Banks*

As stated above, comments were mixed on the FDIC's inquiry as to whether the community development test should be separated from the current small bank test. Many industry commenters preferred to have a community development criterion, which would permit a bank to engage in one or more community development activities, and opposed a separate community development test. On the other hand, many community organizations and others expressed concern that the criterion was overly flexible and would result in a narrow focus that would ignore a broad range of community needs, including investments.

The OCC, FDIC, and Board believe that the proposal for a separate community development rating presents an appropriate focus on community development activities for intermediate small banks and makes transparent the weight that community development performance receives in the overall rating. Under the proposed community development test for these "intermediate" small banks, community development loans, qualified investments, and community development services would be evaluated together, resulting in a single rating for community development performance. While the lending test for

small banks permits consideration of community development lending and qualified investments "as appropriate," such activities by an intermediate small bank generally would be considered under the community development test. An intermediate small bank's rating for community development would play a significant role in the bank's overall rating, as would its rating on the separate test of the bank's lending. To ensure that community development performance and retail lending are appropriately weighted under the proposal, and given the flexibility that would be available to satisfy the community development test through a variety of activities, an intermediate small bank would have to achieve a rating of at least satisfactory on both tests to be assigned an overall rating of satisfactory.

The number and amount of community development loans, the number and amount of qualified investments, and the provision of community development services, by an intermediate small bank, and the bank's responsiveness through such activities to community development lending, investment, and services needs, would be evaluated in the context of the bank's capacities, business strategy, the needs of the relevant community, and the number and types of opportunities for community development activities. The federal banking agencies intend that the proposed community development test would be applied flexibly to permit a bank to apply its resources strategically to the types of community development activities (loans, investments, and services) that are most responsive to helping to meet community needs, even when those activities are not necessarily innovative, complex, or new.

As noted in the February 2004 proposal, some community banks face intense competition for a limited supply of qualified investments that are safe and sound and yield an acceptable return. Competition for scarce investments also may result in "churning," or the repeated purchase and sale, of the same pool of investments. To "fill the silo" of investments for purposes of the CRA investment test, these banks may have made or purchased investments that may not be meaningful or responsive to the needs of their community, whereas additional lending or provision of services by the bank could have been more responsive to local community development needs. The OCC, FDIC, and Board recognize that these constraints may affect the investment performance of particular banks, and believe that a more flexible community

<sup>3</sup> This represents a change from the FDIC's August 2004 proposal. In that proposal, FDIC proposed amending the prong of the definition of community development relating to community services. See 12 CFR 345.12(g)(2).

development test for intermediate small banks provides a better framework to evaluate a bank's capacity, the types of investments that are reasonably available in a bank's community, and how a bank fosters community development goals in its assessment areas.

As part of the proposed community development test for intermediate small banks, the OCC, FDIC, and Board also anticipate that examiners would use their discretion, using performance context, to assign appropriate weight in a bank's current period rating to prior-period outstanding investments that reflect a substantial financial commitment or outlay by the bank designed to have a multi-year impact, in addition to investments made during the current examination cycle.

In providing this flexibility for intermediate small banks, it is not the intention of the federal banking agencies to permit a bank to simply ignore one or more categories of community development. Nor would the proposal prescribe any required threshold proportion of community development loans, qualified investments, and community development services for these banks. Instead, the OCC, FDIC, and Board would expect that a bank will appropriately assess the needs in its community, engage in different types of community development activities based on those needs and the bank's capacities, and that it will take reasonable steps to apply its community development resources strategically to meet those needs.

Under the proposal, retail banking services provided by intermediate small banks would no longer be evaluated in a separate service test. Instead, services for low- and moderate-income people would be taken into account in the community development test. Under that test, the federal banking agencies would consider bank services intended primarily to benefit low- and moderate-income people, such as low-cost bank accounts and banking services such as low-cost remittance services.

Giving banks more flexibility on how to apply their community development resources to respond to community needs through a more strategic use of loans, investments, and services is intended to reduce burden and make the evaluation of community banks' community development records more effective.

#### Community Development Definition

The regulations' present definition of "community development" has been criticized by community banks and community organizations alike for

failing to recognize the unique community development needs of certain rural areas. The definition covers four categories of activities, three of which (affordable housing, community services, and economic development) are defined in terms of the activity's targeting of low- or moderate-income people or small businesses or farms, and one of which (revitalization and stabilization activities) is defined in terms of its targeting of low- or moderate-income census tracts. The OCC, FDIC, and Board propose to amend two of the categories—affordable housing and revitalization and stabilization activities—by adding references to individuals in "underserved rural areas" and in "designated disaster areas."<sup>4</sup>

In response to the FDIC's August 2004 proposal to revise the definition of "community development" to include the provision of affordable housing to individuals in rural areas (in addition to low- or moderate-income individuals under the current rule), several commenters noted that the provision of affordable housing was critical in certain rural areas. Some community organizations serving rural areas commented that the CRA process should promote affordable housing in rural areas across the country.

As described in the "Request for Comments" discussion below, the OCC, FDIC, and Board seek comment on a variety of approaches to identify the community development needs of rural areas. The approach reflected in the proposed amendments is based on the premise that the provision of *affordable housing*—in addition to activities that revitalize and stabilize underserved rural areas—may meet a critical need of individuals in certain underserved rural areas, even if those individuals may not meet the technical requirements of the definition of "low- or moderate-income" in the current regulation. The proposed amendment would clarify that bank support of affordable housing that benefits individuals in need of affordable housing in underserved rural areas will qualify as a community development activity.

With respect to the current definition covering revitalization and stabilization activities, this category does not address revitalization and stabilization activities in most rural counties, since most rural counties do not have any low- or

moderate-income census tracts.<sup>5</sup> Under the CRA regulation, a tract's income classification derives from its relationship to the median family income of the state's rural, or non-metropolitan areas as a whole, which could be relatively low and declining. Community banks and community organizations have said that the tract-income limitation has made the definition of "community development" ineffective for addressing the needs of rural areas that do not have low- or moderate-income tracts, but are in decline, have been designated for redevelopment, or need revitalizing or stabilizing. This aspect of the proposed amendment to the definition of "community development" is designed to recognize the benefits of activities that revitalize and stabilize underserved rural areas that do not meet the technical definition of "low- or moderate-income" census tracts. Such activities might include, depending upon the circumstances, state or local infrastructure bonds and loans to construct healthcare facilities. They would not include, however, activities that benefit primarily higher-income individuals in underserved rural areas or rural areas that are not underserved. In evaluating the responsiveness of community development activities in underserved rural areas, examiners would give significant weight to factors such as the extent to which low- or moderate-income individuals benefited from the activities.

Under the revised community development definition, a "designated disaster area" is an area that has received an official designation as a disaster area.

<sup>5</sup> Under the definition of "low- or moderate-income" census tract in the CRA regulations, 57 percent of non-metropolitan counties have no low- or moderate-income tracts, compared to 13 percent of metropolitan counties. The reason for this disparity is that rural census tracts are drawn over relatively large geographic areas, often having relatively heterogeneous populations that, when averaged, tend toward the middle. This leads to a concentration of 72 percent of rural census tracts in the middle-income category, which leaves a small share (15 percent) in the low- and moderate-income categories. Moreover, because most rural counties have relatively few census tracts, the relatively few *low- or moderate-income* rural census tracts are distributed unevenly among rural counties. As would be expected, they also appear to be distributed unevenly among bank CRA assessment areas. About 42 percent of non-metropolitan assessment areas reported by large banks in 2003, compared to 14 percent of the metropolitan assessment areas they reported, lacked such tracts. (The regulation requires large banks to report their assessment areas; the assessment areas of small banks are not required to be reported.)

<sup>4</sup> Staff interpretations of "affordable housing" and "revitalization and stabilization" can be found in Interagency Questions and Answers Regarding Community Reinvestment, (66 FR 36620, 36625-36626, July 12, 2001) (Q&A \_12(h)(1)-1, \_12(h)(4)-1).



### Effect of Certain Credit Practices on CRA Evaluations

The OCC, FDIC, and Board again propose to revise the regulations to address the impact on a bank's CRA rating of evidence of discrimination or other illegal credit practices. The regulations would provide that evidence of discrimination, or evidence of credit practices that violate an applicable law, rule, or regulation, will adversely affect an agency's evaluation of a bank's CRA performance. The regulations also would be revised to include an illustrative list of such practices, including evidence of discrimination against applicants on a prohibited basis in violation of, for example, the Equal Credit Opportunity (15 U.S.C. 1691 *et seq.*) or Fair Housing Acts (42 U.S.C. 3601 *et seq.*); evidence of illegal referral practices in violation of section 8 of the Real Estate Settlement Procedures Act (12 U.S.C. 2607); evidence of violations of the Truth in Lending Act (12 U.S.C. 1601 *et seq.*) concerning a consumer's right to rescind a credit transaction secured by a principal residence; evidence of violations of the Home Ownership and Equity Protection Act (15 U.S.C. 1639); and evidence of unfair or deceptive credit practices in violation of section 5 of the Federal Trade Commission Act (15 U.S.C. 45(a)(1)).<sup>6</sup> We believe that specifying examples of violations that give rise to adverse CRA consequences in the CRA regulations, rather than solely in interagency guidance on the regulations, will improve the usefulness of the regulations and provide critical information in primary compliance source material.

Under the proposal, a bank's evaluation will be adversely affected by such practices regardless of whether the practices involve loans in the bank's assessment area(s) or in any other location or geography. In addition, a bank's CRA evaluation also can be adversely affected by evidence of such practices by any affiliate, if any loans of that affiliate have been considered in the bank's CRA evaluation.

In response to comments on the February 2004 proposal, the federal banking agencies do not propose to include in the CRA regulations a provision that evidence of collateral-based lending also can adversely affect an agency's evaluation of a bank's CRA performance.

<sup>6</sup> Evidence of credit practices that violate other laws, rules or regulations, including a federal banking agency regulation or a state law, if applicable, also may adversely affect a bank's CRA evaluation.

### Request for Comments

The OCC, FDIC, and Board welcome comments on any aspect of this proposal, particularly, those issues noted below.

- The federal banking agencies invite comment on whether other approaches would be more appropriate to addressing the CRA burdens and obligations of banks with less than \$1 billion in assets. Is there another appropriate asset threshold to use when defining intermediate small banks, and, if so, why?

- We seek comment on the proposal to adjust the asset size for small and intermediate small banks on an ongoing basis, based on changes to the Consumer Price Index.

- Under the proposal, banks with assets between \$250 million and \$1 billion will no longer be required to report data on small business, small farm, and community development lending. The federal banking agencies seek comment specifically addressing whether and how the public has used the loan information that has been reported to date by such intermediate small banks (for example, by reference to specific studies on bank lending patterns that used the data), and whether other sources of data about this lending can be used for such purposes going forward.

- Does the proposal provide more flexibility in how an intermediate small bank may apply its community development resources through a more strategic use of loans, investments and services? Does the proposal to permit examiners to use performance context to give consideration in a current-period rating, to prior-period outstanding investments that reflect a substantial financial commitment by the bank, also provide more flexibility for intermediate small banks?

- Does the proposal to evaluate all community development activities of intermediate small banks under one test have the potential to make the evaluations of those banks' community development performance more effective than under the current regulation?

- Should the community development test for intermediate small banks be separately rated as proposed? If so, should an intermediate small bank be required to achieve a rating of at least "satisfactory" under both the small bank lending and community development tests to achieve an overall "satisfactory" CRA rating? Should the bank's community development test performance be weighted equally with its lending test performance in assigning

an overall CRA rating? Would other ratings floors or weights be appropriate to provide greater flexibility in certain circumstances? If so, under what circumstances?

- The federal banking agencies seek comment on whether the existing definition of "community development" provides sufficient recognition for community services to individuals residing in underserved rural areas and designated disaster areas and, if not, how to encourage the provision of such services to persons in underserved rural areas and designated disaster areas that have the greatest need.<sup>7</sup>

- We also seek comment on the merits of the proposed treatment of the definition of "community development" in underserved rural and designated disaster areas and invite suggestions for alternatives.

- We seek comment on the proper way to define "rural." Should we adopt a definition and, if so, which one? For example, should all areas outside a metropolitan area be considered "rural"? Alternatively, should the federal banking agencies define rural consistent with the definition employed by the Census Bureau? The Census Bureau defines any territory or population not meeting its criteria for "urban" to be "rural." Are there other definitions the federal banking agencies should consider?

- We also seek comment on the proper way to define "underserved" when used in connection with rural areas. Should we adopt a definition and, if so, which one? For example, should the term refer solely to those rural areas showing signs of economic distress or lack of investment? If so, what indicia should the federal banking agencies use to identify such rural areas? Should we use criteria from other federal programs, such as the Community Development

<sup>7</sup> The FDIC's August NPRM added individuals in rural communities to the community services category. Comments were mixed in response to this part of that proposal. Some commenters expressed the concern that a broader definition would permit consideration of activities that benefit middle- and upper-income individuals. On the other hand, others stated that the regulations should recognize that some rural communities lack financial resources for economic and infrastructure improvement such as school construction, revitalizing Main Street, and maintaining or improving water and sewer systems. Banks are frequently called upon to help meet these needs. In light of these comments, this proposal would not change the definition of community development regarding community services provided to low- or moderate-income individuals. Rather, the proposal recognizes that activities that revitalize and stabilize underserved areas may also include many activities that benefit rural residents. We also seek comment on whether the definition of "community development" should be amended to explicitly include community services targeted to individuals in underserved rural and designated disaster areas.

Financial Institutions Fund (CDFI) rules? Indicators used by the CDFI Fund to define "investment areas" include counties with (a) unemployment rates one-and-a-half times the national average, (b) poverty rates of 20% or more, or (c) population loss of 10 percent or more between the previous and most recent census, or a net migration loss of 5 percent or more over the five-year period preceding the most recent census.

- Should "underserved rural area" be defined in the regulation to also encompass those rural areas that have been targeted by a governmental agency for redevelopment, without regard to median income characteristics of the area?

- Should "underserved rural area" be limited to low- and moderate-income areas, without regard to whether those areas show signs of economic distress, lack of investment, or are targeted for redevelopment by a governmental agency? If so, should the OCC, FDIC, and Board adopt a different method than currently exists in the regulation for determining when a rural area is low- or moderate-income? For example, under the current regulations, the area must be a low- or moderate-income census tract, which the regulations define as a tract with median family income that does not exceed 80% of the statewide non-metropolitan median family income. Would raising the low- and moderate-income threshold in non-metropolitan communities from 80% of non-metropolitan median family income to some higher figure, such as 85%, 90%, or 100%, more appropriately identify underserved rural areas? Alternatively, would identifying another measure of median income instead of the non-metropolitan median income, such as the statewide median income, more appropriately define low- and moderate-income for purposes of defining underserved rural areas by reference to low- and moderate-income characteristics?

- As proposed, the definition of "community development" would encompass affordable housing for people who do not meet the regulatory definition of "low- or moderate-income" if, and only if, they reside in underserved rural areas. The federal banking agencies seek comment on whether the current regulatory definition of "low- or moderate-income individual" is unduly restrictive for purposes of identifying individuals in rural areas who need affordable housing. If so, in what ways?

#### Solicitation of Comments on Use of Plain Language

Section 722 of the Gramm-Leach-Bliley Act, Pub. L. 106-102, sec. 722, 113 Stat. 1338, 1471 (Nov. 12, 1999), requires the federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. We invite your comments on how to make the proposal easier to understand. For example:

- Have we organized the material to suit your needs? If not, how could this material be better organized?
- Are the requirements in the proposal clearly stated? If not, how could the regulation be more clearly stated?
- Does the proposal contain language or jargon that is not clear? If so, which language requires clarification?
- Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes to the format would make the regulation easier to understand?
- What else could we do to make the regulation easier to understand?

#### Community Bank Comment Request

In addition, we invite your comments on the impact of this proposal on community banks. The federal banking agencies recognize that community banks operate with more limited resources than larger institutions and may present a different risk profile. Thus, the federal banking agencies specifically request comments on the impact of the proposal on community banks' current resources and available personnel with the requisite expertise, and whether the goals of the proposal could be achieved, for community banks, through an alternative approach.

#### Regulatory Flexibility Act

*OCC and FDIC:* Under section 605(b) of the Regulatory Flexibility Act (RFA), 5 U.S.C. 605(b), the regulatory flexibility analysis otherwise required under section 604 of the RFA is not required if an agency certifies, along with a statement providing the factual basis for such certification, that the rule will not have a significant economic impact on a substantial number of small entities. The OCC and FDIC have reviewed the impact of this proposed rule on small banks and certify that the proposed rule will not have a significant economic impact on a substantial number of small entities.

The Small Business Administration (SBA) has defined "small entities" for banking purposes as a bank or savings institution with less than \$150 million

in assets. See 13 CFR 212.01. This proposed rule primarily affects banks with assets of at least \$250 million and under \$1 billion. The proposed amendments decrease the regulatory burden for banks within that asset range by relieving them of certain reporting and recordkeeping requirements applicable to larger institutions.

The proposal to eliminate the \$1 billion holding company threshold as a factor in determining whether banks will be subject to the streamlined CRA examination or the more in-depth CRA examination applicable to larger institutions will impact a limited number of small banks, which are affiliated with holding companies with assets over \$1 billion. The FDIC estimates that only 110 of approximately 5,300 FDIC-regulated banks had assets of under \$150 million and were affiliated with a holding company with over \$1 billion in assets. The OCC estimates that only 36 of approximately 2,000 OCC-regulated banks met these criteria. Because so few small banks will be affected by the proposed revisions to Parts 25 and 345, a regulatory flexibility analysis is not required. Nevertheless, the OCC and FDIC are willing, in response to any comments received regarding the proposal's economic impact on small banks with assets of under \$150 million, to reevaluate the RFA certifications and, if appropriate, publish regulatory flexibility analyses in conjunction with the issuance of any final rule.

*Board:* Subject to certain exceptions, the Regulatory Flexibility Act (5 U.S.C. 601-612) (RFA) requires an agency to publish an initial regulatory flexibility analysis with a proposed rule whenever the agency is required to publish a general notice of proposed rulemaking for a proposed rule. The Supplementary Information describes the proposed regulations and the proposal's objectives. The Board, in connection with its initial regulatory flexibility analysis, requests public comment in the following areas.

#### A. Reasons for the Proposed Rule

As described in the SUPPLEMENTARY INFORMATION section, the Board, together with the other Agencies, seek to improve the effectiveness of the CRA regulations in placing performance over process, promoting consistency in evaluations, and eliminating unnecessary burden. The proposed rule is intended to reduce unnecessary burden while maintaining or improving CRA's effectiveness in evaluating performance.



### *B. Statement of Objectives and Legal Basis*

The Supplementary Information describes the proposal's objectives. The legal basis for the proposed rule is section 806 of the CRA.

### *C. Description of Small Entities To Which the Rule Applies*

The proposed rule would apply to all state-chartered banks that are members of the Federal Reserve System; there are approximately 932 such banks. The RFA requires the Board to consider the effect of the proposal on small entities, which are defined for RFA purposes as all banks with assets of less than \$150 million. There are 473 state member banks with less than \$150 million of assets. All but about 12 state member banks with assets of less than \$150 million are already subject to a streamlined CRA process that is unaffected by this proposal. The rule would eliminate data reporting requirements for these 12 state member banks by eliminating holding-company affiliation as a disqualification for treatment as a "small bank" under the CRA regulations.

### *D. Projected Reporting, Recordkeeping and Other Compliance Requirements*

The Board does not believe that the proposed rule imposes any new reporting or recordkeeping requirements, as defined in section 603 of the RFA. As noted, the rule would eliminate holding-company affiliation as a disqualification for treatment as a "small bank" under the CRA regulations. Accordingly, the rule would eliminate data reporting requirements for about 12 state member banks with assets of less than \$150 million. As noted above, all other state member banks with assets under \$150 million are already exempt from this reporting requirement.

The Board believes that the proposed revisions to the definition of "community development" would not place additional compliance costs or burdens on small institutions. Instead, this proposal would add greater flexibility to the definition in response to requests made by many small banks. The Board believes the same of the provisions regarding the effect of evidence of illegal credit practices on CRA evaluations. State banks of all sizes are already subject to laws against such practices, and the proposal would not affect that.

The Board seeks information and comment on whether application of the proposed rule would impose any costs, compliance requirements, or changes in

operating procedures in addition to or which may differ from those arising from the application of the statute.

### *E. Identification of Duplicative, Overlapping, or Conflicting Federal Rules*

The Board does not believe there are any federal statutes or regulations that would duplicate, overlap, or conflict with the proposed rule. The Board seeks comment regarding any statutes or regulations, including state or local statutes or regulations, that would duplicate, overlap, or conflict with the proposed rule.

### *F. Discussion of Significant Alternatives*

The proposed rule maintains the approach of the existing CRA regulations in exempting small entities from reporting requirements and providing for streamlined lending evaluations for small entities. A complete exemption of small entities from all of the CRA's requirements would be impermissible under the CRA statute. The Board welcomes comments on any significant alternatives that would minimize the impact of the proposed rule on small entities.

### **Executive Order 12866**

The OCC has determined that this proposed rule is not a significant regulatory action under Executive Order 12866.

### **Unfunded Mandates Reform Act of 1995**

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (2 U.S.C. 1532) (Unfunded Mandates Act), requires that an agency prepare a budgetary impact statement before promulgating any rule likely to result in a Federal mandate that may result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector of \$100 million or more in any one year. If a budgetary impact statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. The OCC has determined that the proposal will not result in expenditures by State, local, and tribal governments, or by the private sector, of \$100 million or more in any one year. Accordingly, the proposal is not subject to section 202 of the Unfunded Mandates Act.

### **Paperwork Reduction Act**

#### *Request for Comment on Proposed Information Collection*

In accordance with the requirements of the Paperwork Reduction Act of 1995, the Agencies may not conduct or sponsor, and the respondent is not required to respond to, an information collection (IC) unless it displays a currently valid Office of Management and Budget (OMB) control number (OCC, 1557-0160; Board, 7100-0197; and FDIC, 3064-0092).

The FDIC has obtained OMB-approval for the paperwork burden associated with its CRA regulation at 12 CFR Part 345 under OMB IC 3064-0092. The change in burden to IC 3064-0092 associated with this proposal to raise the threshold for small banks from those with under \$250 million in assets to those with under \$1 billion in assets was submitted to and approved by OMB in connection with a similar proposal published by the FDIC in August 2004 (69 FR 51611, Aug. 20, 2004). This interagency proposal would not, if adopted as final, result in any added change in burden to IC 3064-0092. Therefore, the FDIC is not required to make a submission to OMB under the Paperwork Reduction Act at this time. Nevertheless, the FDIC joins the OCC and the Board in seeking additional comment on the paperwork burden associated with the current proposal.

The Agencies give notice that, at the end of the comment period, the proposed collections of information, along with an analysis of the comments, and recommendations received, will be submitted to OMB for review and approval.

Comments are invited on:

- (a) Whether the collection of information is necessary for the proper performance of the Agencies' functions, including whether the information has practical utility;
- (b) The accuracy of the estimates of the burden of the information collection, including the validity of the methodology and assumptions used;
- (c) Ways to enhance the quality, utility, and clarity of the information to be collected;
- (d) Ways to minimize the burden of the information collection on respondents, including through the use of automated collection techniques or other forms of information technology; and
- (e) Estimates of capital or start up costs and costs of operation, maintenance, and purchase of services to provide information.

At the end of the comment period, the comments and recommendations

received will be analyzed to determine the extent to which the information collections should be modified prior to submission to OMB for review and approval. The comments will also be summarized or included in the Agencies' requests to OMB for approval of the collections. All comments will become a matter of public record.

Comments should be addressed to:  
**OCC:** Mary H. Gottlieb or Camille Dixon, Office of the Comptroller of the Currency, Legislative and Regulatory Activities Division, Attention: Docket No. 05-04, 250 E Street, SW., Mailstop 8-4, Washington, DC 20219. Due to delays in paper mail in the Washington area, commenters are encouraged to submit their comments by fax to (202) 874-4889 or by e-mail to [camille.dixon@occ.treas.gov](mailto:camille.dixon@occ.treas.gov).

**Board:** Comments should refer to Docket No. R-1225 and may be mailed to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551. Please consider submitting your comments through the Board's Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>, by e-mail to [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov), or by fax to the Office of the Secretary at (202) 452-3819 or (202) 452-3102. Rules proposed by the Board and other federal agencies may also be viewed and commented on at <http://www.regulations.gov>.

All public comments are available from the Board's Web site at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm> as submitted, except as necessary for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (C and 20th Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

**FDIC:** Leneta G. Gregorie, Legal Division, Room MB-3082, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429. All comments should refer to the title of the proposed collection. Comments may be hand-delivered to the guard station at the rear of the 17th Street Building (located on F Street), on business days between 7 a.m. and 5 p.m., Attention: Comments/Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

Comments should also be sent to Mark D. Menchik, Desk Officer, Office of Information and Regulatory Affairs, Office of Management and Budget,

Room 10235, Washington, DC 20503.

Comments may also be sent by e-mail to [Mark\\_D\\_Menchik@omb.eop.gov](mailto:Mark_D_Menchik@omb.eop.gov).

**Title of Information Collection:**

**OCC:** Community Reinvestment Act Regulation—12 CFR 25.

**Board:** Recordkeeping, Reporting, and Disclosure Requirements in Connection with Regulation BB (Community Reinvestment Act).

**FDIC:** Community Reinvestment—12 CFR 345.

**Frequency of Response:** Annual.

**Affected Public:**

**OCC:** National banks.

**Board:** State member banks.

**FDIC:** State nonmember banks.

**Abstract:** This Paperwork Reduction Act section estimates the burden that would be associated with the regulations were the agencies to change the definition of "small institution" as proposed, that is, increase the asset threshold from \$250 million to \$1 billion and eliminate any consideration of holding-company size. The two proposed changes, if adopted, would make "small" approximately 1,522 insured depository institutions that do not now have that status. That estimate is based on data for all FDIC-insured institutions that filed Call Reports in 2004. Those data also underlie the estimated paperwork burden that would be associated with the regulations if the proposals were adopted by the agencies. The proposed change to amend the intermediate small bank performance standards to incorporate a separate community development test would have no impact on paperwork burden because the evaluation is based on information prepared by examiners.

**Estimated Paperwork Burden under the Proposal:**

**OCC:**

**Number of Respondents:** 1,877.

**Estimated Time per Response:** Small business and small farm loan register, 219 hours; Consumer loan data, 326 hours; Other loan data, 25 hours; Assessment area delineation, 2 hours; Small business and small farm loan data, 8 hours; Community development loan data, 13 hours; HMDA out-of-MSA loan data, 253 hours; Data on lending by a consortium or third party, 17 hours; Affiliated lending data, 38 hours; Request for designation as a wholesale or limited purpose bank, 4 hours; Strategic Plan, 275 hours; and Public file, 10 hours.

**Total Estimated Annual Burden:** 160,782 hours.

**Board:**

**Number of Respondents:** 934.

**Estimated Time per Response:** Small business and small farm loan register, 219 hours; Consumer loan data, 326

hours; Other loan data, 25 hours; Assessment area delineation, 2 hours; Small business and small farm loan data, 8 hours; Community development loan data, 13 hours; HMDA out-of-MSA loan data, 253 hours; Data on lending by a consortium or third party, 17 hours; Affiliated lending data, 38 hours; Request for designation as a wholesale or limited purpose bank, 4 hours; and Public file, 10 hours.

**Total Estimated Annual Burden:** 114,580 hours.

**FDIC:**

**Number of Respondents:** 5,296.

**Estimated Time per Response:** Small business and small farm loan register, 219 hours; Consumer loan data, 326 hours; Other loan data, 25 hours; Assessment area delineation, 2 hours; Small business and small farm loan data, 8 hours; Community development loan data, 13 hours; HMDA out-of-MSA loan data, 253 hours; Data on lending by a consortium or third party, 17 hours; Affiliated lending data, 38 hours; Request for designation as a wholesale or limited purpose bank, 4 hours; and Public file, 10 hours.

**Total Estimated Annual Burden:** 193,975 hours.

#### **Executive Order 13132**

The OCC has determined that this proposal does not have any Federalism implications, as required by Executive Order 13132.

#### **List of Subjects**

##### **12 CFR Part 25**

Community development, Credit, Investments, National banks, Reporting and recordkeeping requirements.

##### **12 CFR Part 228**

Banks, Banking, Community development, Credit, Investments, Reporting and recordkeeping requirements.

##### **12 CFR Part 345**

Banks, Banking, Community development, Credit, Investments, Reporting and recordkeeping requirements.

#### **Department of the Treasury**

*Office of the Comptroller of the Currency*

##### **12 CFR Chapter I**

##### *Authority and Issuance*

For the reasons discussed in the joint preamble, part 25 of chapter I of title 12 of the Code of Federal Regulations is proposed to be amended as follows:

**PART 25—COMMUNITY  
REINVESTMENT ACT AND  
INTERSTATE DEPOSIT PRODUCTION  
REGULATIONS**

1. The authority citation for part 25 continues to read as follows:

**Authority:** 12 U.S.C. 21, 22, 26, 27, 30, 36, 93a, 161, 215, 215a, 481, 1814, 1816, 1828(c), 1835a, 2901 through 2907, and 3101 through 3111.

2. In § 25.12, revise paragraphs (g)(1), (g)(4), and (u) to read as follows:

**§ 25.12 Definitions.**

\* \* \* \* \*

(g) *Community development* means:

(1) Affordable housing (including multifamily rental housing) for low- or moderate-income individuals, individuals in underserved rural areas, or individuals located in designated disaster areas;

\* \* \* \* \*

(4) Activities that revitalize or stabilize low- or moderate-income geographies, underserved rural areas, or designated disaster areas.

\* \* \* \* \*

(u) *Small bank*—(1) *Definition.* Small bank means a bank that, as of December 31 of either of the prior two calendar years, had assets of less than \$1 billion. Intermediate small bank means a small bank with assets of at least \$250 million and less than \$1 billion as of December 31 of both of the prior two calendar years.

(2) *Adjustment.* The dollar figures in paragraph (u)(1) of this section shall be adjusted annually and published by the OCC, based on the year-to-year change in the average of the Consumer Price Index for Urban Wage Earners and Clerical Workers, not seasonally adjusted, for each twelve-month period ending in November, with rounding to the nearest million.

\* \* \* \* \*

3. Revise § 25.26 to read as follows:

**§ 25.26 Small bank performance standards.**

(a) *Performance criteria*—(1) *Small banks with assets of less than \$250 million.* The OCC evaluates the record of a small bank that is not, or that was not during the prior calendar year, an intermediate small bank, of helping to meet the credit needs of its assessment area(s) pursuant to the criteria set forth in paragraph (b) of this section.

(2) *Intermediate small banks.* The OCC evaluates the record of a small bank that is, or that was during the prior calendar year, an intermediate small bank, of helping to meet the credit needs of its assessment area(s) pursuant

to the criteria set forth in paragraphs (b) and (c) of this section.

(b) *Lending test.* A small bank's lending performance is evaluated pursuant to the following criteria:

(1) The bank's loan-to-deposit ratio, adjusted for seasonal variation, and, as appropriate, other lending-related activities, such as loan originations for sale to the secondary markets, community development loans, or qualified investments;

(2) The percentage of loans and, as appropriate, other lending-related activities located in the bank's assessment area(s);

(3) The bank's record of lending to and, as appropriate, engaging in other lending-related activities for borrowers of different income levels and businesses and farms of different sizes;

(4) The geographic distribution of the bank's loans; and

(5) The bank's record of taking action, if warranted, in response to written complaints about its performance in helping to meet credit needs in its assessment area(s).

(c) *Community development test.* An intermediate small bank's community development performance also is evaluated pursuant to the following criteria:

(1) The number and amount of community development loans;

(2) The number and amount of qualified investments;

(3) The extent to which the bank provides community development services; and

(4) The bank's responsiveness through such activities to community development lending, investment, and services needs.

3a. Revise § 25.28, paragraph (c) to read as follows:

**§ 25.28 Assigned ratings.**

\* \* \* \* \*

(c) *Effect of evidence of discriminatory or other illegal credit practices.*

(1) The OCC's evaluation of a bank's CRA performance is adversely affected by evidence of discriminatory or other illegal credit practices in any geography by the bank or in any assessment area by any affiliate whose loans have been considered as part of the bank's lending performance. In connection with any type of lending activity described in § 25.22(a), evidence of discriminatory or other credit practices that violate an applicable law, rule, or regulation includes, but is not limited to:

(i) Discrimination against applicants on a prohibited basis in violation, for example, of the Equal Credit Opportunity Act or the Fair Housing Act;

(ii) Violations of the Home Ownership and Equity Protection Act;

(iii) Violations of section 5 of the Federal Trade Commission Act;

(iv) Violations of section 8 of the Real Estate Settlement Procedures Act; and

(v) Violations of the Truth in Lending Act provisions regarding a consumer's right of rescission.

(2) In determining the effect of evidence of practices described in paragraph (c)(1) of this section on the bank's assigned rating, the OCC considers the nature, extent, and strength of the evidence of the practices; the policies and procedures that the bank (or affiliate, as applicable) has in place to prevent the practices; any corrective action that the bank (or affiliate, as applicable) has taken or has committed to take, including voluntary corrective action resulting from self-assessment; and any other relevant information.

4. In Appendix A to part 25, revise paragraph (d) to read as follows:

**Appendix A to Part 25—Ratings**

\* \* \* \* \*

(d) *Banks evaluated under the small bank performance standards.*—(1) *Lending test ratings.*—(i) *Eligibility for a satisfactory lending test rating.* The OCC rates a small bank's lending performance "satisfactory" if, in general, the bank demonstrates:

(A) A reasonable loan-to-deposit ratio (considering seasonal variations) given the bank's size, financial condition, the credit needs of its assessment area(s), and taking into account, as appropriate, other lending-related activities such as loan originations for sale to the secondary markets and community development loans and qualified investments;

(B) A majority of its loans and, as appropriate, other lending-related activities, are in its assessment area;

(C) A distribution of loans to and, as appropriate, other lending-related activities for individuals of different income levels (including low- and moderate-income individuals) and businesses and farms of different sizes that is reasonable given the demographics of the bank's assessment area(s);

(D) A record of taking appropriate action, when warranted, in response to written complaints, if any, about the bank's performance in helping to meet the credit needs of its assessment area(s); and

(E) A reasonable geographic distribution of loans given the bank's assessment area(s).

(ii) *Eligibility for an "outstanding" lending test rating.* A small bank that meets each of the standards for a "satisfactory" rating under this paragraph and exceeds some or all of those standards may warrant consideration for a lending test rating of "outstanding."

(iii) *Needs to improve or substantial noncompliance ratings.* A small bank may also receive a lending test rating of "needs to improve" or "substantial noncompliance" depending on the degree to which its

performance has failed to meet the standard for a "satisfactory" rating.

(2) *Community development test ratings for intermediate small banks*—(i) *Eligibility for a satisfactory community development test rating.* The OCC rates an intermediate small bank's community development performance "satisfactory" if the bank demonstrates adequate responsiveness to the community development needs of its assessment area(s) or a broader statewide or regional area that includes the bank's assessment area(s) through community development loans, qualified investments, and community development services. The adequacy of the bank's response will depend on its capacity for such community development activities, its assessment area's need for such community development activities, and the availability of such opportunities for community development in the bank's assessment area(s).

(ii) *Eligibility for an outstanding community development test rating.* The OCC rates an intermediate small bank's community development performance "outstanding" if the bank demonstrates excellent responsiveness to community development needs in its assessment area(s) through community development loans, qualified investments, and community development services, as appropriate, considering the bank's capacity and the need and availability of such opportunities for community development in the bank's assessment area(s).

(iii) *Needs to improve or substantial noncompliance ratings.* An intermediate small bank may also receive a community development test rating of "needs to improve" or "substantial noncompliance" depending on the degree to which its performance has failed to meet the standards for a "satisfactory" rating.

(3) *Overall rating*—(i) *Eligibility for a satisfactory overall rating.* No intermediate small bank may receive an assigned overall rating of "satisfactory" unless it receives a rating of at least "satisfactory" on both the lending test and the community development test.

(ii) *Eligibility for an outstanding overall rating.* (A) An intermediate small bank that receives an "outstanding" rating on one test and at least "satisfactory" on the other test may receive an assigned overall rating of "outstanding."

(B) A small bank that is not an intermediate small bank that meets each of the standards for a "satisfactory" rating under the lending test and exceeds some or all of those standards may warrant consideration for an overall rating of "outstanding." In assessing whether a bank's performance is "outstanding," the OCC considers the extent to which the bank exceeds each of the performance standards for a "satisfactory" rating and its performance in making qualified investments and its performance in providing branches and other services and delivery systems that enhance credit availability in its assessment area(s).

(iii) *Needs to improve or substantial noncompliance overall ratings.* A small bank may also receive a rating of "needs to

improve" or "substantial noncompliance" depending on the degree to which its performance has failed to meet the standards for a "satisfactory" rating.

\* \* \* \* \*

**Federal Reserve System  
12 CFR Chapter II**

*Authority and Issuance*

For the reasons set forth in the joint preamble, the Board of Governors of the Federal Reserve System proposes to amend part 228 of chapter II of title 12 of the Code of Federal Regulations as follows:

**PART 228—COMMUNITY REINVESTMENT (REGULATION BB)**

1. The authority citation for part 228 continues to read as follows:

*Authority:* 12 U.S.C. 321, 325, 1828(c), 1842, 1843, 1844, and 2901 *et seq.*

2. In § 228.12, revise paragraphs (g)(1), (g)(4), and (u) to read as follows:

**§ 228.12 Definitions.**

\* \* \* \* \*

(g) *Community development* means:

(1) Affordable housing (including multifamily rental housing) for low- or moderate-income individuals, individuals in underserved rural areas, or individuals located in designated disaster areas;

\* \* \* \* \*

(4) Activities that revitalize or stabilize low- or moderate-income geographies, underserved rural areas, or designated disaster areas.

\* \* \* \* \*

(u) *Small bank*—(1) *Definition.* Small bank means a bank that, as of December 31 of either of the prior two calendar years, had assets of less than \$1 billion. Intermediate small bank means a small bank with assets of at least \$250 million and less than \$1 billion as of December 31 of both of the prior two calendar years.

(2) *Adjustment.* The dollar figures in paragraph (u)(1) of this section shall be adjusted annually and published by the Board, based on the year-to-year change in the average of the Consumer Price Index for Urban Wage Earners and Clerical Workers, not seasonally adjusted, for each twelve-month period ending in November, with rounding to the nearest million.

\* \* \* \* \*

3. Revise § 228.26 to read as follows:

**§ 228.26 Small bank performance standards.**

(a) *Performance criteria*—(1) *Small banks with assets of less than \$250 million.* The Board evaluates the record

of a small bank that is not, or that was not during the prior calendar year, an intermediate small bank, of helping to meet the credit needs of its assessment area(s) pursuant to the criteria set forth in paragraph (b) of this section.

(2) *Intermediate small banks.* The Board evaluates the record of a small bank that is, or that was during the prior calendar year, an intermediate small bank, of helping to meet the credit needs of its assessment area(s) pursuant to the criteria set forth in paragraphs (b) and (c) of this section.

(b) *Lending test.* A small bank's lending performance is evaluated pursuant to the following criteria:

(1) The bank's loan-to-deposit ratio, adjusted for seasonal variation, and, as appropriate, other lending-related activities, such as loan originations for sale to the secondary markets, community development loans, or qualified investments;

(2) The percentage of loans and, as appropriate, other lending-related activities located in the bank's assessment area(s);

(3) The bank's record of lending to and, as appropriate, engaging in other lending-related activities for borrowers of different income levels and businesses and farms of different sizes;

(4) The geographic distribution of the bank's loans; and

(5) The bank's record of taking action, if warranted, in response to written complaints about its performance in helping to meet credit needs in its assessment area(s).

(c) *Community development test.* An intermediate small bank's community development performance also is evaluated pursuant to the following criteria:

(1) The number and amount of community development loans;

(2) The number and amount of qualified investments;

(3) The extent to which the bank provides community development services; and

(4) The bank's responsiveness through such activities to community development lending, investment, and services needs.

3a. Revise § 228.28(c) to read as follows:

**§ 228.28 Assigned ratings.**

\* \* \* \* \*

(c) *Effect of evidence of discriminatory or other illegal credit practices.* (1) The Board's evaluation of a bank's CRA performance is adversely affected by evidence of discriminatory or other illegal credit practices in any geography by the bank or in any assessment area by any affiliate whose

loans have been considered as part of the bank's lending performance. In connection with any type of lending activity described in § 228.22(a), evidence of discriminatory or other credit practices that violate an applicable law, rule, or regulation includes, but is not limited to:

(i) Discrimination against applicants on a prohibited basis in violation, for example, of the Equal Credit Opportunity Act or the Fair Housing Act;

(ii) Violations of the Home Ownership and Equity Protection Act;

(iii) Violations of section 5 of the Federal Trade Commission Act;

(iv) Violations of section 8 of the Real Estate Settlement Procedures Act; and

(v) Violations of the Truth in Lending Act provisions regarding a consumer's right of rescission.

(2) In determining the effect of evidence of practices described in paragraph (c)(1) of this section on the bank's assigned rating, the Board considers the nature, extent, and strength of the evidence of the practices; the policies and procedures that the bank (or affiliate, as applicable) has in place to prevent the practices; any corrective action that the bank (or affiliate, as applicable) has taken or has committed to take, including voluntary corrective action resulting from self-assessment; and any other relevant information.

4. In Appendix A to part 228, revise paragraph (d) to read as follows:

#### Appendix A to Part 228—Ratings

\* \* \* \* \*

(d) *Banks evaluated under the small bank performance standards.*—(1) *Lending test ratings.*—(i) *Eligibility for a satisfactory lending test rating.* The Board rates a small bank's lending performance "satisfactory" if, in general, the bank demonstrates:

(A) A reasonable loan-to-deposit ratio (considering seasonal variations) given the bank's size, financial condition, the credit needs of its assessment area(s), and taking into account, as appropriate, other lending-related activities such as loan originations for sale to the secondary markets and community development loans and qualified investments;

(B) A majority of its loans and, as appropriate, other lending-related activities, are in its assessment area;

(C) A distribution of loans to and, as appropriate, other lending-related activities for individuals of different income levels (including low- and moderate-income individuals) and businesses and farms of different sizes that is reasonable given the demographics of the bank's assessment area(s);

(D) A record of taking appropriate action, when warranted, in response to written complaints, if any, about the bank's

performance in helping to meet the credit needs of its assessment area(s); and

(E) A reasonable geographic distribution of loans given the bank's assessment area(s).

(ii) *Eligibility for an "outstanding" lending test rating.* A small bank that meets each of the standards for a "satisfactory" rating under this paragraph and exceeds some or all of those standards may warrant consideration for a lending test rating of "outstanding."

(iii) *Needs to improve or substantial noncompliance ratings.* A small bank may also receive a lending test rating of "needs to improve" or "substantial noncompliance" depending on the degree to which its performance has failed to meet the standard for a "satisfactory" rating.

(2) *Community development test ratings for intermediate small banks.*—(i) *Eligibility for a satisfactory community development test rating.* The Board rates an intermediate small bank's community development performance "satisfactory" if the bank demonstrates adequate responsiveness to the community development needs of its assessment area(s) or a broader statewide or regional area that includes the bank's assessment area(s) through community development loans, qualified investments, and community development services. The adequacy of the bank's response will depend on its capacity for such community development activities, its assessment area's need for such community development activities, and the availability of such opportunities for community development in the bank's assessment area(s).

(ii) *Eligibility for an outstanding community development test rating.* The Board rates an intermediate small bank's community development performance "outstanding" if the bank demonstrates excellent responsiveness to community development needs in its assessment area(s) through community development loans, qualified investments, and community development services, as appropriate, considering the bank's capacity and the need and availability of such opportunities for community development in the bank's assessment area(s).

(iii) *Needs to improve or substantial noncompliance ratings.* An intermediate small bank may also receive a community development test rating of "needs to improve" or "substantial noncompliance" depending on the degree to which its performance has failed to meet the standards for a "satisfactory" rating.

(3) *Overall rating.*—(i) *Eligibility for a satisfactory overall rating.* No intermediate small bank may receive an assigned overall rating of "satisfactory" unless it receives a rating of at least "satisfactory" on both the lending test and the community development test.

(ii) *Eligibility for an outstanding overall rating.* (A) An intermediate small bank that receives an "outstanding" rating on one test and at least "satisfactory" on the other test may receive an assigned overall rating of "outstanding."

(B) A small bank that is not an intermediate small bank that meets each of the standards for a "satisfactory" rating under the lending test and exceeds some or

all of those standards may warrant consideration for an overall rating of "outstanding." In assessing whether a bank's performance is "outstanding," the Board considers the extent to which the bank exceeds each of the performance standards for a "satisfactory" rating and its performance in making qualified investments and its performance in providing branches and other services and delivery systems that enhance credit availability in its assessment area(s).

(iii) *Needs to improve or substantial noncompliance overall ratings.* A small bank may also receive a rating of "needs to improve" or "substantial noncompliance" depending on the degree to which its performance has failed to meet the standards for a "satisfactory" rating.

\* \* \* \* \*

#### Federal Deposit Insurance Corporation 12 CFR Chapter III

##### Authority and Issuance

For the reasons set forth in the joint preamble, the Board of Directors of the Federal Deposit Insurance Corporation proposes to amend part 345 of chapter III of title 12 of the Code of Federal Regulations to read as follows:

#### PART 345—COMMUNITY REINVESTMENT

1. The authority citation for part 345 continues to read as follows:

**Authority:** 12 U.S.C. 1814–1817, 1819–1820, 1828, 1831u and 2901–2907, 3103–3104, and 3108(a).

2. In § 345.12, revise paragraphs (g)(1), (g)(4), and (u) to read as follows:

#### § 345.12 Definitions.

\* \* \* \* \*

(g) *Community development* means:

(1) Affordable housing (including multifamily rental housing) for low- or moderate-income individuals, individuals in underserved rural areas, or individuals located in designated disaster areas;

\* \* \* \* \*

(4) Activities that revitalize or stabilize low- or moderate-income geographies, underserved rural areas, or designated disaster areas.

\* \* \* \* \*

(u) *Small bank.*—(1) *Definition.* Small bank means a bank that, as of December 31 of either of the prior two calendar years, had assets of less than \$1 billion. Intermediate small bank means a small bank with assets of at least \$250 million and less than \$1 billion as of December 31 of both of the prior two calendar years.

(2) *Adjustment.* The dollar figures in paragraph (u)(1) of this section shall be adjusted annually and published by the

FDIC, based on the year-to-year change in the average of the Consumer Price Index for Urban Wage Earners and Clerical Workers, not seasonally adjusted, for each twelve-month period ending in November, with rounding to the nearest million.

3. Revise § 345.26 to read as follows:

**§ 345.26 Small bank performance standards.**

(a) *Performance criteria*—(1) *Small banks with assets of less than \$250 million.* The FDIC evaluates the record of a small bank that is not, or that was not during the prior calendar year, an intermediate small bank, of helping to meet the credit needs of its assessment area(s) pursuant to the criteria set forth in paragraph (b) of this section.

(2) *Intermediate small banks.* The FDIC evaluates the record of a small bank that is, or that was during the prior calendar year, an intermediate small bank, of helping to meet the credit needs of its assessment area(s) pursuant to the criteria set forth in paragraphs (b) and (c) of this section.

(b) *Lending test.* A small bank's lending performance is evaluated pursuant to the following criteria:

(1) The bank's loan-to-deposit ratio, adjusted for seasonal variation, and, as appropriate, other lending-related activities, such as loan originations for sale to the secondary markets, community development loans, or qualified investments;

(2) The percentage of loans and, as appropriate, other lending-related activities located in the bank's assessment area(s);

(3) The bank's record of lending to and, as appropriate, engaging in other lending-related activities for borrowers of different income levels and businesses and farms of different sizes;

(4) The geographic distribution of the bank's loans; and

(5) The bank's record of taking action, if warranted, in response to written complaints about its performance in helping to meet credit needs in its assessment area(s).

(c) *Community development test.* An intermediate small bank's community development performance also is evaluated pursuant to the following criteria:

(1) The number and amount of community development loans;

(2) The number and amount of qualified investments;

(3) The extent to which the bank provides community development services; and

(4) The bank's responsiveness through such activities to community

development lending, investment, and services needs.

3a. Revise § 345.28(c) to read as follows:

**§ 345.28 Assigned ratings.**

(c) *Effect of evidence of discriminatory or other illegal credit practices.* (1) The FDIC's evaluation of a bank's CRA performance is adversely affected by evidence of discriminatory or other illegal credit practices in any geography by the bank or in any assessment area by any affiliate whose loans have been considered as part of the bank's lending performance. In connection with any type of lending activity described in § 345.22(a), evidence of discriminatory or other credit practices that violate an applicable law, rule, or regulation includes, but is not limited to:

(i) Discrimination against applicants on a prohibited basis in violation, for example, of the Equal Credit Opportunity Act or the Fair Housing Act;

(ii) Violations of the Home Ownership and Equity Protection Act;

(iii) Violations of section 5 of the Federal Trade Commission Act;

(iv) Violations of section 8 of the Real Estate Settlement Procedures Act; and

(v) Violations of the Truth in Lending Act provisions regarding a consumer's right of rescission.

(2) In determining the effect of evidence of practices described in paragraph (c)(1) of this section on the bank's assigned rating, the FDIC considers the nature, extent, and strength of the evidence of the practices; the policies and procedures that the bank (or affiliate, as applicable) has in place to prevent the practices; any corrective action that the bank (or affiliate, as applicable) has taken or has committed to take, including voluntary corrective action resulting from self-assessment; and any other relevant information.

4. In Appendix A to part 345, revise paragraph (d) to read as follows:

**Appendix A to Part 345—Ratings**

(d) *Banks evaluated under the small bank performance standards*—(1) *Lending test ratings.*—

(i) *Eligibility for a satisfactory lending test rating.* The FDIC rates a small bank's lending performance "satisfactory" if, in general, the bank demonstrates:

(A) A reasonable loan-to-deposit ratio (considering seasonal variations) given the bank's size, financial condition, the credit needs of its assessment area(s), and taking into account, as appropriate, other lending-related activities such as loan originations for

sale to the secondary markets and community development loans and qualified investments;

(B) A majority of its loans and, as appropriate, other lending-related activities, are in its assessment area;

(C) A distribution of loans to and, as appropriate, other lending-related activities for individuals of different income levels (including low- and moderate-income individuals) and businesses and farms of different sizes that is reasonable given the demographics of the bank's assessment area(s);

(D) A record of taking appropriate action, when warranted, in response to written complaints, if any, about the bank's performance in helping to meet the credit needs of its assessment area(s); and

(E) A reasonable geographic distribution of loans given the bank's assessment area(s).

(ii) *Eligibility for an "outstanding" lending test rating.* A small bank that meets each of the standards for a "satisfactory" rating under this paragraph and exceeds some or all of those standards may warrant consideration for a lending test rating of "outstanding."

(iii) *Needs to improve or substantial noncompliance ratings.* A small bank may also receive a lending test rating of "needs to improve" or "substantial noncompliance" depending on the degree to which its performance has failed to meet the standard for a "satisfactory" rating.

(2) *Community development test ratings for intermediate small banks*—(i) *Eligibility for a satisfactory community development test rating.* The FDIC rates an intermediate small bank's community development performance "satisfactory" if the bank demonstrates adequate responsiveness to the community development needs of its assessment area(s) or a broader statewide or regional area that includes the bank's assessment area(s) through community development loans, qualified investments, and community development services. The adequacy of the bank's response will depend on its capacity for such community development activities, its assessment area's need for such community development activities, and the availability of such opportunities for community development in the bank's assessment area(s).

(ii) *Eligibility for an outstanding community development test rating.* The FDIC rates an intermediate small bank's community development performance "outstanding" if the bank demonstrates excellent responsiveness to community development needs in its assessment area(s) through community development loans, qualified investments, and community development services, as appropriate, considering the bank's capacity and the need and availability of such opportunities for community development in the bank's assessment area(s).

(iii) *Needs to improve or substantial noncompliance ratings.* An intermediate small bank may also receive a community development test rating of "needs to improve" or "substantial noncompliance" depending on the degree to which its performance has failed to meet the standards for a "satisfactory" rating.



(3) *Overall rating*—(i) *Eligibility for a satisfactory overall rating.* No intermediate small bank may receive an assigned overall rating of “satisfactory” unless it receives a rating of at least “satisfactory” on both the lending test and the community development test.

(ii) *Eligibility for an outstanding overall rating.* (A) An intermediate small bank that receives an “outstanding” rating on one test and at least “satisfactory” on the other test may receive an assigned overall rating of “outstanding.”

(B) A small bank that is not an intermediate small bank that meets each of the standards for a “satisfactory” rating under the lending test and exceeds some or all of those standards may warrant consideration for an overall rating of “outstanding.” In assessing whether a bank’s performance is “outstanding,” the FDIC considers the extent to which the bank exceeds each of the performance standards for a “satisfactory” rating and its performance in making qualified investments and its performance in providing branches and other services and delivery systems that enhance credit availability in its assessment area(s).

(iii) *Needs to improve or substantial noncompliance overall ratings.* A small bank may also receive a rating of “needs to improve” or “substantial noncompliance” depending on the degree to which its performance has failed to meet the standards for a “satisfactory” rating.

\* \* \* \* \*

Dated: February 22, 2005.

**Julie L. Williams,**  
*Acting Comptroller of the Currency.*

By order of the Board of Governors of the Federal Reserve System, March 4, 2005.

**Jennifer J. Johnson,**  
*Secretary of the Board.*

By order of the Board of Directors.

Dated at Washington, DC, this 22nd day of February, 2005.

Federal Deposit Insurance Corporation.  
**Robert E. Feldman,**  
*Executive Secretary.*

[FR Doc. 05-4797 Filed 3-10-05; 8:45 am]  
BILLING CODE 4810-33-P; 6210-01-P; 6714-01-P

## DEPARTMENT OF TRANSPORTATION

### Federal Aviation Administration

#### 14 CFR Part 71

[Docket No. FAA 2005-20248; Airspace Docket No. 05-AWP-1]

RIN 2120-AA66

#### Proposed Establishment of Class D Airspace; Front Airport, Denver, CO

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Notice of proposed rulemaking.

**SUMMARY:** This notice proposes to establish Class D airspace at Front Range Airport, Denver, Co. An Airport Traffic Control Tower (ATCT) is being constructed at Front Range Airport, Denver, CO which will meet criteria for Class D airspace, Class D airspace is required when the ATCT is open, and to contain and protect Standard Instrument Approach Procedures (SIAPs) and other Instrument Flight Rules (IFR) operations at the airport. This action would establish Class D airspace extending upward from the surface to 8,000 feet Mean Sea Level (MSL) within a 5.1 nautical mile radius of the airport.

**DATES:** Comments must be received on or before April 11, 2005.

**ADDRESSES:** Send comments on this proposal to the Docket Management System, U.S. Department of Transportation, Room Plaza 401, 400 Seventh Street, SW., Washington, DC 20590-0001. You must identify the docket number FAA-2005-20248/Airspace Docket No. 05-AWP-1, at the beginning of your comments. You may also submit comments on the Internet at <http://dms.dot.gov>. You may review the public docket containing the proposal, any comments received, and any final disposition in person in the Dockets Office between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The Docket Office (telephone 1-800-647-5527) is on the plaza level of the Department of Transportation NASSIF Building at the above address.

An informal docket may also be examined during normal business hours at the office of the Regional Air Traffic Division, Federal Aviation Administration, Room 2010, 15000 Aviation Boulevard, Lawndale California, 90261.

**FOR FURTHER INFORMATION CONTACT:** Larry Tonish, Airspace Specialist, Airspace Branch, Air Traffic Division, Federal Aviation Administration, 15000 Aviation Boulevard, Lawndale, California; telephone (310) 725-6613.

#### SUPPLEMENTARY INFORMATION:

##### Comments Invited

Interested parties are invited to participate in this proposed rulemaking by submitting such written data, views or arguments as they may desire. Comments that provide the factual basis supporting the views and suggestions presented are particularly helpful in developing reasoned regulatory decisions on the proposal. Comments are specifically invited on the overall regulatory, aeronautical, economic, environmental, and energy-related aspects of the proposal.

Communications should identify both docket numbers and be submitted in triplicate to the address listed above. Commenters wishing the FAA to acknowledge receipt of their comments on this notice must submit with those comments a self-addressed, stamped postcard on which the following statement is made: “Comments to Docket No. FAA-2005-20248/Airspace Docket No. 05-AWP-1.” The postcard will be date/time stamped and returned to the commenter. All communications received before the specified closing date for comments will be considered before taking action on the proposed rule. The proposal contained in this notice may be changed in light of the comments received. A report summarizing each substantive public contact with FAA personnel concerned with this rulemaking will be filed in the docket.

#### Availability of NPRMs

An electronic copy of this document may be downloaded through the Internet at <http://dms.dot.gov>. Recently published rulemaking documents can also be accessed through the FAA’s Web page at <http://www.faa.gov> or the Superintendent of Document’s Web page at <http://www.access.gpo.gov/nara>. Additionally, any person may obtain a copy of this notice by submitting a request to the Federal Aviation Administration, Office of Air Traffic Airspace Management, ATA-400, 800 Independence Avenue, SW., Washington, DC 20591, or by calling (202) 267-8783. Communications must identify both docket numbers for this notice. Persons interested in being placed on a mailing list for future NPRM’s should contact the FAA’s Office of Rulemaking, (202) 267-9677, to request a copy of Advisory Circular No. 11-2A, Notice of Proposed Rulemaking Distribution System, which describes the application procedure.

#### The Proposal

The FAA is considering an amendment to part 71 of the Federal Aviation Regulations (14 CFR part 71) to establish Class D airspace at Front Range Airport, Denver, CO. An ATCT is being constructed at Front Range Airport, and Class D airspace is required during the hours the ATCT is open. Class D controlled airspace is necessary for the safety of aircraft executing SIAPs and other IFR operations at Front Range Airport. Class D airspace will be effective during specified dates and times established in advance by a Notice to Airmen. The effective date and time will, thereafter be published in the Airport/Facility Directors.

## Press Releases

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### FDIC Revises Payday Lending Guidance

**FOR IMMEDIATE RELEASE**  
**PR-19-2005 (3-2-2005)**

**Media Contact:**  
**David Barr (202) 898-6992**

The Federal Deposit Insurance Corporation (FDIC) today revised and clarified its July 2003 examination guidance for FDIC-supervised institutions that offer payday loans. Payday loans are small-dollar, unsecured, short-term advances that have high fees relative to the size of the loan. When used frequently or for long periods, the costs can rapidly exceed the amount borrowed and can create a serious financial hardship for the borrower. The FDIC believes that providing high-cost, short-term credit on a recurring basis to customers with long-term credit needs is not responsible lending, and increases banks' credit, legal, reputational and compliance risks. If institutions engaged in payday lending activities fail to limit their risk exposure, operate in a safe and sound manner, or comply with all applicable laws, the FDIC may take a range of actions, including formal and informal enforcement actions, which may require institutions to discontinue payday lending.

The revised guidance targets frequent borrower use of this short-term credit product. It states that banks should ensure that payday loans are not provided to customers who have had payday loans outstanding from any lender for a total of three months in the previous 12-month period. FDIC-supervised institutions currently engaged in payday lending were instructed to submit plans detailing how they will address the revised guidance. Of the more than 5,200 FDIC-supervised institutions, 12 are engaged in payday lending.

"We are troubled when we see banks extending these very high-cost loans to customers who really need an alternative longer-term credit product. The revised guidance being issued today places more responsibility on banks to ensure that the payday loans they are making to customers are what they are being billed as - short-term emergency cash - rather than a regular source of funds," said Michael Zamorski, Director of the Division of Supervision and Consumer Protection.

In addition, the FDIC announced that it anticipates using a mystery shopper program in conjunction with its examination process of institutions involved in payday lending.

###

Attachment: [Guidelines for Payday Lending](#)

Congress created the Federal Deposit Insurance Corporation in 1933 to restore public confidence in the nation's banking system. The FDIC insures deposits at the nation's 8,975 banks and savings associations and it promotes the safety and soundness of these institutions by identifying, monitoring and addressing risks to which they are exposed. The FDIC receives no federal tax dollars - insured institutions fund its operations.

FDIC press releases and other information are available on the Internet via the World Wide Web at [www.fdic.gov](http://www.fdic.gov) and may also be obtained through the FDIC's Public Information Center (877-275-3342 or 202-416-6940).





## Financial Institution Letters

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### Guidelines for Payday Lending

#### Purpose

This guidance provides information about payday lending, a particular type of subprime lending, and supplements and clarifies previously issued guidance about such programs, including the July 2003 Guidelines for Payday Lending.<sup>1</sup> It describes safety and soundness and compliance considerations for examining and supervising state nonmember institutions that have payday lending programs.

This guidance is necessitated by the high risk nature of payday lending and the substantial growth of this product. It describes the FDIC's expectations for prudent risk-management practices for payday lending activities, particularly with regard to concentrations, capital, allowance for loan and lease losses, classifications, and protection of consumers. The guidelines also address recovery practices, income recognition, and managing risks associated with third-party relationships.

When examiners determine that management of safety and soundness or compliance risks is deficient, they should criticize management and initiate corrective action. Such actions may include formal or informal enforcement action. When serious deficiencies exist, enforcement actions may instruct institutions to discontinue payday lending.

#### Background

In recent years a number of lenders have extended their risk selection standards to attract subprime loans. Among the various types of subprime loans, "payday loans" are now offered by an increasing number of insured depository institutions.

Payday loans (also known as deferred deposit advances) are small-dollar, short-term, unsecured loans that borrowers promise to repay out of their next paycheck or regular income payment (such as a social security check). Payday loans are usually priced at a fixed dollar fee, which represents the finance charge to the borrower. Because these loans have such short terms to maturity, the cost of borrowing, expressed as an annual percentage rate (APR), is very high.<sup>2</sup>

In return for the loan, the borrower usually provides the lender with a check or debit authorization for the amount of the loan plus the fee. The check is either post-dated to the borrower's next payday or the lender agrees to defer presenting the check for payment until a future date, usually two weeks or less. When the loan is due, the lender expects to collect the loan by depositing the check or debiting the borrower's account or by having the borrower redeem the check with a cash payment. If the borrower informs the lender that he or she does not have the funds to repay the loan, the loan is often refinanced<sup>3</sup> through payment of an additional fee. If the borrower does not redeem the check in cash and the loan is not refinanced, the lender normally puts the check or debit authorization through the payment system. If the borrower's deposit account has insufficient funds, the borrower typically incurs a NSF charge on this account. If the check or the debit is returned to the lender unpaid, the lender also may impose a returned item fee plus collection charges on the loan.

#### Significant Risks

Borrowers who obtain payday loans generally have cash flow difficulties, and few, if any, lower-cost borrowing alternatives. In addition, some payday lenders perform minimal analysis of the borrower's ability to repay either at the loan's inception or upon refinancing; they may merely require a current pay

stub or proof of a regular income source and evidence that the customer has a checking account. Other payday lenders use scoring models and consult nationwide databases that track bounced checks and persons with outstanding payday loans. However, payday lenders typically do not obtain or analyze information regarding the borrower's total level of indebtedness or information from the major national credit bureaus (Equifax, Experian, TransUnion). In addition, payday lenders generally do not conduct a substantive review of the borrower's credit history. The combination of the borrower's limited financial capacity, the unsecured nature of the credit, and the limited underwriting analysis of the borrower's ability to repay pose substantial credit risk for insured depository institutions.

Insured depository institutions may have payday lending programs that they administer directly, using their own employees, or they may enter into arrangements with third parties. In the latter arrangements, the institution typically enters into an agreement in which the institution funds payday loans originated through the third party. These arrangements also may involve the sale to the third party of the loans or servicing rights to the loans.<sup>4</sup> Institutions also may rely on the third party to provide additional services that the bank would normally provide, including collections, advertising and soliciting applications. The existence of third party arrangements may, when not properly managed, significantly increase institutions' transaction, legal, and reputation risks.

Federal law authorizes federal and state-chartered insured depository institutions making loans to out of state borrowers to "export" favorable interest rates provided under the laws of the state where the bank is located. That is, a state-chartered bank is allowed to charge interest on loans to out of state borrowers at rates authorized by the state where the bank is located, regardless of usury limitations imposed by the state laws of the borrower's residence.<sup>5</sup> Nevertheless, institutions face increased reputation risks when they enter into certain arrangements with payday lenders, including arrangements to originate loans on terms that could not be offered directly by the payday lender.

Payday loans are a form of specialized lending not typically found in state nonmember institutions, and are most frequently originated by specialized nonbank firms subject to state regulation. Payday loans can be subject to high levels of transaction risk given the large volume of loans, the handling of documents, and the movement of loan funds between the institution and any third party originators. Because payday loans may be underwritten off-site, there also is the risk that agents or employees may misrepresent information about the loans or increase credit risk by failing to adhere to established underwriting guidelines.

## Procedures

### General

Examiners should apply this guidance to banks with payday lending programs that the bank administers directly or that are administered by a third party contractor. This guidance does **not** apply to situations where a bank makes occasional low-denomination, short-term loans to its customers.

As described in the *2001 Subprime Guidance*, a program involves the regular origination of loans, using tailored marketing, underwriting standards and risk selection. The *2001 Subprime Guidance* applies specifically to institutions with programs where the aggregate credit exposure is equal to or greater than 25% or more of tier 1 capital. However, because of the significant credit, operational, legal, and reputation risks inherent in payday lending, this guidance applies regardless of whether a payday loan program meets that credit exposure threshold.

All examiners should use the procedures outlined in the *Subprime Lending Examination Procedures*, as well as those described here. While focused on safety and soundness issues, segments of the *Subprime Lending Examination Procedures* also are applicable to compliance examinations. They will need to be supplemented with existing procedures relating to specific consumer protection laws and regulations.

Due to the heightened safety and soundness and compliance risks posed by payday lending, concurrent risk management and consumer protection examinations should be

conducted absent overriding resource or scheduling problems. In all cases, a review of each discipline's examinations and workpapers should be part of the pre-examination planning process. Relevant state examinations also should be reviewed.

Examiners may conduct targeted examinations of the third party where appropriate. Authority to conduct examinations of third parties may be established under several circumstances, including through the bank's written agreement with the third party, section 7 of the Bank Service Company Act, or through powers granted under section 10 of the Federal Deposit Insurance Act. Third party examination activities would typically include, but not be limited to, a review of compensation and staffing practices; marketing and pricing policies; management information systems; and compliance with bank policy, outstanding law, and regulations. Third party reviews should also include testing of individual loans for compliance with underwriting and loan administration guidelines, appropriate treatment of loans under delinquency, and re-aging and cure programs.

### **Third-Party Relationships and Agreements**

The use of third parties in no way diminishes the responsibility of the board of directors and management to ensure that the third-party activity is conducted in a safe and sound manner and in compliance with policies and applicable laws. Appropriate corrective actions, including enforcement actions, may be pursued for deficiencies related to a third-party relationship that pose concerns about either safety and soundness or the adequacy of protection afforded to consumers.

The FDIC's principal concern relating to third parties is that effective risk controls are implemented. Examiners should assess the institution's risk management program for third-party payday lending relationships. An assessment of third-party relationships should include an evaluation of the bank's risk assessment and strategic planning, as well as the bank's due diligence process for selecting a competent and qualified third party provider. (Refer to the *Subprime Lending Examination Procedures* for additional detail on strategic planning and due diligence.)

Examiners also should ensure that arrangements with third parties are guided by written contract and approved by the institution's board. At a minimum, the arrangement should:

- Describe the duties and responsibilities of each party, including the scope of the arrangement, performance measures or benchmarks, and responsibilities for providing and receiving information;
- Specify that the third party will comply with all applicable laws and regulations;
- Specify which party will provide consumer compliance related disclosures;
- Authorize the institution to monitor the third party and periodically review and verify that the third party and its representatives are complying with its agreement with the institution;
- Authorize the institution and the appropriate banking agency to have access to such records of the third party and conduct onsite transaction testing and operational reviews at third party locations as necessary or appropriate to evaluate such compliance;
- Require the third party to indemnify the institution for potential liability resulting from action of the third party with regard to the payday lending program; and
- Address customer complaints, including any responsibility for third-party forwarding and responding to such complaints.

Examiners also should ensure that management sufficiently monitors the third party with respect to its activities and performance. Management should dedicate sufficient staff with the necessary expertise to oversee the third party. The bank's oversight program should monitor the third party's financial condition, its controls, and the quality of its service and support, including its resolution of consumer complaints if handled by the third party. Oversight programs should be documented sufficiently to facilitate the monitoring and management of the risks associated with third-party relationships.

## Safety and Soundness Issues

### Concentrations

Given the risks inherent in payday lending, concentrations of credit in this line of business pose a significant safety and soundness concern. In the context of these guidelines, a concentration would be defined as a volume of payday loans totaling 25 percent or more of a bank's Tier 1 capital. Where concentrations of payday lending are noted, bank management should be criticized for a failure to diversify risks. Examiners will work with institutions on a case-by-case basis to determine appropriate supervisory actions necessary to address concentrations. Such action may include directing the institution to reduce its loans to an appropriate level, raise additional capital, or submit a plan to achieve compliance.

### Capital Adequacy

The FDIC's minimum capital requirements generally apply to portfolios that exhibit substantially lower risk profiles and that are subject to more stringent underwriting procedures than exist in payday lending programs. Therefore, minimum capital requirements are not sufficient to offset the risks associated with payday lending.

As noted in the *2001 Subprime Guidance*, examiners should reasonably expect, as a starting point, that an institution would hold capital against subprime portfolios in an amount that is one and a half to three times greater than what is appropriate for non-subprime assets of a similar type. However, payday lending is among the highest risk subsets of subprime lending, and significantly higher levels of capital than the starting point should be required.

The *2001 Subprime Guidance* indicates that institutions that underwrite higher risk subprime pools, such as payday loans, need significantly higher levels of capital, perhaps as high as 100% of the loans outstanding (dollar-for-dollar capital), depending on the level and volatility of risk. Risks to consider when determining capital requirements include the unsecured nature of the credit, the relative levels of risk of default, loss in the event of default, and the level of classified assets. Examiners should also consider the degree of legal or reputational risk associated with the payday business line, especially as it relates to third-party agreements.

Because of the higher inherent risk levels and the increased impact that payday lending portfolios may have on an institution's overall capital, examiners should document and reference each institution's capital evaluation in their comments and conclusions regarding capital adequacy. (Refer to the *2001 Subprime Guidance* for further information on capital expectations.)

### Allowance for Loan and Lease Losses (ALLL) Adequacy

As with other segments of an institution's loan portfolio, examiners should ensure that institutions maintain an ALLL that is adequate to absorb estimated credit losses within the payday loan portfolio. Consistent with the *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Associations (Interagency Policy Statement on ALLL)*,<sup>6</sup> the term "estimated credit losses" means an estimate of the current amount of loans that is not likely to be collected; that is, net charge-offs that are likely to be realized in a segment of the loan portfolio given the facts and circumstances as of the evaluation date. Although the contractual term of each payday loan may be short, institutions' methodologies for estimating credit losses on these loans should take into account the fact that many payday loans remain continuously outstanding for longer periods because of renewals and rollovers. In addition, institutions should evaluate the collectibility of accrued fees and finance charges on payday loans and employ appropriate methods to ensure that income is accurately measured.

Examiners should ensure that institutions engaged in payday lending have methodologies and analyses in place that demonstrate and document that the level of the ALLL for payday loans is appropriate. The application of historical loss rates to the payday loan

portfolio, adjusted for the current environmental factors, is one way to determine the ALLL needed for these loans. Environmental factors include levels of and trends in delinquencies and charge-offs, trends in loan volume, effects of changes in risk selection and underwriting standards and in account management practices, and current economic conditions. For institutions that do not have loss experience of their own, it may be appropriate to reference the payday loan loss experience of other institutions with payday loan portfolios with similar attributes. Other methods, such as loss estimation models, are acceptable if they estimate losses in accordance with generally accepted accounting principles. Examiners should review documentation to ensure that institutions loss estimates and allowance methodologies are consistent with the *Interagency Policy Statement on ALLL*.

#### **Classification Guidelines**

The *Uniform Retail Credit Classification and Account Management Policy (Retail Classification Policy)*<sup>7</sup> establishes general classification thresholds for consumer loans based on delinquency, but also grants examiners the discretion to classify individual retail loans that exhibit signs of credit weakness regardless of delinquency status. An examiner also may classify retail portfolios, or segments thereof, *where underwriting standards are weak and present unreasonable credit risk*, and may criticize account management practices that are deficient.

Most payday loans have well-defined weaknesses that jeopardize the liquidation of the debt. Weaknesses include limited or no analysis of repayment capacity and the unsecured nature of the credit. In addition, payday loan portfolios are characterized by a marked proportion of obligors whose paying capacity is questionable. As a result of these weaknesses, payday loan portfolios should be classified Substandard.

Furthermore, payday loans that have been outstanding for extended periods of time evidence a high risk of loss. While such loans may have some recovery value, it is not practical or desirable to defer writing off these essentially worthless assets. Payday loans that are outstanding for greater than 60 days from origination generally meet the definition of Loss. In certain circumstances, earlier charge off may be appropriate (i.e., the bank does not renew beyond the first payday and the borrower is unable to pay, the bank closes an account, etc.). The institution's policies regarding consecutive advances also should be considered when determining Loss classifications. Where the economic substance of consecutive advances is substantially similar to "rollovers" - without appropriate intervening "cooling off" or waiting periods - examiners should treat these loans as continuous advances and classify accordingly.

When classifying payday loans, examiners should reference the *Retail Classification Policy* as the source document. Examiners would normally not classify loans for which the institution has documented adequate paying capacity of the obligors and/or sufficient collateral protection or credit enhancement.

#### **Renewals/Rewrites**

The *Retail Classification Policy* establishes guidelines for extensions, deferrals, renewals, or rewrites of closed-end accounts. Despite the short-term nature of payday loans, borrowers that request an extension, deferral, renewal, or rewrite should exhibit a renewed willingness and ability to repay the loan. Examiners should ensure that institutions adopt and adhere to the *Retail Classification Policy* standards that control the use of extensions, deferrals, renewals, or rewrites of payday loans. Under the *Retail Classification Policy*, institutions' standards should:

- Limit the number and frequency of extensions, deferrals, renewals, and rewrites;
- Prohibit additional advances to finance unpaid interest and fees and simultaneous loans to the same customer; and
- Ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained.

In addition to the above items, institutions should also:

- Establish appropriate "cooling off" or waiting periods between the time a payday loan is repaid and another application is made;
- Establish the maximum number of loans per customer that are allowed within one calendar year or other designated time period; and
- Provide that no more than one payday loan is outstanding with the bank at a time to any one borrower.
- Ensure that payday loans are not provided to customers who had payday loans outstanding **at any lender** for a total of three months during the previous 12 months. When calculating the three-month period, institutions should consider the customers' total use of payday loans at all lenders.

When a customer has used payday loans more than three months in the past 12 months, institutions should offer the customer, or refer the customer to, an alternative longer-term credit product that more appropriately suits the customer's needs. Whether or not an institution is able to provide a customer alternative credit products, an extension of a payday loan is not appropriate under such circumstances.

#### **Accrued Fees and Finance Charges<sup>8</sup>**

Examiners should ensure that institutions evaluate the collectibility of accrued fees and finance charges on payday loans because a portion of accrued interest and fees is generally not collectible. Although regulatory reporting instructions do not require payday loans to be placed on nonaccrual based on delinquency status, institutions should employ appropriate methods to ensure that income is accurately measured. Such methods may include providing loss allowances for uncollectible fees and finance charges or placing delinquent and impaired receivables on nonaccrual status. After a loan is placed on nonaccrual status, subsequent fees and finance charges imposed on the borrower would not be recognized in income and accrued, but unpaid fees and finance charges normally would be reversed from income.

#### **Recovery Practices**

After a loan is charged off, institutions must properly report any subsequent collections on the loan.<sup>9</sup> Typically, some or all of such collections are reported as recoveries to the ALLL. In some instances, the total amount credited to the ALLL as recoveries on an individual loan (which may have included principal, finance charges, and fees) may exceed the amount previously charged off against the ALLL on that loan (which may have been limited to principal). Such a practice understates an institution's net charge-off experience, which is an important indicator of the credit quality and performance of an institution's portfolio.

Consistent with regulatory reporting instructions and prevalent industry practice, recoveries represent collections on amounts that were previously charged off against the ALLL. Accordingly, institutions must ensure that the total amount credited to the ALLL as recoveries on a loan (which may include amounts representing principal, finance charges, and fees) is limited to the amount previously charged off against the ALLL on that loan. Any amounts collected in excess of this limit should be recognized as income.

#### **Compliance Issues**

Payday lending raises many consumer protection issues and attracts a great deal of attention from consumer advocates and other regulatory organizations, increasing the potential for litigation. Regardless of whether state law characterizes these transactions as loans, they are considered extensions of credit for purposes of federal consumer protection law. Laws and regulations to be closely scrutinized when reviewing payday lending during consumer compliance examinations include:

#### **Community Reinvestment Act (CRA)/ Part 345**

Under interagency CRA regulations and interpretive guidance, a payday lending program may adversely affect CRA performance. For example, evidence of discriminatory or other

illegal credit practices are inconsistent with helping to meet community credit needs and adversely affect an evaluation of a financial institution's performance. Examples of illegal credit practices include, but are not limited to violations of: the Equal Credit Opportunity Act, concerning discouraging or discriminating against consumers on a prohibited basis; the Truth in Lending Act, regarding disclosures and certain loan restrictions; and the Federal Trade Commission Act, concerning unfair and deceptive acts or practices. Under longstanding interagency regulatory guidance, only illegal credit practices adversely affect CRA performance and may result in a lower CRA rating. As in all other aspects of the CRA evaluation, FDIC examiners will continue to follow the CRA regulations and guidance issued jointly by the federal banking agencies (FDIC, Federal Reserve, OTS and OCC) and in effect at the time of an examination.

However, other questionable payday lending practices, while not specifically prohibited by law, may be inconsistent with helping to meet the convenience and needs of the community. For example, payday loans to individuals who do not have the ability to repay, or that may result in repeated renewals or extensions and fee payments over a relatively short span of weeks, do not help to meet credit needs in a responsive manner. A full description of the payday lending program and such practices should be included in the section of the CRA Public Performance Evaluation that describes the institution. This section provides a description of the institution's profile, business strategy, and product offerings inside and outside the assessment area(s). As with any public comment, public comments regarding payday lending practices should be discussed appropriately in a financial institution's CRA Public Performance Evaluation, and included in the institution's CRA Public File.

#### **Truth in Lending Act/ Regulation Z**

TILA and Regulation Z<sup>10</sup> require banks engaged in consumer lending to ensure that accurate disclosures are provided to customers. A bank that fails to disclose finance charges and APRs accurately for payday loans - considering the small dollar tolerance for inaccuracies - risks having to pay restitution to consumers, which in some instances could be substantial. This risk remains even if the bank provides loans through a third-party agreement.

TILA and Regulation Z also require banks to advertise their loan products in accordance with their provisions. For example, advertisements that state specific credit terms may state only those terms that actually are or will be arranged or offered by the creditor. If an advertisement states a rate of finance charge, it must state the rate as an APR, using that term. If the APR may be increased after the initial origination date, the advertisement must so state. Additional disclosures also may be required in the advertisements.

#### **Equal Credit Opportunity Act/ Regulation B**

Illegal discrimination may occur when a bank has both payday and other short-term lending programs that feature substantially different interest rate or pricing structures. Examiners should determine to whom the products are marketed, and how the rates or fees for each program are set, and whether there is evidence of potential discrimination. Payday lending, like other forms of lending, is also susceptible to discriminatory practices such as discouraging applications, requesting information or evaluating applications on a prohibited basis. If the lender requires that a borrower have income from a job, and does not consider income from other sources such as social security or veterans benefits, then it is illegally discriminating against applicants whose income derives from public assistance.

ECOA and Regulation B limit the type of information that may be requested of applicants during an application for credit. A creditor may not refuse to grant an individual account to a creditworthy applicant on the basis of sex, marital status or any other prohibited basis. A state nonmember bank must ensure that its payday lending program complies with these limitations.

ECOA and Regulation B require creditors to notify applicants of adverse actions taken in



connection with an application for credit. Notices of adverse action taken must be provided within specified time frames and in specified forms. State nonmember banks involved in payday lending must ensure that such notices are given in an accurate and timely manner.

#### **Fair Credit Reporting Act**

A bank engaged directly or indirectly in payday lending is responsible for complying with requirements to provide notice to a consumer when it declines an application for credit or takes other adverse action based on certain information. If adverse action is taken based on information received from a consumer reporting agency, the consumer must be notified and provided the name and address of the consumer reporting agency. It is important to note that information in "bad check lists" or databases that track outstanding payday loans are considered to be consumer reports, and therefore the companies that provide such a tracking service (such as Teletrack) are consumer reporting agencies. If adverse action is taken based on information received from a third party that is not a consumer reporting agency, the adverse action notice must direct the consumer to the bank, and not any third party, for details regarding the character of the information (even where the payday loan applications are received by the bank through a third party such as a payday lender).

#### **Electronic Fund Transfer Act (EFTA)/ Regulation E and Truth in Savings Act (TISA)**

Payday lending arrangements that involve the opening of a deposit account or the establishment of "electronic fund transfers" must meet the disclosure and other requirements of both the EFTA and TISA. Examples include providing a device to access funds from a deposit account, or depositing a payday loan directly in a borrower's account and debiting the subsequent payment.

#### **Fair Debt Collection Practices Act (FDCPA)**

If a bank engages in payday lending through an arrangement with a third party, and the third party collects defaulted debts on behalf of the bank, the third party may become subject to the provisions of the FDCPA. Although the bank itself may not be subject to the FDCPA, it may face reputational risk if the third party violates the FDCPA in collecting the bank's loans. A compliance program should provide for monitoring of collection activities, including collection calls, of any third party on behalf of the bank.

#### **Federal Trade Commission Act (FTC Act)**

The Federal Trade Commission Act (FTC Act) declares that unfair or deceptive trade practices are illegal. (See 15 USC § 45(a)). State nonmember banks and their institution-affiliated parties will be cited for violations of section 5 of the FTC Act and the FDIC will take appropriate action pursuant to its authority under section 8 of the Federal Deposit Insurance Act when unfair or deceptive trade practices are discovered. Examiners should focus attention on marketing programs for payday loans, and also be alert for potentially abusive collection practices. Of particular concern is the practice of threatening, and in some cases pursuing, criminal bad check charges, despite the payment of offsetting fees by the consumer and the lender's knowledge at the time the check was accepted that there were insufficient funds to pay it. If evidence of unfair or deceptive trade practices is found, examiners should consult with the regional office and the region should consult with Washington.

Where entities other than banks engage in unfair or deceptive trade practices, the FDIC will coordinate its response with the Federal Trade Commission. (Refer to FIL-57-2002, dated May 30, 2002, for further information.)

#### **Privacy of Consumer Financial Information/Part 332**

Payday lending arrangements are subject to the same information sharing restrictions and requirements as any other type of financial service or product provided by FDIC-supervised institutions to consumers. The bank should ensure consumers are appropriately provided with a copy of the bank's initial, revised, and annual notices, as applicable. In addition, the bank should ensure that a consumer's nonpublic personal information is used and disclosed only as permitted and described in the privacy notice.

### **Safeguarding Customer Information**

The *Interagency Guidelines Establishing Standards for Safeguarding Customer Information*, Appendix B to Part 364, require banks to implement a written information security program to protect the security, confidentiality, and integrity of customer information. The guidelines require banks to assess reasonably foreseeable internal and external threats that could result in unauthorized uses or destruction of customer information systems, and to design a security program to control those risks. A bank's board of directors should approve the written program and oversee its implementation.

Examiners should ensure the bank has appropriately addressed the security risks in payday lending arrangements to safeguard customer information, whether in paper, electronic, or other form, maintained by or on behalf of the bank.

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<sup>1</sup> See January 31, 2001, interagency Expanded Guidance for Subprime Lending Programs (FIL 9-2001) (2001 Subprime Guidance); January 24, 2000, Subprime Lending Examination Procedures (RD Memo No. 00-004); March 4, 1999, Interagency Guidelines on Subprime Lending (FIL-20-99); and May 2, 1997, Risks Associated with Subprime Lending (FIL-44-97).

<sup>2</sup> The typical charge is \$15 to \$20 per \$100 advanced for a two-week period, resulting in an APR of nearly 400%.

<sup>3</sup> Payday lenders generally use the term "rollover." Other terms used may include extension, deferral, renewal or rewrite.

<sup>4</sup> Insured depository institutions also may fund payday lenders through a lending relationship. This guidance does not address such situations.

<sup>5</sup> See section 27 of the Federal Deposit Insurance Act, 12 U.S.C. § 1831d (enacted as section 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 [the "DIDMCA"]). The authority of national banks to export favorable interest rates on loans to borrowers residing in other states was recognized by the U.S. Supreme Court in *Marquette National Bank of Minneapolis v. First Omaha Service Corp.*, 439 U.S. 299 (1978), in the context of section 85 of the National Bank Act. That authority was subsequently extended to credit unions, savings associations, state nonmember banks and insured foreign branches in the DIDMCA to provide competitive lending equality with national banks.

<sup>6</sup> See July 25, 2001, Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Associations (FIL 63-2001).

<sup>7</sup> See June 29, 2000, Uniform Retail Credit Classification and Account Management Policy (FIL -40-2000).

<sup>8</sup> AICPA Statement of Position 01-6 Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others, provides guidance for accounting for delinquency fees.

<sup>9</sup> AICPA Statement of Position 01-6 provides recognition guidance for recoveries of previously charged-off loans.

<sup>10</sup> Federal Reserve Board staff considered payday loans in the context of Regulation Z, and found that they are a form of credit under the Truth in Lending Act. 12 CFR Part 226, Supplement I, Subpart A, Section 226.2(a)(14), note 2. If the fees are finance charges, as they usually will be, see 12 CFR Part 226.4, they must be disclosed as an APR, regardless of how the fee is characterized under state law.



## Press Releases

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### FDIC to Hold Public Hearing on Preemption Petition

**FOR IMMEDIATE RELEASE**  
**PR-25-2005 (3-16-2005)**

**Media Contact:**  
**David Barr (202-898-6992)**

The Federal Deposit Insurance Corporation (FDIC) has scheduled a public hearing on May 24, 2005, on a preemption petition from the Financial Services Roundtable (Roundtable), a trade association for integrated financial services companies.

The Roundtable has asked the FDIC to issue a rule that would provide that a state bank's home state law governs its interstate activities and those of its subsidiaries to the same extent that the National Bank Act governs a national bank's interstate business. In its request, the Roundtable indicated its belief that such a rule would create parity between state-chartered banks and national banks with interstate activities and operations.

The FDIC is holding the hearing to obtain the public's views on the petition. The FDIC believes that public participation will provide valuable insight into the issues presented by the petition and will assist the FDIC in responding to the rulemaking request. The FDIC is interested in obtaining the views of the financial institutions industry, consumer groups, state financial institution supervisors, other state authorities, industry trade groups and the general public on the legal, policy and other issues raised in the petition.

The hearing will be held on Tuesday, May 24, 2005, from 8:30 a.m. to 5:00 p.m. in the FDIC's Board Room. Anyone interested in making an oral presentation at the hearing must deliver a written request to the FDIC no later than 5:00 p.m., Monday, May 9 and deliver a copy of the written statement and a two-page (or shorter) summary to the FDIC no later than 5:00 p.m., Monday, May 16. Each participant will be limited to a 15-minute oral presentation at the hearing. There is no limit on the length of a participant's written statement. Opportunities to make an oral presentation at the hearing are limited; not all requests may be granted.

Anyone interested in submitting a written statement without making an oral presentation at the hearing may do so. All such statements must be received by the FDIC no later than 5:00 p.m., Monday, May 16. Attendance at the hearing is not required in order to submit a written statement.

Requests to make oral presentations and written statements can be delivered to the FDIC by e-mail, mail or hand-delivery -- e-mail: [comments@fdic.gov](mailto:comments@fdic.gov); mail: Robert E. Feldman, Executive Secretary, 550 17th Street, N.W., Washington, DC 20429; or hand-delivery: Guard station at the rear of 550 17th Street (located on F Street, N.W.) on business days between 7:00 a.m. and 5:00 p.m.

A copy of the Roundtable's petition and the *Federal Register* notice about the hearing and questions the FDIC has about the rulemaking request are available on the FDIC's Web site, <http://www.fdic.gov/regulations/laws/federal/propose.html>.

For more information about the hearing, please contact Valerie Best, Assistant Executive Secretary, at 202-898-3812.

###

Congress created the Federal Deposit Insurance Corporation in 1933 to restore public confidence in the nation's banking system. The FDIC insures deposits at the nation's 8,975 banks and savings associations and it promoted the safety and soundness of these institutions by identifying, monitoring and addressing risks to which they are exposed. The FDIC receives no federal tax dollars - insured institutions fund its operations.

FDIC press releases and other information are available on the Internet via the World Wide Web at [www.fdic.gov](http://www.fdic.gov) and may also be obtained through the FDIC's Public Information Center (877-275-3342 or 202-416-6940).

Last Updated 03/16/2005

[communications@fdic.gov](mailto:communications@fdic.gov)

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defined in the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*), because the majority of applicants (grain industry) that apply for these official services, and are subjected to GIPSA supervision fees, do not meet the requirements for small entities. This rule will affect entities engaged in shipping grain to and from points within the United States and exporting grain from the United States. GIPSA estimates there are approximately 9,500 off-farm storage facilities and 18 export elevators in the United States that could receive services from delegated States or designated agencies. Official services are available from 7 delegated States and 49 designated agencies. For clarification, any and all grain that is exported from the U.S. export port locations must, as required by the USGSA, be inspected and/or weighed. These services are either performed by GIPSA or delegated States. Further, some grain exported from interior locations may also require inspection and/or weighing services unless the services are waived as provided in section 800.18 of the regulations. These services are provided by designated agencies. The USGSA does not require inspection or weighing services for grain marketed within the U.S. Consequently, these services are permissive and may be performed by official agencies. The USGSA (7 U.S.C. 71 *et seq.*) authorizes GIPSA to provide supervision of official grain inspection and weighing services, and to charge and collect reasonable fees for performing these services. The fees collected are to cover, as nearly as practicable, GIPSA's costs for performing these services, including related administrative and supervisory costs.

GIPSA realizes that any increase in supervision fees will be charged by official agencies to the users (grain industry) of the official grain inspection and weighing system. Although, the overall effect of this proposal will be passed on to the users of official grain inspection and weighing services, mostly large corporations, David R. Shipman, Deputy Administrator, GIPSA, has determined that this proposed rule will not have a significant impact on a substantial number of small entities as defined in the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*).

#### List of Subjects in 7 CFR Part 800

Administrative practice and procedure, Grain.

For the reasons set out in the preamble, 7 CFR part 800 is proposed to be amended as follows:

#### PART 800—GENERAL REGULATIONS

1. The authority citation for part 800 continues to read as follows:

Authority: Public Law 94-582, 90 Stat. 2867, as amended (7 U.S.C. 71 *et seq.*)

2. In §800.71(a), Schedule C is amended by removing Table 1 and adding introductory text in its place as set forth below, and by redesignating Table 2 as Table 1.

#### § 800.71 Fees assessed by the Service.

(a) \* \* \*

#### Schedule C—Fees for FGIS Supervision of Official Inspection and Weighing Services Performed by Delegated States and/or Designated Agencies in the United States.

The supervision fee is charged at \$0.011 per metric ton inspected and/or weighed.

\* \* \* \* \*

David R. Shipman,

Acting Administrator, Grain Inspection, Packers and Stockyards Administration.

[FR Doc. 05-5501 Filed 3-18-05; 8:45 am]

BILLING CODE 3410-EN-P

#### FEDERAL DEPOSIT INSURANCE CORPORATION

##### 12 CFR Chapter III

#### Petition for Rulemaking to Preempt Certain State Laws

AGENCY: Federal Deposit Insurance Corporation (FDIC).

ACTION: Notice of public hearing.

**SUMMARY:** This document announces a public hearing on a petition for rulemaking ("Petition") that would preempt certain state laws. Generally, the Petition asks the FDIC to issue a rule that preempts the application of certain state laws to the interstate operations and activities of state banks. The stated purpose of the requested rulemaking is to establish parity between state-chartered banks and national banks in interstate activities and operations. A copy of the Petition is attached to this document. The FDIC has scheduled a hearing to obtain the public's views on the issues presented by the Petition. This document sets forth the date, time, location, and other details of the hearing; it also summarizes the Petition and highlights several issues that participants in the hearing may wish to address. Opportunities to make an oral presentation at the hearing are limited, and not all requests may be granted. Attendance at the hearing is not

required in order to submit a written statement.

**DATES:** The hearing will be held on Tuesday, May 24, 2005, from 8:30 a.m. to 5 p.m. Anyone wishing to make an oral presentation at the hearing must (i) deliver a written request to the Executive Secretary of the FDIC, no later than 5 p.m. on Monday, May 9, 2005; and (ii) deliver a copy of his or her written statement plus a two-page (or less) summary of the statement to the Executive Secretary no later than 5 p.m. on Monday, May 16, 2005. All limited-appearance statements submitted in lieu of an oral presentation must be received by the Executive Secretary no later than 5 p.m. on Monday, May 16, 2005.

**ADDRESSES:** The hearing will be held in the Board room at the FDIC's headquarters, 550 17th Street, NW., Washington, DC.

You may submit a written request to make an oral presentation at the hearing, a copy of the written statement you will present, and the two-page (or less) summary, or a limited-appearance statement by any of the following methods:

- Agency Web site: <http://www.FDIC.gov/regulations/laws/federal/propose.html>. Click on *Submit Comment*.
- E-mail: [comments@FDIC.gov](mailto:comments@FDIC.gov).
- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments/Legal ESS, Room 3060, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.
- Hand Delivered/Courier: The guard station at the rear of the 550 17th Street Building (located on F Street), on business days between 7 a.m. and 5 p.m.
- Public Inspection: All statements and summaries may be inspected and photocopied in the FDIC Public Information Center, Room 100, 801 17th Street, NW., Washington, DC, between 9 a.m. and 4:30 p.m. on business days.
- Internet Posting: Statements and summaries received will be posted without charge to <http://www.FDIC.gov/regulations/laws/federal/propose.html>, including any personal information provided.

**FOR FURTHER INFORMATION CONTACT:** For questions regarding the conduct of the hearing: contact Valerie Best, Assistant Executive Secretary, (202) 898-3812; for questions regarding substantive issues: contact Robert C. Fick, Counsel, (202) 898-8962; or Joseph A. DiNuzzo, Counsel, (202) 898-7349, Legal Division, Federal Deposit Insurance Corporation, Washington, DC 20429.

**SUPPLEMENTARY INFORMATION:**

## I. Overview of the Rulemaking Petition

The Financial Services Roundtable, a trade association for integrated financial services companies ("Petitioner"), submitted the Petition to the FDIC. The Petition asks that the FDIC adopt rules concerning the interstate activities of insured state banks and their subsidiaries that are intended to provide parity between state banks and national banks. Generally, the requested rules would provide that a state bank's home state law governs the interstate activities of state banks and their subsidiaries to the same extent that the National Bank Act ("NBA") governs a national bank's interstate activities. A copy of the entire Petition is appended to this notice. The Petitioner requests that the FDIC adopt rules with respect to the following areas:

- The law applicable to activities conducted in a host state by a state bank that has an interstate branch in that state,
- The law applicable to activities conducted by a state bank in a state in which the state bank does not have a branch,
- The law applicable to activities conducted by an operating subsidiary ("OpSub")<sup>1</sup> of a state bank,
- The scope and application of section 104(d) of the Gramm-Leach-Bliley Act ("GLBA") regarding preemption of certain state laws or actions that impose a requirement, limitation, or burden on a depository institution, or its affiliate, and
- Implementation of section 27 of the Federal Deposit Insurance Act ("FDI Act") (which permits state depository institutions to export interest rates).

The Petitioner argues that it is both necessary and timely for the FDIC to adopt rules that clarify the ability of state banks operating interstate to be governed by a single framework of law and regulation to the same extent as national banks. According to the Petitioner, over the last decade the federal charters for national banks and federal thrifts have been correctly interpreted by the Office of the Comptroller of the Currency ("OCC") and the Office of Thrift Supervision ("OTS"), with the repeated support of the federal courts, to provide broad federal preemption of state laws that might otherwise apply to the activities or operations of federally-chartered banking institutions within a state. The result, it asserts, is that national banks and federal savings associations now can do business across the country

<sup>1</sup> Generally, an operating subsidiary is subsidiary of a bank or savings association that only engages in activities that its parent bank or savings association may engage in.

under a single set of federal rules. In contrast, the Petitioner believes that there is widespread confusion and uncertainty with respect to the law applicable to state banks engaged in interstate banking activities. Furthermore, it argues, this uncertainty produces the potential for litigation and enforcement actions, deters state banks from pursuing profitable business opportunities, and causes substantial expense to a state bank that decides to convert to a national bank in order to gain greater legal certainty. Finally, the Petitioner asserts that the FDIC has the authority, tools and responsibility to correct this imbalance.

## II. The FDIC's Approach to the Petition

The FDIC will hold a hearing to obtain the public's views on the Petition. The FDIC believes that public participation will provide valuable insight into the issues presented by the Petition and will assist the FDIC in deciding how to respond to the rulemaking request. The FDIC's options include: (i) Denying the entire Petition, (ii) granting the entire Petition, (iii) granting the Petition in part and denying the Petition in part, and (iv) seeking further clarification of the Petition from the Petitioner. If the FDIC grants all or part of the Petition, a notice of proposed rulemaking will be published in the *Federal Register*, and an additional opportunity for public comment will be provided. The FDIC is interested in obtaining the views of the financial institutions industry, consumer groups, state financial institution supervisors, other state authorities, industry trade groups and the general public on the legal, policy, and other issues raised in the Petition.

## III. Issues Presented by the Petition

Although the FDIC is particularly interested in obtaining the public's views on the general and specific issues highlighted in this notice, we also are interested in the public's views on any other legal or policy issues implicated by the Petition. As a result, the FDIC encourages interested parties to address not only the highlighted issues, but also all other issues raised by the Petition.

### A. General Issues

With respect to the general issues raised by the Petition, the FDIC requests the public's views on the following:

G-1. Is a preemptive rule in these areas necessary to preserve the dual banking system?

G-2. What would be the impact on consumers if a preemptive rule were issued in these areas?

G-3. What are the implications of rulemaking in these areas for state banking regulation?

G-4. Would the measures urged by Petitioner achieve competitive balance between federally-chartered and state-chartered financial institutions as advocated by the Petitioner?

G-5. Are there alternative mechanisms available that would achieve the policy goals advocated by the Petitioner?

G-6. Should the issue of competitive parity in interstate operations be left to Congress?

G-7. If the FDIC determines that it has the legal authority to proceed with a preemptive rule, are there reasons why the FDIC should decline to do so? If so, what are they?

G-8. What would be the negative impact, if any, of the FDIC adopting a preemptive regulation as suggested by the Petitioner?

G-9. Do the states have a legitimate interest in how banks conduct business within their borders that would be undermined by the Petitioner's request?

G-10. Can state banks be expected to benefit if the FDIC were to preempt state law in the area of interstate banking operations? If so, how?

G-11. What considerations should the FDIC take into account that either support or challenge the proposition that Congress intended to provide the comprehensive parity envisioned by the Petition?

G-12. Is there a need for clarification on what law applies to the interstate operations of state banks?

### B. Specific Issues

Each of the five subject areas addressed by the Petition is described in summary fashion below. However, you are encouraged to read the Petition itself (which is attached) to gain complete details on the requested action. Each of the five subject areas is followed immediately by specific issues upon which the FDIC requests public input.

1. The law Applicable to Activities Conducted in a Host State by a State Bank That has an Interstate Branch in That State

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal I)<sup>2</sup> generally established a federal framework for interstate branching for both state banks and national banks. Both Riegle-Neal I and amendments made to Riegle-Neal I by the Riegle-Neal Amendments Act of

<sup>2</sup> Public Law 103-328, 108 Stat. 2338 (1994) (codified to various sections of title 12 of the United States Code).

1997 ("Riegle-Neal II")<sup>3</sup> contain express preemption provisions regarding which host state laws apply to a branch of an out-of-state bank.

The Petitioner asserts that Congress enacted Riegle-Neal II to provide competitive equality between state banks and national banks with respect to interstate banking. Riegle-Neal II revised the language of section 24(j)(1) of the FDI Act to read as follows:

The laws of the host state, including laws regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches, shall apply to any branch in the host state of an out-of-state state bank to the same extent as such state laws apply to a branch in the host state of an out-of-state national bank. To the extent host state law is inapplicable to a branch of an out-of-state state bank in such host state pursuant to the preceding sentence, home state law shall apply to such branch.

Riegle-Neal II, therefore, provides that host state law does not apply to a branch in the host state of an out-of-state, state bank to the same extent that host state law does not apply to a branch in the host state of an out-of-state national bank. When host state law does not apply, Riegle-Neal II provides that home state law applies. The Petitioner raises the issue of what law applies to activities of an out-of-state, state bank in a host state in which the bank maintains a branch, when those activities are conducted by the bank directly, or through an OpSub, or by some means other than the branch. The Petitioner argues that the FDIC should issue a rule that provides that home state law applies uniformly to all business of the bank in that State, whether by the bank directly, through the host state branch, through a loan production office ("LPO"), or through some other non-branch office, or through an OpSub.

The FDIC requests the public's views on the following specific issues:

1-1. What considerations should the FDIC take into account that either support or challenge the proposition that Congress granted the FDIC the authority to make home state law apply to all business conducted by a state bank in a host state in which the bank has a branch, whether conducted directly, or through a branch, a loan production office (an LPO), other office, or OpSub?

1-2. If the FDIC were to adopt a rule as requested, who should determine for each state whether the NBA and OCC rules would preempt host state law for national banks?

1-3. If the FDIC were to adopt a rule as requested, how should the applicable home state law be determined when the home state statute law is silent?

2. The law Applicable to Activities Conducted by a State Bank in a State in Which the State Bank Does Not Have a Branch

The Petitioner requests that the FDIC adopt rules to provide that the home state law of a state bank will apply to its activities in other states (i.e., any state other than its home state) to the same extent as the NBA applies to the activities of national banks. The Petitioner cites Riegle-Neal II and section 104(d) of GLBA as an indication of Congressional intent on this issue. In addition, Petitioner refers to principles of administrative law that permit an agency to reasonably fill in statutory gaps and address the application of existing laws to new developments.

The FDIC requests the public's views on the following specific issue(s):

2-1. What considerations should the FDIC take into account that either support or challenge the proposition that an out-of-state, state bank should be able to operate in a state where the bank has no branches under the bank's home state law to the same extent that an out-of-state national bank can operate under the NBA and OCC rules?

3. The law Applicable to Activities Conducted by an Operating Subsidiary ("OpSub") of a State Bank

The Petitioner requests that FDIC adopt a rule that expressly provides that an OpSub of a state bank will be governed by the same law that is applicable to its parent state bank, except when state law applies to an OpSub of a national bank.

The FDIC requests the public's views on the following specific issues:

3-1. What considerations should the FDIC take into account that either support or challenge the proposition that an OpSub should be able to operate under the bank's home state law to the same extent that an OpSub of a national bank can operate under the NBA and OCC rules?

3-2. What considerations should the FDIC take into account that either support or challenge the proposition that an OpSub should be deemed equivalent to a division of the bank itself?

3-3. If the FDIC were to adopt the requested rule, what requirements should the subsidiary meet in order to be considered an OpSub, e.g., should it be wholly-owned, majority-owned, or just controlled by the bank?

4. The Scope and Application of Section 104(d) of GLBA Regarding Preemption of Certain State Laws or Actions That Impose a Requirement, Limitation, or Burden on a Depository Institution, or Its Affiliate

Section 104 of the GLBA ("section 104")<sup>4</sup> is titled "Operation of State Law." It expresses the intent of Congress that the McCarran-Ferguson Act which is entitled "An Act to express the intent of Congress with reference to the regulation of the business of insurance"<sup>5</sup> "remains the law of the United States." (Section 104(a)). In addition, it: (a) Addresses insurance licensing requirements for persons engaged in the business of insurance; (b) addresses the extent to which a state may regulate affiliations between depository institutions and insurers; (c) addresses the extent to which states may impose restrictions on insurance sales by depository institutions; (d) indicates that states may not prevent or restrict depository institutions or their affiliates from engaging in activities authorized or permitted under GLBA;<sup>6</sup> and (e) limits the ability of states to discriminate between depository institutions engaged in insurance activities authorized or permitted by GLBA or other federal law and others engaged in such activities.

The Petitioner contends that section 104(d) expressly preempts state laws or actions that discriminate against "depository institutions" or their affiliates. It urges the FDIC to exercise its authority under sections 8 and 9 of the FDI Act to adopt rules to make it clear that state laws, rules, or actions are preempted under section 104(d) when they provide for disparate treatment between an out-of-state national bank or in-state bank and an out-of-state state bank, or its affiliates. The Petitioner suggests, alternatively, that the FDIC adopt a statement of policy addressing the scope and effect of section 104(d) for state banks. The Petitioner asserts that although state banks subject to FDIC regulation are the intended beneficiaries of this express preemption, the preemption is not being utilized by state banks because the statute is relatively new and complex and the relevant provisions have not been construed by any

<sup>4</sup> 15 U.S.C. 6701.

<sup>5</sup> 15 U.S.C. 1011 *et seq.* Among other things, the McCarran-Ferguson Act provides that "the business of insurance, and every person engaged therein, should be subject to the laws of the several states which relate to the regulation or taxation of such business." (15 U.S.C. 1012(a)) and that "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance \* \* \* unless such Act specifically relates to the business of insurance." (15 U.S.C. 1012(b)).

<sup>6</sup> See section 104(d)(1).

<sup>3</sup> Public Law 105-24 (1997).



agency or court. It states that rules are needed in view of the complexity and general lack of understanding of section 104(d).

The Petitioner argues that the breadth of section 104(d) preemption and its purpose to reach state law or actions that would provide disparate treatment for any type of depository institution (including an out-of-state state bank) in relation to its competitors is evident from section 104(d)'s language.

The Petitioner has described certain actions that if taken by the FDIC will, in its opinion, clarify by regulation or policy statement that state laws, rules, or actions cannot differentiate between in-state and out-of-state banks. The Petitioner specifically requests that the FDIC issue a rule or policy statement: (a) Stating that the section 104 preemption applies to insured banks and their subsidiaries, affiliates and associated persons; (b) defining a "person" to include a depository institution, subsidiary, affiliate, and associated person; (c) stating that the word "restrict" in section 104(d)(1) includes any state law, rule, interpretation or action that calls for any limitation or requirement; (d) addressing each of the four non-discrimination provisions in section 104(d)(4) to confirm that each is a distinct test and that any state law or action that fails one test is preempted; (e) addressing the scope of "actions" in section 104(d)(4) to include all types of formal or informal administrative actions by any state or local governmental entity, including decisions with respect to civil enforcement of state rules; (f) addressing section 104(d)(4)(D)(i) in light of the terms used in subparagraph (ii) to specify that paragraph (i) addresses treatment under state law of an out of state, state bank which would be an "insured depository institution," that is different from the treatment of any national bank or in-state state bank which would be an "other person engaged in the same activity" under these provisions; and (g) defining "state law" to include laws, ordinances and rules of political subdivisions, including any counties and municipalities.

The FDIC requests the public's views on the following specific issues:

4-1. GLBA is a not codified as part of the FDI Act, is silent as to rulemaking and applies to all insured depository institutions. What barriers, if any, would there be to the FDIC adopting a regulation or policy statement implementing section 104?

4-2. What considerations should the FDIC take into account that either support or challenge the proposition

that section 104 preempts state law in the manner described by Petitioner?

4-3. What barriers, if any, would there be to the FDIC adopting a regulation or policy statement applicable to all insured depository institutions based on section 104?

4-4. Is it reasonable for the FDIC to read section 104 as having some application to interstate banking operations in general?

4-5. The areas of section 104 Petitioner identifies for rulemaking are very discrete but taken together may have a broad impact. What are the overall implications (favorable as well as negative) of adopting the section 104 regulatory guidance suggested by the Petitioner?

5. Implementation of Section 27 of the FDI Act (Which Permits State Depository Institutions To Export Interest Rates)

Section 27 of the FDI Act ("section 27")<sup>7</sup> establishes the maximum amount of interest that a state-chartered insured depository institution or insured branch of a foreign bank (collectively, "state bank") may charge its borrowers. Generally, the statute authorizes a state bank to charge interest at the greater of the rate allowed by the laws of the State, territory, or district where the bank is located or not more than one percentage point above the discount rate on 90-day commercial paper at the Federal Reserve bank for the Federal Reserve district where the bank is located.<sup>8</sup> The statute also specifies that state banks may charge the rates authorized by the statute "notwithstanding any State constitution or statute which is hereby preempted for the purposes of this section."<sup>9</sup> As is the case under section 85 of the NBA for national banks, section 27 allows state banks to charge out-of-state borrowers interest at the rates allowed by the law of the State where the bank is located, even if such rates exceed the usury limitations imposed by the borrower's state of residence.<sup>10</sup>

Section 27 contains two subsections which are patterned after provisions in the NBA. Subsection (a) corresponds to section 85 of the NBA ("section 85"),<sup>11</sup> which addresses the interest rates that

national banks are authorized to charge their borrowers. Subsection (b) corresponds to section 86 of the NBA ("section 86"),<sup>12</sup> which addresses penalties and limitations of actions for charging interest in excess of the amount allowable under section 85.

Because section 27 was enacted to provide state banks "competitive equality" with national banks and is patterned after the corresponding provisions in the NBA, the FDIC and the courts have construed section 27 in virtually the same manner as the OCC and the courts have construed sections 85 and 86. For example, in General Counsel's Opinion No. 10 ("GC Opinion No. 10"),<sup>13</sup> the FDIC's General Counsel concluded that section 27 and section 85 should be construed in *pari materia* and that the term interest, for purposes of section 27, includes those charges that a national bank is authorized to charge under section 85 and the OCC's interpretive rule defining interest for purposes of section 85.<sup>14</sup> In General Counsel's Opinion No. 11 ("GC Opinion No. 11")<sup>15</sup> the FDIC's General Counsel interpreted section 27 as applying to state banks operating interstate branches in a manner similar to the OCC's interpretation of the application of section 85 to national banks operating interstate branches. In GC Opinion No. 11 it was observed that, like an interstate national bank under section 85, a state bank is "located" in the state where it is chartered and in each state where it has a branch. GC Opinion No. 11 also addressed the criteria for determining when the state laws imposed by the bank's home state or host state should govern the amount of interest authorized on a loan transaction. In addition, the FDIC has interpreted section 27 as providing state banks: (a) The same "most favored lender" status under section 27 as national banks are provided under section 85; (b) the same right to export interest authorized by the state laws of the state where the bank is located to out-of-state borrowers; and (c) the same exclusive remedy for usury violations as is provided national banks under section 86.<sup>16</sup>

<sup>12</sup> 12 U.S.C. 86.

<sup>13</sup> GC Opinion No. 10, 63 FR 19258 (Apr. 17, 1998).

<sup>14</sup> 12 CFR 7.4001(a).

<sup>15</sup> GC Opinion No. 11, 63 FR 27282 (May 18, 1998).

<sup>16</sup> FDIC Advisory Opinion No. 81-3, February 3, 1981, reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,006; FDIC Advisory Opinion No. 81-7, March 17, 1981, reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,008; FDIC Advisory Opinion No. 02-06, December 19, 2002, reprinted in Fed. Banking L. Rep. (CCH) ¶ 82-256.

<sup>7</sup> 12 U.S.C. 1831d.

<sup>8</sup> Section 27 was added to the FDI Act by section 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMCA").

<sup>9</sup> Section 27(a) of the FDI Act; see generally *Greenwood Trust Co. v. Commonwealth of Massachusetts*, 971 F.2d 818 (1st Cir.), cert. denied, 506 U.S. 1052 (1993).

<sup>10</sup> This ability to charge interest at the rates allowed by the state where the bank is located is often referred to as the "exportation doctrine."

<sup>11</sup> 12 U.S.C. 85.

The Petitioner observes that the OCC and OTS have adopted rules codifying the scope of the relevant parallel interest provisions<sup>17</sup> contained in their respective statutes.<sup>18</sup> Therefore, the Petitioner requests that the FDIC adopt parallel provisions by rule to allow state banks to operate in a matching legal framework under section 27.

Therefore, the FDIC requests the public's views on the following specific issues:

5-1. Should the FDIC adopt a parallel rule implementing section 27 for state banks similar to 12 CFR 7.4001 and 12 CFR 560.110?

5-2. Should any other issues be addressed by rulemaking to provide state banks competitive equality with national banks regarding section 27? For example, 12 CFR 7.5009 addresses the location under section 85 of national banks operating exclusively through the Internet. Is a similar rule needed for state banks under section 27?

Under section 525 of the Depository Institutions Deregulation and Monetary Control Act states may "opt-out" of coverage under section 27 at any time.<sup>19</sup> The FDIC believes that Iowa, Puerto Rico, and Wisconsin are the only jurisdictions that have exercised this authority and not rescinded it.

Therefore, the FDIC requests the public's views on the following specific issue:

5-3. What effect would the exercise of the authority to opt-out of coverage under section 27 have on the rule or rules the Petitioner is requesting?

#### IV. Public Hearing

The FDIC will hold a hearing to obtain the public's views on all issues raised by the Petition. The hearing will be held on Tuesday, May 24th, 2005 from 8:30 a.m. to 5 p.m. in the Board room at the FDIC's headquarters, 550 17th Street, NW., Washington, DC. Hearing Officers designated by the FDIC will preside over the hearing. The hearing will be informal, and the rules of evidence will not apply. However, only the Hearing Officers may question a participant during a presentation. Each participant making an oral presentation at the hearing will be limited to 15 minutes. While oral presentations are limited to 15 minutes,

there is no limit on the length of a participant's written statement.

Anyone wishing to make an oral presentation at the hearing must (i) deliver a written request to the Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429 no later than 5 p.m. on Monday, May 9th, 2005; and (ii) deliver a copy of his or her written statement plus a two-page (or less) summary to the Executive Secretary no later than 5 p.m. on Monday, May 16th, 2005. Anyone wishing to submit a written statement of his or her views without making an oral presentation at the hearing may submit a limited-appearance statement. All limited-appearance statements must be received by the Executive Secretary no later than 5 p.m. on Monday, May 16th, 2005. Attendance at the hearing is not required in order to submit a written statement. Each request to make an oral presentation and each participant's statement must include the participant's name, address, telephone number, e-mail address, and, if applicable, the name and address of the institution or organization the participant represents.

Opportunities to make an oral presentation at the hearing are limited, and not all requests may be granted. The FDIC will notify each person who has submitted a request to make an oral presentation at the hearing whether the FDIC will be able to accommodate his or her request. The notice for each person whose request has been granted will include the time scheduled for his or her presentation and a tentative agenda. Depending upon the number of participants requesting an oral presentation, participants may be organized into panels of two or three to accommodate as many participants as possible.

The hearing will be transcribed. The FDIC will provide attendees with any auxiliary aids (e.g., sign language interpretation) required for this meeting. Those attendees needing such assistance should call (202) 416-2089 (Voice); or (202) 416-2007 (TTY), to make necessary arrangements.

Dated in Washington DC, this 16th day of March, 2005.

Federal Deposit Insurance Corporation.

Robert E. Feldman,  
Executive Secretary.

**Appendix: Petition for FDIC Rulemaking Providing Interstate Banking Parity for Insured State Banks, by Letter From the Financial Services Roundtable, 1001 Pennsylvania Ave., NW., Suite 500 South, Washington, DC 20004, Tel 202-289-4322, Fax 202-628-2507, dated March 4, 2005**

March 4, 2005

Robert E. Feldman,  
Executive Secretary, Federal Deposit Insurance Corporation, 550 Seventeenth Street, NW., Washington, DC 20429.

Re: Petition for FDIC Rulemaking Providing Interstate Banking Parity for Insured State Banks

Dear Mr. Feldman: The Financial Services Roundtable<sup>1</sup> ("Roundtable") respectfully petitions the Federal Deposit Insurance Corporation ("FDIC") to promulgate rules under the Federal Deposit Insurance ("FDI") Act and Section 104(d) of the Gramm-Leach-Bliley ("GLB") Act, 15 U.S.C. 6701, to provide parity for state banks and national banks. Specifically, the proposed rule would provide that a state bank's home state law governs the interstate activities of insured state banks and their subsidiaries to the same extent that the National Bank Act governs a national bank's interstate business.

The FDIC has ample authority to take each of the requested actions pursuant to the broad delegation of authority in the FDI Act. It is now clear that FDIC action is required to achieve the result that Congress sought in the 1997 amendment to the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 ("Riegle-Neal I"), Pub. L. 103-328, 108 Stat. 238. See Riegle-Neal Amendments Act of 1997, Pub. L. 105-24 (1997) (amending 12 U.S.C. 1831a(j)) ("Riegle-Neal II"). The requested rulemaking would implement the historic decision of Congress in 1997 to provide competitive equality for state banks and national banks in interstate banking.

The Roundtable submits that it is both necessary and timely for the FDIC to adopt rules making clear the ability of state banks operating interstate to be

<sup>17</sup> 12 CFR 7.4001; 12 CFR 560.110.

<sup>18</sup> The relevant parallel interest provision for the OTS is section 4(g) of the Home Owners Loan Act (12 U.S.C. 1463(g)), which was derived from section 522 of DIDMCA.

<sup>19</sup> Section 525 of DIDMCA, like section 528 that provides lenders a choice of interest rates, is contained in various notes in the United States Code following the various sections that they affect. See, e.g., 12 U.S.C. 1831d (note).

<sup>1</sup> The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Roundtable member companies provide fuel for America's economic accounting directly for \$18.3 trillion in managed assets, \$678 billion in revenue, and 2.1 million jobs.

governed by a single framework of law and regulation to the same extent as national banks. Such an action would ensure the continued vitality of the dual banking system. Accordingly, the Roundtable requests that the FDIC promulgate rules that:

1. Clarify that the governing law applicable to activities conducted in a host state by a state bank that has an interstate branch in that state is its home state law to the same extent that host state law is preempted by the National Bank Act. The FDIC should make clear that "home" state law applies to an out-of-state state bank in a "host" state to the same extent as the National Bank Act applies to an out-of-state national bank, whether the business of the bank is conducted by the bank through the host state branch, by or through an operating subsidiary, or by any other lawful means.

2. Clarify that the governing law applicable to activities conducted by a state bank in a state in which the state bank does not have a branch is its home state law to the same extent that host state law is preempted by the National Bank Act. The FDIC should make clear that a state bank may operate under home state law in any other state to the same extent that an out-of-state national bank may operate under the National Bank Act or under rules promulgated by the Comptroller of the Currency ("OCC"). Such a rule would give effect to the policy underlying Riegle-Neal II and the preemption of discriminatory state law provided in Section 104(d) of the Gramm-Leach-Bliley ("GLB") Act ("Section 104(d)"), 15 U.S.C. 6701(d).

3. Clarify that the law applicable to activities conducted by an operating subsidiary of a state bank is the same law applicable to the bank itself. The FDIC should clarify that when a state bank has established an "operating subsidiary" pursuant to its home state law, that subsidiary will be treated under FDIC rules as if it were the state bank itself. Thus, the operating subsidiary will be subject to state law outside its home state in the same manner as its bank parent is subject to such state law. Such rules would allow state bank operating subsidiaries to engage in interstate business under the same uniform rules as its parent bank, just as national bank operating subsidiaries operate under uniform OCC rules.

4. Adopt rules construing the scope and application of Section 104(d) to make clear that a state law or action is expressly preempted under Section 104(d) when it imposes a requirement, limitation, or burden on a state bank, or its affiliate, that does not also apply to

an out-of-state national bank or in-state bank. Section 104(d) expressly preempts state laws or actions that discriminate against "insured depository institutions," or their affiliates, as defined in the FDI Act. Accordingly, Section 104(d) provides independent basis and support for each of the above requests. Moreover, through implementing rules, the FDIC would provide greater certainty to insured state banks with respect to the scope of this express federal preemption in general. This provision is not well understood and we believe that a rulemaking, not litigation, is the appropriate means to carry out Congressional intent and achieve needed clarity.

5. Implement Section 27 of the FDI Act by adopting a rule parallel to the rules promulgated by the OCC and Office of Thrift Supervision ("OTS"). The scope and implementation of the express preemption for the "interest rate" charged in interstate lending transactions by state and national banks under Section 27 of the FDI Act and Section 85 of the National Bank Act has been authoritatively addressed by the courts and in agency interpretations. The OCC and OTS have adopted rules codifying the scope of the respective statutory provisions for federal institutions. The FDIC should adopt a parallel rule for insured state banks and thus codify existing agency interpretations.

In this letter, we will address (A) the urgent need for the requested rulemaking and the real costs of inaction, (B) the FDIC's authority to promulgate rules of the scope requested, (C) the legislative history demonstrating that Congress specifically intended in Riegle-Neal II to prevent erosion of the dual banking system and in Section 104(d) to prevent disparate treatment and ensure that all banks could compete on relatively equal terms in today's interstate financial services marketplace, and (D) the scope of the proposed rule provisions in greater detail. The Roundtable appreciates the FDIC's consideration of this petition.

#### A. A Rulemaking Is Necessary and the Costs of Inaction Will Be Significant

The requested FDIC action in this petition is necessary to complete the task of restoring balance in the dual banking system that Congress sought to achieve in 1997. Riegle-Neal II reversed a decision in 1994 to treat state and national banks differently with respect to "applicable law." In Riegle-Neal I, state and national banks were under the same rules for the establishment of interstate branches. However, Riegle-Neal I provided that when a national

bank branched interstate into a host state, it was in effect generally subject to the National Bank Act,<sup>2</sup> while the state bank in a parallel case was made subject to host state law. While interstate national banks could operate under a single law, interstate state banks were subjected to multiple state laws.

That disparity led Congress in 1997 to amend Riegle-Neal to adopt an applicable law provision for state banks that closely tracked the national bank provision in Section 36(f) of the National Bank Act.<sup>3</sup> The purpose of the 1997 amendment, which was stated repeatedly by its sponsors, was to provide parity between state banks and national banks with respect to interstate banking.<sup>4</sup> By "parity," they plainly meant the ability of state banks to do business interstate under a uniform law (home state law) just as national banks were authorized to do under Riegle-Neal.<sup>5</sup>

Over the last decade, the federal charters for national banks and federal thrifts have been correctly interpreted by the OCC and OTS, with the repeated support of the federal courts, to provide broad federal preemption of state laws that might appear to apply to the activities or operations of a banking institution in that state. The result is that, in general, national banks and

<sup>2</sup> The Riegle-Neal applicable law provision for national banks states: "(A) In general The laws of the host State regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches shall apply to any branch in the host State of an out-of-State national bank to the same extent as such State laws apply to a branch of a bank chartered by that State, except—(i) when Federal law preempts the application of such State laws to a national bank; or (ii) when the Comptroller of the Currency determines that the application of such State laws would have a discriminatory effect on the branch in comparison with the effect the application of such State laws would have with respect to branches of a bank chartered by the host State." 12 U.S.C. 36(f)(1)(A). The effect of this provision is that any host state law, including a community reinvestment, consumer protection, fair housing, or intrastate branching law, that is preempted under the National Bank Act does not apply to the national bank branch (or the bank) in the host state.

<sup>3</sup> Compare 12 U.S.C. 1831a(j)(1) (text in footnote 9) with 12 U.S.C. 36(f)(1)(A) (text in footnote 2).

<sup>4</sup> As stated by the led sponsor in the House, Rep. Roukema: "The essence of this legislation is to provide parity between state-chartered banks and national banks." 143 Cong. Rec. H3088 (daily ed. May 21, 1997).

<sup>5</sup> See, e.g., statements by the principal sponsors of the 1997 Amendment, Rep. Roukema ("\* \* \* we have \* \* \* with this action, protected the dual banking system while at the same time gaining the advantages of interstate banking"), 143 Cong. Rec. H4231 (daily ed. June 24, 1997), and Chairman D'Amato ("Enactment of H.R. 1306 also would bolster efforts of New York and other states to make sure that State[-]chartered banks have the powers they need to compete efficiently and effectively in an interstate environment"), 143 Cong. Rec. S5637 (daily ed. June 12, 1997).

federal thrifts now can do business across the country under a single set of federal rules. This framework is appropriate for these federal entities in a national financial marketplace. At the same time, in this marketplace a uniform national bank system based on preemption and interstate banking undoubtedly presents a major challenge to the dual banking system and state banks.

In contrast to the general certainty enjoyed by federal institutions, there is widespread confusion and uncertainty with respect to applicable law governing state banks engaged in interstate banking activities. The current uncertainty governing the interstate activities of state banks has had, and will continue to have, several significant adverse effects. Uncertainty carries the potential for litigation and enforcement actions arising from disagreements between regulators, or between a host state regulator and a state bank engaged in interstate activity. Regulatory uncertainty deters state banks from pursuing profitable business opportunities. When a state bank converts to a national charter to gain greater legal certainty, it incurs substantial expense. Each of these consequences has economic significance for state banks and direct implications for the FDIC's enforcement and safety-and-soundness responsibilities.

Moreover, a series of recent major merger and conversion transactions has resulted in an unprecedented migration of assets to the national banking system. It is now apparent that, absent a more certain federal regulatory environment, the state charter will continue to be perceived as less competitive than a national bank charter.

This is the very result that Congress intended to prevent.<sup>6</sup> In 1994, 1997 and 1999 Congress took bold and historic actions to provide uniform federal rules to govern all interstate banking and to ensure that individual state laws could not disfavor any type of depository institution in the multistate financial services marketplace. It is now apparent that the express terms of these statutes have not on their own force been able

<sup>6</sup> The statement by Rep. LaFalce before final House passage of the 1997 amendments captures the purpose to redress the negative effects of the 1994 Riegle-Neal applicable provision for state banks: "Why [must we act now]? Well, it is due to the fact that the national bank regulator has the authority to permit national banks to conduct operations in all the states with some level of consistency. In contrast, under the existing interstate legislation, state banks branching outside their home state must comply with a multitude of different state banking laws in each and every state in which they operate." 143 Cong. Rec. H3094 (daily ed. May 27, 1997). See the discussion of the legislative history in the next section.

to ensure, as Congress intended in enacting Riegle-Neal II, that state banks can participate in interstate banking business on a par with national banks and that state banks face significant state law obstacles when they seek to do business outside their home state. As a consequence, the state banking system, as we have known it, is fundamentally threatened.

In the national financial services marketplace, consumers and providers benefit when banks can provide products and services under a single legal framework applicable across state lines. At the same time, bank customers and the economy also benefit from the diversity, innovation and checks provided by a strong and dynamic dual banking system involving large, regional, and small banks. From the perspective of all parties—consumers, financial institutions, and regulators—further development of a framework of state bank regulation and supervision that is effective, efficient, and seamless across state lines is the right goal. In today's multistate system, that is an essential goal. A banking system in which virtually all interstate banks have national charters and state banks are overwhelmingly local is not the dual banking system this country has historically enjoyed. The dual banking system will retain the dynamic vitality that has made it a mainspring for progress and strength in banking only if it can provide meaningful interstate competitive parity for all interstate state banks, whether cross-border, regional, or national. Significant and unacceptable disparity exists today.

The FDIC has the authority, tools, and responsibility under the FDI Act to correct this imbalance. To implement Congressional intentions it now must promptly provide a uniform interstate applicable law regime for state banks and give practical reality to the express preemption of discriminatory state laws.

#### B. The FDIC Has Authority To Adopt the Requested Rules

The FDIC has ample rulemaking authority to address each of the Roundtable's requests. Section 9 of the FDI Act vests the FDIC with broad authority to adopt rules "it may deem necessary to carry out the provisions of this Act or of any other law which it has the responsibility of administering or enforcing." 12 U.S.C. 1819.<sup>7</sup>

<sup>7</sup> The FDIC's rulemaking authority parallels the OCC's authority. See 12 U.S.C. 93(a) ("the Comptroller of the Currency is authorized to prescribe rules and regulations to carry out the responsibilities of the office"). The statutory provision authorizing the OCC to issue rules is directly analogous to Section 9 of the FDI Act.

The FDIC is vested with responsibility for administering Sections 24 and 27 of the Act to accomplish what Congress intended. Congress, through Section 9, has vested the FDIC with authority to carry out Sections 24 and 27. Moreover, under basic principles of administrative law, agency rules that fill or address a statutory gap generally are afforded considerable deference by courts. See *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 865 (1984) ("Chevron"). Section 9's "generally conferred authority" makes it apparent "that Congress would expect the agency to be able to speak with the force of law when it addresses ambiguity in the statute or fills a space in the enacted law, even one about which 'Congress did not actually have an intent' as to a particular result." *United States v. Mead*, 533 U.S. 218, 229 (2001) (quoting *Chevron*, 467 U.S. at 845).

Riegle-Neal I and II fundamentally changed federal law for state and national banks by authorizing banks to engage fully in banking transactions in other states through interstate branching.<sup>8</sup> As a corollary, Riegle-Neal I provided federal "applicable law" statutes to govern the new interstate banking regime. As originally enacted, the respective applicable law provisions treated national and state banks differently. Riegle-Neal II sought to redress that disparity and provided substantively the same rule for state banks as was originally provided for national banks.<sup>9</sup> The FDIC plainly has authority to implement Riegle-Neal II.

Compare 12 U.S.C. 1819 (FDIC vested with authority "to prescribe \* \* \* such rules and regulations as it may deem necessary to carry out the provisions of this chapter or of any other law which it has the responsibility of administering or enforcing \* \* \*").

<sup>8</sup> Prior to enactment of Riegle-Neal, neither state nor national banks could establish branches outside their home state. Moreover, except with respect to interest charges under 12 U.S.C. 85 and 12 U.S.C. 1831d, federal law did not provide guidance to either state banks or national banks regarding the law applicable to transactions that banks made with customers outside their home states.

<sup>9</sup> See generally section 24(j):

#### (j) ACTIVITIES OF BRANCHES OF OUT-OF-STATE BANKS.—

(1) APPLICATION OF HOST STATE LAW.—The laws of a host State, including laws regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches, shall apply to any branch in the host State of an out-of-State national bank. To the extent host State law is inapplicable to a branch of an out-of-State bank in such host State pursuant to the preceding sentence, home State law shall apply to such branch.

(2) ACTIVITIES OF BRANCHES.—An insured State bank that establishes a branch in a host State may conduct any activity at such branch that is permissible under the laws of the home State of

Continued

The FDIC also has the authority to implement the nondiscrimination provisions of Section 104(d) insofar as the GLB Act addresses state insured depository institutions and to construe the express preemption of discriminatory state law provided in Section 104(d). Section 9 vests the FDIC with authority to promulgate rules to carry out any statute the FDIC is responsible for administering or enforcing. The provisions of the GLB Act that touch upon state depository institutions fall within the regulatory ambit of the FDIC.

A statutory gap, or a clarification of a statute to effect Congressional intent, can be—and should be—addressed by an agency rule. Where, as here, a statute is ambiguous regarding its application to “a particular result” (Mead, 533 U.S. at 229), courts have long recognized that agencies with rule-making authority must be permitted to address the statutory gap as “necessary for the orderly conduct of its business.” *United States v. Storer Broadcasting Co.*, 351 U.S. 192, 202–03 (1956) (finding also that the statute “must be read as a whole and with appreciation of the responsibilities of the body charged with its fair and efficient operation”), *National Petroleum Refiners Ass’n*, 482 F.2d at 681. (“[T]here is little question that the availability of substantive rule-making gives any agency an invaluable resource-saving flexibility in carrying out its task of regulating parties subject to its statutory mandate.”). Courts have consistently applied these administrative law principles—and extended Chevron deference—to rules and regulations issued by the FDIC under its broad rulemaking authority.<sup>10</sup>

such bank, to the extent such activity is permissible either for a bank chartered by the host State (subject to the restrictions in this section) or for a branch in the host State of an out-of-State national bank.

(3) SAVINGS PROVISION.—No provision of this subsection shall be construed as affecting the applicability of—

(A) any State law of any home State under subsection (b), (c), or (d) of section 44; or

(B) Federal law to State banks and State bank branches in the home State or the host State.

(4) DEFINITIONS.—The terms “host State”, “home State”, and “out-of-State bank” have the same meanings as in section 44(f). 12 U.S.C. 1831a(f).

<sup>10</sup> See, e.g., *National Council of Savings Institutions v. FDIC*, 664 F.Supp. 572 (D.D.C. 1987) (sustaining FDIC regulation governing the proper relationship between FDIC-insured banks and their securities-dealing “subsidiaries” or “affiliates”) See also *Wells Fargo Bank, N.A. v. FDIC*, 310 F.3d 202, 208 (D.C. Cir. 2002) (affording Chevron deference to FDIC rule for “second generation” transactions, because statute was silent as to treatment of these transactions and rule would “implement Congressional intent because it prevents financial institutions from manipulating the system”); *America’s Community Bankers v. FDIC*, 200 F.3d 822, 834 (D.C. Cir. 2000) (upholding FDIC denial of

There can be little doubt that Section 9 of the FDI Act vests the FDIC with authority to address these issues.<sup>11</sup>

There is no reason that a rulemaking by the FDIC similar to ones conducted by the OCC should be analyzed any differently. The National Bank Act does not expressly address the law applicable to a national bank outside states where it has branches. Prior to the adoption of the OCC rules, a number of courts determined that national banks were subject to state laws that did not conflict with the provisions of the National Bank Act.<sup>12</sup> Nonetheless, the courts have upheld the OCC rules and determinations that make clear that national banks and their operating subsidiaries are governed by the National Bank Act wherever they do business. These OCC rules have generally received Chevron deference.<sup>13</sup>

Further, under Section 8 of the FDI Act, an insured bank may be subject to an enforcement action of the FDIC if “in the opinion of the appropriate Federal banking agency, any insured depository institution, depository institution which has insured deposits, or any institution-affiliated party is engaging or has engaged, or the agency has reasonable cause to believe that the depository institution or any institution-affiliated party is about to engage, in an unsafe or unsound practice in conducting the business of such depository institution, or is violating or has violated, or the agency has reasonable cause to believe that the depository institution or any institution-affiliated party is about to violate, a law, rule, or regulation.” 12 U.S.C. 1818(b)(1). The FDIC has

refund assessment under Chevron, where statute merely stated that FDIC could utilize “any other factors” to “set” the assessment amount and thus was “facially ambiguous”); *Federal Deposit Ins. Corp. v. Sumner Financial Corp.*, 451 F.2d 898, 902–903 (5th Cir. 1971) (affording “great deference” to FDIC interpretation of FDI Act through regulation concerning advertising by regulated banks).

<sup>11</sup> Riegle-Neal I and II provide express ability for a state bank to establish a branch in a host state, to thus gain the ability to engage in any or all of its permitted activities in that host state, and to apply its home state law (unless a national bank, and thus the state bank, must apply host state law) to that branch. But the statutory text does not directly address the governing law applicable to the state bank’s activities permitted in the host state under the authority provided by Riegle-Neal, but conducted by the bank outside of its branch, by an operating subsidiary or another means. An ordinary task of a regulatory agency is to construe such a statutory provision in a rule.

<sup>12</sup> See *National State Bank v. Long*, 630 F.2d 981 (3d Cir. 1980); *Perdue v. Crocker National Bank*, 702 P.2d 503 (Cal. 1985); *Best v. U.S. National Bank*, 739 P.2d 554 (Or. 1987).

<sup>13</sup> See, e.g., *NationsBank of N.C. v. VALIC*, 513 U.S. 251 (1995); *Barnett Bank of Marion County v. Nelson*, 517 U.S. 25, 33 (1996); *Wachovia Bank, N.A. v. Watters*, 334 F. Supp. 2d, 957, 963–65 (W.D. Mich. 2004); *Wachovia v. Burke*, 319 F. Supp. 2d 275 (D. Conn. 2004).

authority to adopt rules with respect to legal compliance by insured banks that provide guidance to those banks and agency staff charged with making supervisory, enforcement and examination decisions. That can be accomplished by using authority under Section 9 to address issues of compliance with state law, including the meaning and scope of Section 104.<sup>14</sup>

### C. The Requested Rulemakings Would Advance the Congressional Purpose To Prevent Erosion of the Dual Banking System by Maintaining Parity Between State and National Banks

Beginning with the enactment of Section 27, Congress has taken bold and historic action on more than one occasion to preempt a wide range of state laws so that state banks can operate on a par with national banks in the multistate financial services marketplace that has come into existence in recent decades. The broad sweep of what Congress intended to accomplish is evident in the terms and legislative history of Riegle-Neal II and Section 104(d). Those statutes further the decades-old principle of competitive equality embodied in federal law and repeatedly recognized by the courts and the FDIC.<sup>15</sup> The requested FDIC rule would implement these Congressional purposes.

The principle of fundamental competitive parity has been woven by Congress and the courts into the very fabric of the dual banking system. The dual system was created when Congress created the national bank system alongside the state banking system. In the Federal Reserve Act, Congress expressly provided for state banks, as well as national banks, to be member

<sup>14</sup> The FDIC previously has engaged in a rulemaking in comparable circumstances. In 1982, the FDIC adopted a Statement of Policy addressing the applicability of the Glass-Steagall Act to securities activities of subsidiaries of insured nonmember banks. 47 FR 38984, September 3, 1982. That Statement of Policy construed Section 20 of the Glass-Steagall Act and concluded that the restrictions in that section on securities affiliates of insured banks did not prevent insured nonmember banks subject to the FDIC’s regulation and supervision from having “bona fide” securities affiliates or subsidiaries. The provisions of Glass-Steagall construed in the Statement of Policy (like the provisions of GLB at issue here) were not part of the FDI Act, but the FDIC issued a rule to provide clear guidance to insured state banks, and the exercise of the FDIC’s rulemaking authority in that case was upheld. See *National Council of Savings Institutions v. FDIC*, 664 F.Supp. 572 (D.D.C. 1987). Issuing guidance to state insured banks concerning the scope of Section 104 of the GLB Act is a necessary and appropriate exercise of the FDIC’s authority to carry out its regulatory mandate.

<sup>15</sup> See *First Nat’l Bank v. Walker Bank & Trust Co.*, 385 U.S. 252 (1966); *First Nat’l Bank in Plant City v. Dickinson*, 396 U.S. 122 (1969); FDIC Advisory Letter 00–5.



banks. The McFadden Act as passed and as amended in the 1930s embodied a federal policy of competitive equality in branching. In the FDI Act, deposit insurance was made available to all state and national banks.

Since 1980, Congress has amended the FDI Act to ensure state-national bank parity, to ensure a strong and balanced dual banking system, and to prevent discriminatory state laws from favoring one type of charter over another. In 1980, in response to the challenges presented by the 1978 Marquette case, Congress provided interstate usury parity for state banks in Section 27 of the FDI Act.<sup>16</sup> See 12 U.S.C. 1831d(a). In 1991, Congress addressed state laws providing state banks more expansive powers than national banks, a disparity in favor of state banks that Congress believed had implications for safety-and-soundness, bank competitiveness, and the dynamic for change in the dual banking system. That enactment provided that state bank activities would be limited to activities permissible for national banks, unless the FDIC determined that for a state bank to engage in an otherwise impermissible activity would not pose a significant risk to the deposit insurance fund. See 12 U.S.C. 1831a(a)-(e). This policy of parity was continued in Riegle-Neal and the GLB Act.

#### *1. The Legislative History of Riegle-Neal Amendments Demonstrates Congressional Purpose to Provide Parity Between National Banks and State Banks*

In Riegle-Neal, Congress reversed more than 150 years of federal policy and enacted comprehensive federal laws governing interstate banking for all banks. Except for the applicable law provisions, Riegle-Neal as originally enacted gave parallel treatment to state and national banks. In 1997, Congress recognized that the original state bank applicable law provision was placing state banks at a substantial disadvantage and was undermining the state system. It acted swiftly to redress the state-national bank balance in Riegle-Neal II. The specific drafting approach, the underlying policy and the express purpose of that 1997 statute all sought to ensure that state banks would operate under a uniform interstate "applicable law" regime based on home state law parallel to the national bank regime. It sought to ensure parity in the dynamic interstate banking environment.

The legislative history of Riegle-Neal II makes clear that Congress' goal was to

facilitate competitive equality for state banks and national banks in interstate banking. The 1997 amendments originated in the House Banking Committee. At final passage, the principal sponsor of the bill, Rep. Marge Roukema (R-NJ), chair of the Subcommittee on Financial Institutions, and senior members of the House Banking Committee, on a bipartisan basis, expressed the intent to provide a level playing field, not narrowly in terms of competition between state and national bank branches, but broadly in terms of the ability of state banks to match national banks in doing business across the country.

As Rep. Roukema stated when introducing the bill for vote on the House floor: "The essence of this legislation is to provide parity between state-chartered banks and national banks. \* \* \* This legislation is critical to the survival of the dual banking system. \* \* \* [A] strong state banking system is necessary for the economic well-being of the individual States and for innovation in financial institutions." In her final statement before final passage, she repeated the necessity and purpose of the bill: "[W]e have \* \* \* with this action, protected the dual banking system while at the same time gaining the advantages of interstate banking."<sup>17</sup> No contrary statement was made by any House or Senate member during the floor debates preceding final passage.

Representative Roukema's statements were echoed and reinforced by senior members from each political party. On the Republican side, Rep. Mike Castle (R-DEL) addressed state bank's competitive needs "across the Nation": "As we enter the age of interstate banking and branching, it is necessary to ensure that state banks can compete fairly with national banks as more banking is done between States and across the Nation. This legislation will ensure that there is a level playing field between state and national banks."<sup>18</sup> Rep. Doug Bereuter (R-NEB) emphasized the benefits for the state system, "This Member was intimately involved in the original Riegle-Neal Act and was concerned at that time that States' rights were protected. \* \* \* This Member believes that this measure actually reinforces States' rights by maintaining the viability of the state charter by ensuring parity with the national bank charter \* \* \* [and] urges his colleagues to join him in approving

this important protection of the dual banking system."<sup>19</sup>

A senior Democrat, Rep John LaFalce (D-NY), articulated the purpose clearly: " \* \* \* I do believe [the bill's] passage is vital to maintain the dual banking system. It is the dual banking system that by giving banks a choice of Federal or state charters has helped to ensure that our U.S. banking industry has remained strong and competitive. \* \* \* [In 1994, Congress did not adequately anticipate the negative impact the interstate law would have on state banks.] Why so? Well, it is due to the fact that the national bank regulator has the authority to permit national banks to conduct operations in all the states with some level of consistency. In contrast, under the existing interstate legislation, state banks branching outside their home state must comply with a multitude of different state banking laws in each and every state in which they operate."<sup>20</sup>

When the Riegle-Neal II bill was considered in the Senate, concern also was expressed about the erosion of the dual banking system caused by the disparity in applicable law enacted in Riegle-Neal. In his floor statement preceding final Senate passage, Senate Banking Committee Chairman Alphonse D'Amato (R-NY) stated the importance of Riegle-Neal II for the continued vitality of the dual banking system:

[T]he trigger date for nationwide interstate branching has passed—June 1, 1997. This important legislation will preserve the benefits of the dual banking system and keep the state banking charter competitive in an interstate environment. \* \* \*

The bill is necessary to preserve confidence in a state banking charter for banks with such a charter that wish to operate in more than one state. In addition, it will curtail incentives for unnecessary Federal preemption of State laws. Finally, the bill will restore balance to the dual banking system by ensuring that neither charter operates at an unfair advantage in this new interstate environment. \* \* \*

New York has more than 90 State [-]chartered banks. \* \* \* Without this

<sup>19</sup> Id. at H3094. Rep. Spencer Bacchus (R-ALA) similarly stated: " \* \* \* we have heard almost unanimous testimony that the unfortunate and unintended consequences of our failure to make these clarifications will be the devaluation of state banking charters in favor of national charters and the gradual decline of the state banking system \* \* \* " Id. at H3095.

<sup>20</sup> Id. at H3094. Rep. Bruce Vento (D-MN) similarly stated: "The legislation will maintain the dynamic balance between the chartering of national and state banks and banking systems. This is a necessary measure. It must be enacted to clarify and ensure the viability of America's dual banking system." Id. at H3093.

<sup>16</sup> See *Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp.*, 439 U.S. 299 (1978).

<sup>17</sup> See 143 Cong. Rec. H3088 (daily ed. May 21, 1997), H4231 (daily ed. June 24, 1997).

<sup>18</sup> 143 Cong. Rec. H3095 (daily ed. May 27, 1997).

legislation, the largest of these institutions may be tempted to convert to a national charter in order to operate in more than one State. \* \* \*

The current law may be unclear as to whether consistent rules are used to determine what laws and powers apply to the out-of-state branches of state and federally chartered banks. \* \* \*

[Summary of the bill's terms omitted]

Enactment of H.R. 1306 also would bolster efforts of New York and other states to make sure that State[-]chartered banks have the powers they need to compete efficiently and effectively in an interstate environment.<sup>21</sup>

*2. Section 104 of the GLB Act Reflects Congress' Intent To Preempt Discriminatory State Laws Adversely Affecting Any Depository Institution*

Congress enacted Section 104 as part of the GLB Act in 1999 to address state laws providing competitive inequalities among entities offering the same financial products and services. Section 104 originated as a provision intended to sweep away a variety of state laws that had blocked or imposed special requirements or conditions on banks seeking to engage in insurance activities permitted under their charter law. During the legislative process, the section was expanded to provide express preemption of not just state insurance laws, but any state law that placed impediments or burdens on any insured depository institution seeking to provide financial services across the country. Even though the non-insurance provisions of Section 104(d) are far less detailed than the insurance provisions of Section 104, the Congressional purpose and breadth of preemption with respect to non-insurance activities are express in the nature and scope of the words used.

Congress determined that in a national financial services marketplace individual states should not be able to impose burdens or requirements adversely affecting any depository institution, or its affiliates. As enacted, Section 104(d) provides broad preemption of discriminatory state laws adversely affecting any type of depository institution or any affiliate of a depository institution. It was enacted for the purpose of ensuring that no insured depository institution—including a state bank and its financial affiliates—would be disadvantaged competitively by the operation of state law when it engages in a financial activity, whether on its own, with an affiliate or with “any other person.”

The legislative history of Section 104(d), and particularly the paragraph (4) nondiscrimination provisions, is sparse, and thus its purpose and intent are best drawn from its terms. It is important to note that Section 104 addresses how banking organizations conduct the full range of permitted financial activities, whether by the depository institution itself or by an affiliate, including both “traditional” affiliates such as mortgage or finance companies and the new affiliations permitted under the GLB Act. It focuses on state laws that affect how depository institutions or its affiliates engage in any of their permitted activities. This focus is evident in the Senate Banking Committee report in 1999. That Committee had taken the lead role in fashioning Section 104 in the form ultimately enacted. Its report expressly addressed the section's broad, preemptive purpose with respect to state laws that impinge on how financial activities are conducted: “[T]he Committee is aware that some States have used their regulatory authority to discriminate against insured depository institutions, their subsidiaries and affiliates. The Committee has no desire to have State regulation prevent or otherwise frustrate the affiliations and activities authorized or permitted by this bill. Thus, Section 104 clarifies the application of State law to the affiliations and activities authorized or permitted by the bill (or other Federal law), and ensures that applicable State law cannot prevent, discriminate against, or otherwise frustrate such affiliations or activities.”<sup>22</sup>

Section 104(d) has a purpose parallel to Riegle-Neal II—to ensure that depository institutions will be able to compete across the country on equal terms and to prevent state laws or actions from providing disparate treatment that would disadvantage any bank vis-à-vis its competitors. When an out-of-state state bank is subject to a state law imposing any requirement, limitation, or burden to which a national bank or in-state bank is not subject, Section 104(d) by its literal terms preempts that state law.

**D. In the Requested Rulemaking, the FDIC Should Clarify the Applicable Law Governing the Interstate Activities of State Banks To Provide Parallel Uniformity for State Banks With National Banks**

In light of the FDIC's authority under its statute and the express purposes and policies of Congress enacted in recent

statutes, the Roundtable believes that the FDIC can, and should, adopt rules so that state banks can operate interstate under uniform rules based on home state law and thus parallel to national banks. We now address in turn the specific parts of the requested rulemaking.

*1. The FDIC Should Clarify That in General Home State Law Is the Governing Law Applicable to All Activities Conducted in a Host State by a State Bank That Has an Interstate Branch in That State to the Same Extent That Host State Law Is Preempted by the National Bank Act*

This petition seeks a rule addressing the appropriate applicable law to govern the activities of a state bank when it has entered a host state with a branch as permitted by Riegle-Neal and thus has a federal law authorization to transact all its legally permissible activities within that host state. The requested rule would expressly permit a state bank to apply home state law uniformly to all its business done in a host state parallel to the ability of national banks to apply the National Bank Act under OCC rules. Riegle-Neal II plainly provides that if the National Bank Act preempts host state law for national banks, home state law is the applicable law when the out-of-state bank engages in any or all of its permissible activities in or through its host state branch. The Riegle-Neal applicable law provisions for both state and national banks are silent, however, with respect to the governing law applicable to a transaction that the bank could conduct through its branch, but is effecting without any involvement by the host state branch.

Riegle-Neal I authorized the bank to engage in any or all of its permitted activities in the host state once it has a single branch there and to apply its home state law. The only question under Riegle-Neal II is whether Congress intended different law to apply depending on the means used by the bank to conduct its permitted business in the host state or the structure of the transaction (that is, whether use of home state law as the applicable law depends on some actual branch involvement in the bank's transaction).<sup>23</sup> The legislative purpose is clear: Congress was focused on the

<sup>23</sup> For example, although the statutory text directly addresses the law applicable to a Tennessee bank with a branch in Oklahoma that makes a loan to an Oklahoma resident through its Oklahoma branch (Tennessee law applies), the text does not speak directly to the governing law applicable to the identical loan originated by the Tennessee bank from its home office in Tennessee (or through an operating subsidiary).

<sup>21</sup> 143 Cong. Rec. S5637 (daily ed. June 12, 1997).

<sup>22</sup> S. Rept. 106-44 (April 28, 1999) at 11 [Senate Banking Committee] (emphasis added).

bank's interstate activities, not the means used by the bank. By adopting the requested rule, the FDIC will achieve the result Congress intended.

The FDIC should fill the statutory gap and clarify the application of home state law to host state activities by adopting a rule for state banks that provides for uniform application of home state law whenever a national bank can apply the National Bank Act. The FDIC rule should make it clear that the state bank's home state law will apply to all of the bank's activities in a host state whenever a host state law would be preempted by OCC rules for a national bank.

Specifically, the rule should make it plain that any host state statute, rule, order, etc., that would be preempted under the terms of the OCC preemption rule, or an OCC interpretive letter, would also be preempted for a state bank. If there is any uncertainty about the application of the OCC rules in any case, the rule might allow the home state regulator, or the FDIC, to determine in writing whether OCC rules would provide preemption for national banks. The FDIC should reserve the ability to make any final determination (with consultation with the OCC as needed). In parallel fashion, the rule should provide that if home state statute law is silent, the home state regulator can determine by rule, order, or interpretative statement/letter what applicable home state law is. In general, the home state regulator's written determinations, whether by rule, order, or interpretative statement/letter, should govern, but could be subject to review by the FDIC, upon request of the host state regulator or upon the FDIC's own initiative.

The rule might also address another Riegle-Neal provision addressing the home-host state relationship. Section 10(h)(3) of the FDI Act expressly provides that the "State bank supervisors from 2 or more States may enter into cooperative agreements to facilitate State regulatory supervision of State banks, including cooperative agreements relating to the coordination of examinations and joint participation in examinations." The state regulators, through the Conference of State Bank Supervisors, have entered into a landmark nationwide cooperative agreement, as well as agreements involving a specific bank by the states where that bank has branches. The FDIC rule could provide guidance on the effect of Section 10(h)(3).

*2. The FDIC Should Clarify That Home State Law is the Governing Law Applicable to Activities Conducted by a State Bank in a State in Which the State Bank Does Not Have a Branch to the Same Extent That State Law Is Preempted by the National Bank Act*

The Roundtable requests that the FDIC adopt parallel rules under its Section 9 authority to provide that the home state law of a state bank will apply to its activities in other states to the same extent as the National Bank Act applies to the activities of national banks. The rule should provide that whenever a state law is preempted by the National Bank Act or OCC rules, it also would not apply to an out-of-state insured bank, which would be governed by its home state charter law. The requested rule thus would implement the terms and policies of Section 104(d) and the policies of Riegle-Neal II and address gaps in existing law. Like the parallel OCC rules, the requested rules would reduce legal risk, guide legal compliance by insured banks, and aid the FDIC in making enforcement decisions under Section 8 of the FDI Act. Further, by promoting operating efficiency and competitiveness in interstate banking and by reducing the real costs arising from legal uncertainty and risk, the proposed rule would contribute to the safe and sound operation of state banks.

To a large extent, the Riegle-Neal and GLB legislation confirmed the existence of a robust interstate marketplace for financial services and provided a federal legal framework for the conduct of this interstate commerce. Although the express purpose of Riegle-Neal II was to provide state banks competitive equality with national banks in interstate banking, it did not by its terms address the law applicable to banks outside states where they maintain a branch. The GLB Act addressed the entire financial services marketplace and, like Riegle-Neal I and II, adopted broad federal rules to implement the goal of a "level playing field". In Section 104(d) Congress plainly recognized the need for financial services providers, including insured depository institutions, that operate across the country to do so under uniform rules and not to be subject to individual state rules or actions that would disadvantage some or all depository institutions. Accordingly, Congress provided the very broad express preemption stated in Section 104(d) to address this perceived need.

As is often the case, Congress did not address in those acts every issue presented by the developments and

problems it was considering, nor did it address future developments. Under established principles of administrative law, as discussed above, the federal agencies that administer and implement statutory grants of authority have an important role in adopting rules that implement Congressional purposes, reasonably fill in statutory gaps and address the application of existing laws to new developments and contexts.

The policy of Section 104 has a similar goal as Riegle-Neal II, but plainly addresses a different aspect of the same problem—discriminatory state laws that disadvantage depository institutions, including state banks, seeking to compete in interstate financial service markets. Section 104(d) thus directly informs and supports this requested rule. Under Section 104(d), when state law provides for a different result for out-of-state state banks compared to national and in-state state banks, that law is preempted. Given Section 104(d) and the FDIC's authority to address compliance with law under FDI Act Section 8, the FDIC can adopt a rule consistent with the logic and policy of Riegle-Neal II that will provide state banks competitive equality in every state so that no insured state bank will be required to comply with a state law unless a national bank also would be subject to that law.

OCC rules have provided national banks substantial certainty and clarity concerning the law governing national bank activities across the country.<sup>24</sup> These OCC actions have had the effect of making national banks more competitive and efficient in interstate

<sup>24</sup> The Comptroller has addressed the reality of multistate banking by adopting rules that provide that a national bank and its operating subsidiaries operate solely under the National Bank Act and OCC rules wherever they do business across the country. The OCC rules expressly provide that the National Bank Act, not state law, governs the deposit, lending, and other activities of national banks, except as specifically provided in the OCC rules. See 12 CFR 7.4007-7.4009. The National Bank Act does not expressly address the law applicable to a national bank outside states where it has branches. Indeed, prior to the adoption of OCC rules addressing these issues in recent years, a number of courts determined that national banks were subject to state laws that did not conflict with the provisions of the National Bank Act. E.g., *National State Bank v. Long*, 630 F.2d 981 (3d Cir. 1980); *Perdue v. Crocker National Bank*, 702 P.2d 503 (Cal. 1985); *Best v. U.S. National Bank*, 739 P.2d 554 (Or. 1987). Nevertheless, the courts including the U.S. Supreme Court, have upheld OCC rules and determinations since 1944 that flesh out the National Bank Act and spell out the ability of national banks and their operating subsidiaries to apply the National Bank Act wherever they do business. These OCC determinations have generally received Chevron deference. E.g., *NationsBank of N.C. v. VALIC*, 513 U.S. 251 (1995), *Barnett Bank of Marion County v. Nelson*, 517 U.S. 25, 33 (1996), *Wachovia Bank, N.A. v. Watters*, 334 F. Supp. 2d 957, 963-65 (W.D. Mich. 2004).



banking and have reduced legal risk. These rules, as supplemented by interpretations and guidance issued by the OCC, also have clarified the scope of the OCC's compliance and enforcement responsibilities and standards with respect to the safe and sound operation of national banks. The FDIC has authority to provide a parallel result for state banks in its rules.

**3. The FDIC Should Clarify That Home State Law Governs the Activities of an Operating Subsidiary of a State Bank to the Same Extent as Home State Law Applies to the Parent Bank**

In a 1996 rulemaking, which codified existing interpretations, and in subsequent modifications, the OCC has adopted comprehensive rules concerning the establishment and operation of operating subsidiaries. See 12 CFR 5.34; 69 FR 64478 (Nov. 5, 2004). The OCC rules as amended in 2001 further specify that state law applies to a national bank operating subsidiary to the same extent state law would apply to the national bank itself. See 12 CFR 7.4006. The FDIC should similarly make clear that an operating subsidiary established by a state bank under its home state law, like the operating subsidiary of a national bank, will be governed by the same law as would its insured state bank parent, except when a state law would apply to the activities of a national bank operating subsidiary.

The Roundtable recognizes that the authority of an insured state bank to establish an operating subsidiary must arise under its charter law. Whether a state bank can have an "operating subsidiary" will be determined by appropriate home state authorities under the bank's charter law. Nevertheless, the FDIC plainly has authority to determine that a state bank operating subsidiary that is treated for all purposes as if it were a division of the bank will be subject to the FDI Act and FDIC rules in the same way as its insured bank parent, parallel to a national bank operating subsidiary. The OCC rules concerning operating subsidiaries were adopted without the existence of any express provision in the National Bank Act.<sup>25</sup>

The FDIC has discretion under Section 9 and Section 24(f) to determine by rule that a subsidiary that is an operating subsidiary under home state law will be treated under the FDI Act as

<sup>25</sup> When the authority for a national bank to establish a financial subsidiary was authorized under the CLB Act in 1999, new Section 24a in the National Bank Act implicitly confirmed the existing OCC approach to establishing operating subsidiaries. See 66 FR 34784, 34788 (July 2, 2001).

if it were a division or branch of the state bank.<sup>26</sup> This rule provision would thus allow a state bank operating subsidiary to engage in interstate banking activities in host states and other states on the same terms on which its state bank parent operates.

**4. The FDIC Should Adopt Rules Construing the Scope and Application of Section 104(d) To Make Clear that State Laws, Rules, or Actions Are Preempted Under Section 104(d) When They Provide for Disparate Treatment Between an Out-of-State National Bank or In-State Bank and an Out-of-State State Bank, or an Affiliate Thereof**

The Roundtable also requests that the FDIC provide greater clarity and certainty to insured state banks with respect to the scope of the federal preemption provided in Section 104(d) of the GLB Act. In view of the complexity of Section 104(d) and the general lack of understanding of its provisions, FDIC rules are needed. Moreover, a rulemaking is a preferable means for providing needed clarity than either litigation or an enforcement proceeding.

Section 104(d) provides express federal preemption of certain state laws that affect "insured depository institutions", as defined in the FDI Act. Insured state banks subject to FDIC regulation are the intended beneficiaries of the Section 104(d) preemption. Yet state banks today are not utilizing this preemption, because the statute is relatively new and complex and the relevant provisions have not been construed by any agency or court. Given the complexity of the Section 104(d) provisions, FDIC guidance would provide much needed clarity and certainty. Accordingly, we request the FDIC to exercise its authority under FDI Act Sections 8 and 9 to adopt rules that specify the scope of the express preemption provided under Section 104(d) for insured state banks. Alternatively, the FDIC might adopt a statement of policy addressing the scope and effect of Section 104(d) for state banks.

<sup>26</sup> The FDIC has recognized in Advisory Letter 99-5 that a state bank operating subsidiary may be treated the same as a state bank branch if the operating subsidiary engages in activities that would require a branch designation. Advisory Letter 99-5 recognizes that because a bank established and controls its operating subsidiary, the offices of an operating subsidiary are similarly "established" by the bank for branching purposes. This result is also consistent with the terms of Section 1813(o) of the FDI Act, in which a "domestic branch" is defined to include any "additional office" of a bank. The FDIC thus has recognized the concept underlying the "operating subsidiary" and thus can apply it more uniformly to all state bank activities by rule.

The breadth of the Section 104(d) preemption and its purpose to reach state law or actions that would provide disparate treatment for any type of depository institution, including the distinct class of out-of-state state banks, vis-à-vis its competitors are evident in the language of the statute. Section 104(d)(4)(D) provides four distinct nondiscrimination tests for any state law or action that "restricts" any depository institution or any affiliate.<sup>27</sup> These provisions of Section 104 were carefully drafted and the text demonstrates that Congress made careful distinctions when determining whether state discrimination between competitors should be impermissible, and thus and preempted, under federal law.<sup>28</sup> The distinctions in the statutory

<sup>27</sup> The pertinent portions of Section 104(d) are as follows:

(d) Activities.

(1) In general. Except as provided in paragraph (3), and except with respect to insurance sales, solicitation, and cross marketing activities, which shall be governed by paragraph (2), no State may, by statute, regulation, order, interpretation, or other action, prevent or restrict a depository institution or an affiliate thereof from engaging directly or indirectly, either by itself or in conjunction with an affiliate, or any other person, in any activity authorized or permitted under this Act and the amendments made by this Act. \* \* \*

(4) Financial activities other than insurance. No State statute, regulation, order, interpretation, or other action shall be preempted under paragraph (1) to the extent that—

(A) It does not relate to, and is not issued and adopted, or enacted for the purpose of regulating, directly or indirectly, insurance sales, solicitations, or cross marketing activities covered under paragraph (2);

(B) It does not relate to, and is not issued and adopted, or enacted for the purpose of regulating, directly or indirectly, the business of insurance activities other than sales, solicitations, or cross marketing activities, covered under paragraph (3);

(C) It does not relate to securities investigations or enforcement actions referred to in subsection (f); and

(D) it—

(i) Does not distinguish by its terms between depository institutions, and affiliates thereof, engaged in the activity at issue and other persons engaged in the same activity in a manner that is in any way adverse with respect to the conduct of the activity by any such depository institution or affiliate engaged in the activity at issue;

(ii) As interpreted or applied, does not have, and will not have, an impact on depository institutions, or affiliates thereof, engaged in the activity at issue, or any person who has an association with any such depository institution or affiliate, that is substantially more adverse than its impact on other persons engaged in the same activity that are not depository institutions or affiliates thereof, or persons who do not have an association with any such depository institution or affiliate;

(iii) Does not effectively prevent a depository institution or affiliate thereof from engaging in activities authorized or permitted by this Act or any other provision of Federal law; and

(iv) Does not conflict with the intent of this Act generally to permit affiliations that are authorized or permitted by Federal law. 15 U.S.C. 6701(d).

<sup>28</sup> Compare the "other person" language in subparagraphs (i) and (ii). Subparagraph (i)

language permit the FDIC to address the meaning of Section 104(d) for a state bank confronting state laws outside its home state that disadvantage it by putting it in a different legal or competitive position than its national bank or in-state state bank competitors.

The following specific items might be covered in an FDIC rule or statement of policy:

- The rule should state that the Section 104(d) preemption applies to insured banks, and to their subsidiaries, affiliates and associated persons.

- The rule should define a "person" to include a depository institution, subsidiary, affiliate, and associated person.

- The rule should state that in view of the breadth of the nondiscrimination requirements stated in Section 104(d) the word "restrict" in Section 104(d)(1) is to be read broadly to include any state law, rule, interpretation or action that calls for any limitation or requirement. Any state law that "restricts" but is nondiscriminatory under Section 104(d)(4) is not preempted under Section 104(d). By the same token, any state law that "restricts" and is discriminatory under Section 104(d)(4) is preempted under Section 104(d).

- The rule should address each of the four nondiscrimination provisions in Section 104(d)(4) to confirm that each is a distinct test and that any state law or action that fails any one test is preempted.

- The rule should address the scope of "actions" in Section 104(d)(4) to include all types of formal or informal administrative actions by any state or local governmental entity, including decisions with respect to civil enforcement of state rules.

- The rule should address Section 104(d)(4)(D)(i) in light of the terms used in subparagraph (ii) to specify that subparagraph (i) addresses treatment under state law of an out-of-state insured state bank, which is plainly an "insured depository institution," that is different from the treatment of any national bank or in-state state bank and banks, which is an "other person engaged in the same activity" under these provisions. It should also specify that this discrimination can take various forms, including state laws, rules, or "actions" that treat out-of-state state banks or their subsidiaries differently from in-state or federal institutions, whether expressly (e.g., through a state law exemption for federal institutions,

addresses "other persons engaged in the same activity", while Subparagraph (ii) addresses "other persons engaged in the same activity that are not depository institutions or affiliates thereof."

but not out-of-state state banks insured institutions), by operation of law (e.g., when state law is preempted for national banks or federal thrifts, and federal credit unions, but not for out-of-state state banks), or by an administrative determination to enforce a state rule against an out-of-state state bank or affiliate, but not against a federal entity. The rule could give examples.

- The rule should define "state law" to include laws, ordinances, rules, etc. of political subdivisions (including any county, municipality, etc.).

5. *The FDIC Should Implement Section 27 of the FDI Act by Adopting a Rule Parallel to the Rules Promulgated by the OCC and OTS*

The scope and implementation of the express preemption for the "interest rate" charged in interstate lending transactions by state and national banks under Section 27 of the FDI Act and Section 85 of the National Bank Act have been authoritatively addressed by the courts<sup>29</sup> and in agency interpretations.<sup>30</sup> Nevertheless, both the OCC and OTS have adopted rules codifying the scope of the respective statutory provisions. We request that the FDIC adopt parallel provisions by rule so that state banks will operate in a matching legal framework under these parallel statutes.

\* \* \* \* \*

The Roundtable appreciates the FDIC's consideration of this petition. We recognize that it is very broad and asks the FDIC to undertake a major rulemaking. We believe that such an effort is urgently needed to preserve a strong dual banking system, to maintain safety and soundness, and to ensure that it is attractive to both large and small banks. Such a system is an integral, essential part of the framework for banking in the United States. While we strongly support the development of interstate banking and federal preemption over the last decade, we believe that the modernization of American banking requires a parallel modernization of the state half of the dual banking system. Since the issues concern interstate business and preemption, the needed actions must come at the federal level. As discussed above, we believe that Congress has given the FDIC both the tools and responsibility to address these needs.

The Roundtable and its members stand ready to work with the FDIC and

<sup>29</sup> *Greenwood Trust Co. v. Mass.*, 971 F.2d 818 (1st Cir. 1992), *Smiley v. Citibank*, 517 U.S. 735 (1996).

<sup>30</sup> See FDIC General Counsel Opinions 10 and 11.

its staff to achieve these important objectives. If you have any further questions or comments, please do not hesitate to contact me or John Beccia at (202) 289-4322.

Sincerely,

Richard M. Whiting,  
Executive Director and General Counsel.  
cc: Chairman Donald E. Powell, William F.  
Kroener III, Esq.

[FR Doc. 05-5499 Filed 3-18-05; 8:45]

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## ENVIRONMENTAL PROTECTION AGENCY

### 40 CFR Parts 52 and 81

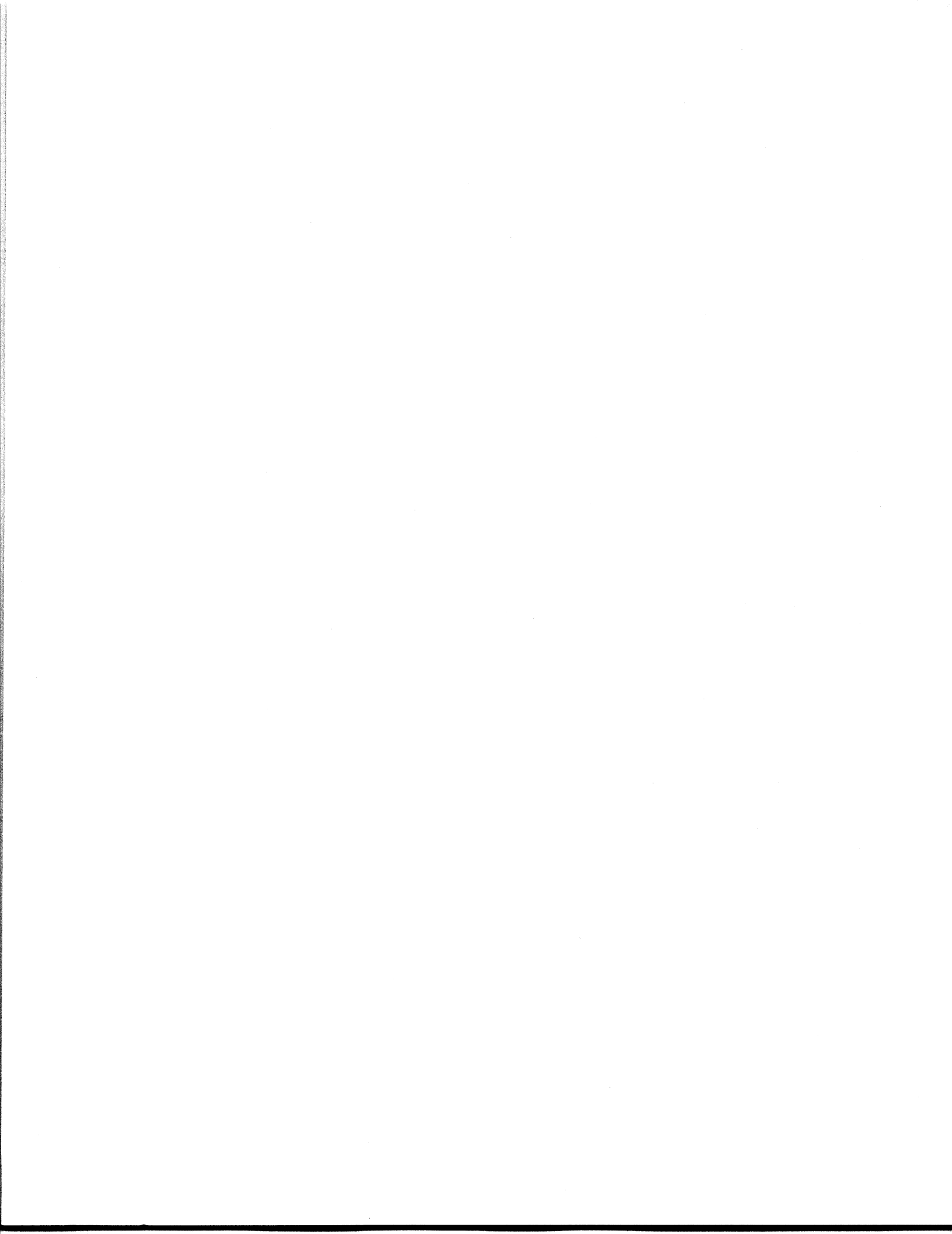
[AZ131-0078; FRL-7887-1]

### Approval and Promulgation of Implementation Plans and Designation of Areas for Air Quality Planning Purposes; Arizona

AGENCY: Environmental Protection Agency (EPA).

ACTION: Proposed rule.

**SUMMARY:** EPA is proposing to approve the Arizona Department of Environmental Quality's submittals of revisions to the Arizona state implementation plan that include substitution of the clean fuel fleet program requirement with the cleaner burning gasoline program, adoption of the serious area 1-hour ozone plan, and adoption of the 1-hour ozone maintenance plan for the Phoenix (Arizona) metropolitan 1-hour ozone nonattainment area. We are also proposing to approve Arizona's request to redesignate the Phoenix metropolitan 1-hour ozone nonattainment area from nonattainment to attainment. EPA proposes these actions pursuant to those provisions of the Clean Air Act that obligate the agency to take action on submittals of revisions to state implementation plans and requests for redesignation. In addition, under section 107 of the Clean Air Act, we are proposing to revise the boundary of the Phoenix metropolitan 1-hour ozone nonattainment area to exclude the Gila River Indian Reservation. EPA is proposing this last action consistent with the Federal trust responsibility to the Tribes and for the purpose of relieving the Agency or the Gila River Indian Community of the need to promulgate and implement plans and measures for the Community that are not needed for attainment or maintenance of the 1-hour or 8-hour ozone national ambient air quality standard.



**RECENT DEVELOPMENTS UNDER THE  
UNIFORM COMMERCIAL CODE**

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**SECTION F**



**RECENT DEVELOPMENTS UNDER THE  
UNIFORM COMMERCIAL CODE**

**ARTICLE 1** ..... **F-1**

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## 2005 CONFERENCE ON LEGAL ISSUES FOR FINANCIAL INSTITUTIONS

### RECENT DEVELOPMENTS UNDER THE UNIFORM COMMERCIAL CODE

John T. McGarvey

and

Thomas C. Fenton

Morgan & Pottinger, P.S.C.

#### Article 1

Article 1 may be the most important Article of the Uniform Commercial Code<sup>1</sup> because its general provisions and definitions apply to all of the other Articles. While Article 1 has been amended piecemeal as other Articles of the UCC have been updated, it was not until 2001 that it was first subject to a general redrafting.

The 2001 version of Article 1 has been adopted by 12 states, including our border state of Virginia. It is currently before the legislatures of 8 other states, including our border state of Illinois.

Substantive changes include:

- Expanded definition of “good faith” – “honesty in fact and the observance of reasonable commercial standards of fair dealing.” KRS 355.1-201(19) now defines good faith as “honesty in fact in the conduct or transaction concerned.” This change brings Article 1 into conformity with the “reasonable commercial standards” requirement found in other Articles.
- “Course of performance” is added as a rule of construction for interpretation of contracts, along with course of dealing and usage of trade. Course of performance now exists in Articles 2 and 2A, but has not been expressly extended to the rest of the UCC.
- Integrates the federal Electronic Signatures in Global and National Commerce Act.

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<sup>1</sup> The UCC, as adopted in Kentucky, is found at KRS Chapter 355.



- Statute of frauds is deleted from Article 1, relying on specific provisions in other Articles.
- Major shift in choice of law rules. Existing law provides that the parties to a contract may agree that it is governed by the law of any jurisdiction with a reasonable relationship to the contract. For commercial situations, Revised Article 1 provides that the law of any state may be adopted without regard to the reasonable relationship test. For consumer contracts, Revised Article 1 allows for the same rule, except that a consumer may not be deprived of legal rights afforded by the law of the state where the consumer resides or takes delivery of the goods. Most states that have adopted Revised Article 1 have carved out this revision and carry forward some version of the reasonable relationship test.

Revised Article 1 will likely be offered to the Kentucky Legislature with the next significant amendments to the UCC.

## **Article 2 - Sales**

Kentucky and all of its sister states cling to the 1960 version of Article 2 on sales. Amendments to Article 2, offered to the states in 2003, are before the legislatures of Kansas and Nevada but have not been introduced in any other state. No state has yet adopted the proposed amendments. Significant changes in Article 2 include:

- Newly defined terms and new provisions to facilitate electronic transactions.
- Increase in the statute of frauds dollar amount from \$500 to \$5,000.
- Special protections afforded consumers in consumer contracts, a departure from the existing unitary approach.
- Two new statutory express warranties available to remote purchasers based on statements that articulate an affirmation of fact, promise, or description, where the statements are on a record packaged with or accompanying goods, or in an advertisement or similar communication to the public.
- Shipment terms such as FOB, FAS, and CIF would be repealed as outmoded.

The warranty provisions have been particularly controversial. The National Conference of Commissioners on Uniform State Laws has expressed concern over the slowness of the states in adopting the proposed amendments to Article 2. There is little likelihood the amendments will be introduced in the Kentucky Legislature in the near future.

### **Article 2A - Leases**

Kentucky quickly adopted both the original version of Article 2A and its 1990 amendments. There are proposed changes for Article 2A that reflect the changes in Article 2 on sales. However, as with the amendments to Article 2, there is little likelihood of adoption in Kentucky in the foreseeable future.

### **Recent Case Law Under Articles 2 and 2A**

*Wise v. Alpha Leasing Company, Inc.*, 2002-CA-001254 (Ky. App. Aug. 8, 2003) (Not to be published).

The leasing company was protected from an action based on breach of implied warranties of merchantability and fitness for particular purpose through application of KRS 355.2A-212 and 355.2A-213, which contain exceptions for a "finance lease." The lessor is protected from these claims when the lessor does not select, manufacture, or supply the leased goods.

*Goodin v. TBF Financial*, 2004 WL 813352, 53 UCC Rep. Serv. 2D 265, 2002-CA-001336 (Ky. App. April 16, 2004) (Not to be published).

Lessors have the right to calculate damages due on the default of a lessee under KRS 355.2A-528, or by any method adopted by the parties in the lease agreement.

*Barnes v. Community Trust Bank*, 121 S.W.3d 520 (Ky. App. 2003).

The bank obtained summary judgment in the Madison Circuit Court for a deficiency due under a retail installment contract. (Retail installment contracts for the purchase of a motor vehicle are governed by KRS 190.090 *et seq.*) The lawsuit to enforce the contract was filed five and one half years after the bank repossessed and sold its collateral. The issue raised by *Barnes* on appeal was whether the action was barred by the 4-year statute of limitation in KRS 355.2-725. Until *Barnes*, purchasers/assignees of retail motor

vehicle paper in Kentucky had always assumed the applicable statute of limitation was the 15-year contract statute, KRS 413.090.

The Court of Appeals ruled in favor of *Barnes* and held that “an action for breach of a contract for sale . . . should have been brought within four years of defendant’s breach.” Although deciding the case under Article 2, Judge Huddleston, writing for a unanimous court, reached out to the commercial reasonability test of Article 9 in writing the decision, despite Article 2’s exclusion of security transactions. *See*, KRS 355.2-102.

In its Opinion, the Court neither discussed nor analyzed KRS 355.2-102, the scope section of Article 2, that holds transactions intended to operate only as a security transaction, are excluded from Article 2, even if the transaction is in the form of an unconditional contract to sell. Professor Hawkland harmonizes the intersection of Article 2 and Article 9 in this manner: “If a question arises as to the quality of the goods sold, the warranty sections of Article 2 will govern, but the rights of the seller to foreclose will be governed by Part [6] of Article 9.” Hawkland, Uniform Commercial Code Series, § 2-102:5. Presumably the right to foreclose also included the right to collect the deficiency.

Neither does the Kentucky decision address a decision of the Supreme Court of North Carolina that found that state’s legislature intended Article 9 to govern the security aspects of purchase money security agreements (including retail installment sale contracts), rejected the application of the 4-year statute of Article 2 § 725, and applied that state’s 10-year statute of limitation for “sealed instruments.”

Kentucky became the eighth state in the nation to apply the 4-year statute of Article 2 to the enforcement of motor vehicle retail installment contracts. (Maryland, one of the other states, applied the 4-year statute in lieu of a shorter statute for the enforcement of general contract obligations.)

When a purchaser finances a motor vehicle by means of a note and security agreement, with a bank or credit union, the applicable statute of limitation is the new 6-year statute under KRS 355.3-118. Senate Bill 114, in the 2005 Legislature, sought to harmonize the statutes of limitation for the two primary means of financing motor vehicles by adopting a similar 6-year statute to enforce contracts under KRS Chapter 190. The bill passed the senate and died in house committee.

The *Barnes* decision requires the holders of motor vehicle retail installment contracts to decide from what date the 4-year statute of limitation runs. Options are the date the customer first misses a payment, the date the holder accelerates the balance due under the contract, the date of sale in the event of repossession, or the maturity date. There is also the issue of whether payments subsequent to any of these events toll the statute of limitation. There are Kentucky cases, outside the area of retail installment contracts, that suggest subsequent payments on a debt toll a statute of limitation. However, without legislative relief, it is safe to say that if there has ever been a four year gap in payments, the statute has run.

### **Articles 3 and 4 - Negotiable Instruments and Bank Deposits and Collections**

Kentucky and 45 other states use the 1990 amendments to Articles 3 and 4. Two states, New York and South Carolina, have not yet adopted the 1990 amendments. Arkansas and Minnesota have adopted the limited amendments promulgated in 2002, and the amendments have been introduced in Nevada. The 2002 amendments:

- Allow reversal of payment on “preauthorized drafts” drawn on consumer accounts, allowing fraud losses to be shifted to the bank of first deposit.
- Revise 3-603 to make a debtor on a note subject to double liability only if the debtor continues to make payments to the original holder after receiving notice of a transfer, conforming to real estate mortgage law.
- Confirms the right of an assignee to recover on an instrument lost by the assignor.
- Conform the suretyship rules of 3-419 and 3-605 to the Restatement of Suretyship and Guaranty.
- Make various amendments to implement the policy of the Uniform Electronic Transactions Act.
- Provide, similar to 9-404, that a note for which the FTC requires a notice to be included will be treated as if the notice has been included whether it appears on the note or not.

Technology has so outpaced Articles 3 and 4, even the 2002 amendments, that there has been no rush to adopt the amendments and an overhaul, particularly to address ACH transactions, is being considered.

### **Recent Case Law Under Articles 3 and 4**

*Bradley v. National City Bank of Kentucky*, 2004 WL 3017297, 2003-CA-002711 (Ky. App. December 30, 2004) (Not to be published).

Action against a bank to recover on converted negotiable instruments was barred by the three-year statute of limitation under KRS 355.3-118(7)(a). The discovery rule does not apply to the statute of limitation on a suit against a depository bank.

*Jones v. Christian County School Employees Federal Credit Union*, 2002-CA-001635 (Ky. App. Jan. 23, 2004) (Not to be published).

Jones sought recovery from the credit union for conversion of a draft through forgery of Jones' endorsement as a co-payee. This is another action involving the statute of limitation under KRS 355.3-118, where the Court correctly applied subsection 7(a) to bar an action for conversion of an instrument more than three years after the claim for relief accrues.

*Morgan v. Crawford*, 106 S.W.3d 480 (Ky. App. 2003).

This case correctly applied Revised Article 3 regarding payment in full checks. The court noted that revisions to KRS 355.1-207(2) and KRS 355.3-311 in 1997 overruled the earlier Court of Appeals decision in *Ditch Witch Trenching Co., of Ky., Inc. v. C & S Carpentry Services, Inc.*, 812 S.W. 2d 171 (Ky. App. 1991).

KRS 355.3-311 (effective January 1, 1997) specifically provides that if a person against whom a claim is asserted proves (a) that he in good faith tendered an instrument as payment in full satisfaction, (b) the amount was unliquidated or subject to a bona fide dispute, (c) the claimant obtained payment of the instrument, and (d) the instrument, or an accompanying writing, contained a conspicuous statement to the effect that the instrument was tendered as full satisfaction of the claim, then the claim is discharged.

In this case, the appellant had stricken the payment in full language from a check, negotiated the instrument, and brought a claim for an alleged balance due. Under former Article 3 this was the equivalent of negotiating under protest. It does not work today.<sup>2</sup>

*The Cecilian Bank v. Sarver*, 2003 WL 23005721, 2002-CA-000076 (Ky. App. Dec. 24, 2003) (Not to be published) (Motion for discr. review granted Nov. 20, 2004, in 2004-SC-000036; dismissed as settled Feb. 8, 2005).

The appeal on this case was dismissed by agreement of parties following the grant of discretionary review by the Kentucky Supreme Court. The decision of the Court of Appeals will not be published. However, the underlying decision from the Court of Appeals is instructive as to the transition between the former 15 year statute of limitation on enforcement of a note and the 6 year statute adopted effective January 1, 1997.

The Kentucky Court of Appeals vacated a judgment of the Hardin Circuit Court which ruled the bank's suit on a note was outside the applicable statute of limitation. The 1990 revisions to Article 3 (effective in Kentucky January 1, 1997) provide, at KRS 355.3-118(1): "[A]n action to enforce the obligation of a party to a note payable at a definite time must be commenced within six (6) years after the due date or dates stated in the note or, if a due date is accelerated, within six (6) years after the accelerated due date."

The note matured January 15, 1994. The suit to enforce the note was not brought until August 31, 2000. The trial court found the action untimely and entered judgment for the defendant. Applying KRS 446.080(3), the Kentucky Court of Appeals found the new statute of limitation to be only prospective in nature and inappropriately applied by the trial court as retroactive.

Prior to the enactment of KRS 355.3-118, the applicable statute of limitation was the 15-year statute for written contracts, KRS 413.090. Now, 3-118 sets out a series of statutes of limitation for various forms of instruments, notes, and drafts.

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<sup>2</sup> Section 3-311(3) includes certain exceptions to the discharge rule – one for organizations that published a designation of a person or office for handling disputed claims, and another for refunds of the amount tendered within 90 days. However, actual knowledge of the payer's "full satisfaction" intent will defeat either exception and result in discharge. 3-311(4).

## **Article 4A - Funds Transfers**

*In Re Calumet Farm, Inc, In Re Calumet Farm, Inc.: First National Bank & Trust Co. v. Brandt*, 398 F.3d 555 (6th Cir. 2005), reh. *en banc* denied, March 16, 2005.

A wire transfer was botched to the extent that \$770,301.58 was wired rather than \$77,301.58. The bank attempted to recover the overpayment from the recipient of the wire transfer. The recipient defended on the discharge for value rule. The Court ruled that under Kentucky law a beneficiary of a wire transfer may properly invoke the discharge for value rule, and retain funds erroneously transmitted, unless the beneficiary is notified of the error before it discharges debt based on the receipt of value. In essence, the Court ruled that a creditor becomes a bona fide purchaser and may keep a payment made by mistake as long as the creditor discharges an obligation of its debtor before it becomes aware of the mistake. However, the Sixth Circuit found the recipient had prior notice of the mistake and could not retain the funds based on the discharge for value rule.

## **Article 7 – Documents of Title**

A Revised Article 7 was offered to the states in 2003 and has been adopted by 8 states, including Kentucky's neighboring state of Virginia. The Article is before the legislatures of 12 additional states, including the bordering states of Illinois and West Virginia. The primary purpose of the revision is to allow for the development of electronic documents of title and to update the original 1960 Article for modern times in light of state, federal, and international developments.

Revised Article 7 provides for the legal recognition of electronic documents of title, issues of authentication, application of the statute of frauds to electronic documents, and interchangeability of electronic and paper documents. The revision adopts the concept of "control" first developed in Article 8 for investment securities. The concept of "control" is also used in Article 9 with respect to security interests in securities, financial assets, and investment accounts. "Control" also applies in the Uniform Electronic Transactions Act regarding the negotiation of promissory notes. In Revised Article 7, "control" likewise provides the electronic equivalent of negotiation.

There have been so few cases under Article 7 in Kentucky that any effort to adopt the revisions in Kentucky will probably be paired with the revision effort for some other Article of

the UCC. However, the modernization of Kentucky's law may be of great importance to the growth in logistics businesses, and to those who finance such businesses.

## **Article 9 – Secured Transactions**

### **Recent Case Law Under Article 9**

*Layne v. Bank One, Kentucky, N.A.*, 395 F.3d 271 (6th Cir. 2005).

The plaintiffs borrowed money and secured their loans with shares of publicly traded common stock in the company of which they were principals. When the market price of the stock fell precipitously, the bank did not sell the stock but entered into discussions with its borrowers to obtain additional collateral.

The debtors argued that the bank's failure to promptly sell the shares that held the collateral constituted the failure to exercise reasonable care in the custody and preservation of its collateral. The Sixth Circuit, however, found that duty does not include the duty to sell stock before a stock declines in value, even if the bank was at one time over secured.

There was proof in the case that the debtors never specifically requested that the bank sell the stock after it declined below the required loan to value ratio. Predicting how Kentucky would rule, the Sixth Circuit held that a lender is under no obligation to sell shares of stock, and that if a borrower is concerned about share value it is the borrower's responsibility to take remedial steps such as paying off a loan or substituting other assets for the pledged shares. The Sixth Circuit further held that the sale of the publicly traded shares on a recognized national market was per se commercial reasonable; citing Revised Article 9, KRS 355.9-610 and KRS 355.9-627(2).

*Brock v. Community Trust Bank*, 2005 WL 37146, 2004-CA-000301 (Ky. App. Feb. 11, 2005) (Not to be published).

The bank's notice of sale for a repossessed motor vehicle notified the debtor that the vehicle would be sold on January 18, 2001. However, the notice cut off the debtor's right of redemption at 5:00 p.m. on January 15, 2001. Although there is case law in other states that a debtor's right of redemption continues until the auctioneer's hammer falls, in this unpublished decision, the Kentucky Court of Appeals held that the bank's contract with



the auction company constituted the form of contract for sale referred to in former KRS 355.9-506 and that the notice of disposition was sufficient under former KRS 355.9-504.

Another important point of the case is the allegation by debtor's counsel that the bank violated KRS 190.090 (motor vehicle installment contracts) by assessing a \$75 processing fee to creditor as part of the principal balance on the contract. The court found that the \$75 fee was initially added to the balance, but subsequently deducted on a line titled "Less: Prepaid Finance Charges." The court thus concluded that the processing fee was not included in the principal balance of the contract and that the bank did not violate the motor vehicle installment contract act.

*In Re Howard: Howard v. Whitesville Credit Union*, 312 Bankr. 840 (Bkrcty. W.D. Ky. 2004).

The court found a note's future advance clause enforceable under Kentucky law and held that collateral for the first note served as security for a second note and that the motor vehicle in question remained encumbered until the second note was paid in full. The court specifically held that "(f)uture advances clauses are generally enforceable in Kentucky." The court noted that in consumer credit cases the future advance should be of the same class as the general advance but under the facts of the case found the appropriate tests were met in that both transactions involved the purchase of vehicles.

### **Kentucky's Secretary of State Filing System**

Kentucky completes the transition period from former Article 9 to Revised Article 9 at 12:01 a.m. July 1, 2006. All locally filed financing statements (except those covering as-extracted collateral, timber to be cut, or made as fixture filings) will cease to be effective June 30, 2006,<sup>3</sup> unless they have been refiled through an initial in-lieu-of continuation statement with the Kentucky Secretary of State, or, for debtors that are organizations organized under the laws of another state or who are natural persons resident in another state, the appropriate central filing office of that state (usually the secretary of state's office). Except for the narrow classes of collateral in which local filing remains appropriate, after June 30, 2006, it will no longer be

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<sup>3</sup> Presumably at the end of June 30, 2006. The statute, KRS 355.9-705(3)(b), indicates the date but not a time. The official comments to 9-705 offer no help. However, Part 7 of Article 9 includes several references to financing statements filed before July 1, 2001, leading to the inference that 12:00 p.m. June 30 is the time intended.

necessary to search the records of county clerk's offices, and a complete UCC financing statement search can be accomplished on the web site of the Kentucky Secretary of State.

Incomplete and incorrect in-lieu filings will continue to cause confusion and problems for years to come. Common problems include omission of a collateral description, omission of the local office filing date or file numbers, omission of the magic words "which financing statement remains effective," and attaching as exhibits (some with and sometimes without a reference incorporating the exhibits) the prior financing statement that does not use the collateral terminology now in Revised Article 9. In Kentucky, these problems can arise only with paper filings – these mistakes cannot be made with electronic filings because the Secretary's web site prevents these errors. While in-lieu filings will not be made after June 30, 2006, creditors will continue to rely on in-lieu filings that were made, and junior creditors and trustees in bankruptcy will examine the in-lieu filings in search of such errors.

A potential safety net may exist in KRS 355.9-506, which states what is known as the minor errors rule. It provides: "A financing statement substantially satisfying the requirements of this part is effective, even if it has minor errors or omissions, unless the errors or omissions make the financing statement seriously misleading." The reference to "this part" means Part 5 of Article 9, but the in-lieu requirements are set out in Part 7, specifically, KRS 355.9-706(3). The additional information requirements for an in-lieu initial financing statement are: (a) to identify the financing statement being continued by the office in which it was filed, the date of filing and file numbers of the financing statement, and the date of filing and file number (if any) of the most recent continuation statement, and (b) to affirmatively declare that the now identified prior financing statement "remains effective." On its face, the minor errors rule does not apply to the in-lieu information. It is therefore unclear whether the minor errors rule would save an in-lieu financing statement that omitted a filing date or transposed a filing number. If the minor errors rule does not apply, such an in-lieu financing statement is potentially defective, and the creditor's security interest would be unperfected. However, the drafters of Revised Article 9 agree that it was intended that the minor errors rule should apply to all financing statements, including those filed under 9-706. Professor Richard H. Nowka has written an excellent article arguing that the minor errors rule of 9-506 covers the information required by 9-706(3). *See, Minor Errors in "In-Lieu-Of" Statements Under U.C.C. Section 9-706: Did The Drafters Of Revised Article 9 Forget The Safety Net?*, 42 Brandeis L.J. 721, Summer 2004.

The drafters of Revised Article 9 inadvertently created one potential glitch for secured parties. For a financing statement that would have expired during the last six months of 2001, a continuation statement filed locally during the six months preceding that expiration date would, under prior law, have continued the effective period of the financing statement for another five years from the expiration date. For instance, a continuation statement filed in the appropriate county clerk's office on May 1, 2001, would have continued a financing statement that had been filed on November 1, 1996, and established a new expiration date of November 1, 2006. However, June 30, 2006, is a "drop dead" date for the transition from former Article 9 to Revised Article 9. All financing statements continued with local filings during January through June 2001 will cease to be effective, regardless of the expiration date under former Article 9, at the end of June 30, 2006.

Secretary of State Trey Grayson continues to build on the accomplishments of his predecessor, John Y. Brown, III (both University of Kentucky College of Law graduates), in establishing for Kentucky one of the best, most utilitarian, and most economic electronic filing systems in the nation. The only glitch thus far discovered in the electronic system is the availability of information on amendments that electronically terminate either paper or electronically filed financing statements. To amend a financing statement, including an amendment of termination, Revised Article 9 requires the name of the secured party of record that authorized the amendment or an affirmative indication that the termination is authorized by a debtor, providing the name of the debtor authorizing the amendment. This data is not now being displayed by the computer system for terminations filed electronically, although the data is required to be input by the person doing the filing. The fraud implications are apparent. While an unauthorized termination is not effective as to the properly perfected secured party, a subsequent secured party that relies on the electronic termination cannot verify from the system that a termination was properly authorized.

**FEDERAL PREEMPTION  
AND THE REGULATION OF PREDATORY LENDING**

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**SECTION G**



**FEDERAL PREEMPTION AND THE REGULATION  
OF PREDATORY LENDING**

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**FEDERAL PREEMPTION  
AND THE REGULATION OF PREDATORY LENDING**

**Richard A. Vance  
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I. INTRODUCTION.

The issue of federal preemption of state banking law arises in a variety of contexts, from interest rate exportation, to the substantive regulation of abusive lending practices, even to the regulation of ATM charges. Traditionally, it has arisen with regard to national banks and federal thrift institutions, but increasingly, some suggest that state banks insured by the FDIC may also invoke preemption under a variety of theories.

This outline briefly reviews the theoretical basis for the doctrine of federal preemption, the steps the Office of the Comptroller of the Currency (“OCC”) is taking to address abusive lending practices, the concerns of state banking regulators, the implications of proposed federal predatory lending law, and finally, a new FDIC rulemaking scheduled to begin in May 2005.

In a speech on February 11, 2002, former Comptroller John D. Hawke, Jr., laid out the theoretical case for federal preemption for national banks in a nutshell:

“There is no question that national banks’ immunity from many state laws is a significant benefit of the national charter – a benefit that the OCC has fought hard over the years to preserve. The ability of national banks to conduct a multi-state business subject to a single uniform set of federal laws, under the supervision of a single regulator, free from visitorial powers of various state authorities, is a major advantage of the national charter.”

Many state regulators and legislators, the Conference of State Bank Supervisors, consumer groups and others believe the agency’s preemption efforts are nothing more than a



power grab. While the OCC has generally been thought to be on firm ground in defending its preemption authority in the courts, the agency may have been less successful in defending preemption in the press and the court of public opinion.

This most recent preemption controversy is largely centered around whether a national bank is subject to a host of relatively new state laws pertaining to unfair, deceptive, predatory or abusive lending practices and other state instituted consumer protection issues. Furthermore, the controversy extends to who has the authority to enforce compliance with these state laws. The OCC's position is generally that these state laws are largely preempted by federal law and, accordingly, not applicable to national banks and their operating subsidiaries and the OCC has sole "visitorial" authority (i.e., supervisory and enforcement authority) over national banks and their operating subsidiaries, except where federal law permits states to act. According to the OCC, the doctrine of federal preemption is nothing new; it has been well established for more than one hundred years. The states largely argue that preemption undercuts their ability to regulate abusive lending practices within their jurisdictions, thereby damaging the state bank system, and ultimately destroying the "dual banking system." (See Press Release concerning *New York v. First Horizon Home Loan Corp.*, Exhibit D.)

Meanwhile, Congress is again turning its attention to the problem of abusive lending practices. Congress had enacted the Home Ownership and Equity Protection Act ("HOEPA") back in 1994. Many states felt that the federal act provided insufficient protection to consumers, and moved to adopt their own, more restrictive, predatory lending acts (including Kentucky, at KRS 360.100(2003)). However, Congress continues to entertain more extensive regulation in the area, and such regulation could preempt state predatory lending laws. For example, currently

under consideration is H.R. 1182, which is based on the original North Carolina predatory lending bill, and would preempt state law in this area.

Finally, on March 21, 2005, the FDIC announced the initiation of a rulemaking to consider a petition to preempt certain state laws as applied to regulate the activities of federally-insured state banks. 70 Fed. Reg. 13413 (March 21, 2005). The petitioners argue that the regulation is necessary to protect parity with national banks. The state regulatory authorities rejoin that such preemption would create a unitary banking system and render state bank regulation irrelevant. If adopted, such FDIC rules would indeed have far-reaching implications for the regulation of state banks.

## II. What is the Dual Banking System?

The OCC describes the Dual Banking System as follows:

“The ‘dual banking system’ refers to the parallel state and federal banking systems that co-exist in the United States. The federal system is based on a federal bank charter, powers defined under federal law, operation under federal standards, and oversight by a federal supervisor. The state system is characterized by state chartering, bank powers established under state law, and operation under state standards, including oversight by state supervisors.”

Office of the Comptroller of the Currency, *National Banks and the Dual Banking System* (2003).

## III. What is the Role of Federal Preemption?

In a news release for a speech given on February 12, 2002, Comptroller Hawke described the role of preemption by saying:

“In his speech, the Comptroller described the role of federal preemption. Acting under the Supremacy Clause of the Constitution, the courts have consistently limited the ability of states to prevent or significantly interfere with lawful activities of national banks. The courts have held that states may not prevent national banks from engaging in congressionally-granted powers, or stand as an obstacle to the purposes for which the national bank charter was created. In addition, the states may not regulate at all in areas where federal interest predominates or where Congress has fully ‘occupied the field.....’ The Comptroller noted that preemption must be ‘value-blind’ with respect to the desirability of the state law involved. In preemption situations, the only relevant issue is whether the state law would impair or significantly interfere with a national bank’s exercise of powers granted to it under federal law.”

#### IV. What is the Rule Dealing with Visitorial Powers for National Banks?

In September 2003, the OCC released a paper entitled *National Banks and the Dual Banking System*, which describes dual banking and visitorial powers by the OCC for a national bank as follows:

“Preemption of state laws that would ‘retard, impede, burden, or in any manner control’ national banks’ ability to exercise powers authorized under federal law, and the OCC’s extensive, virtually exclusive ‘visitorial powers’ over national banks, are differences in national and state bank powers and supervisory implementation that are not inconsistent with the dual banking system; they are the defining characteristics of it....The allocation of any supervisory responsibility for the new national banking system to the states would have been inconsistent with this need to protect national banks from state interference. Congress, accordingly, established a federal supervisory regime and vested responsibility to carry it out in the newly created OCC. Congress granted the OCC the broad authority ‘to make a thorough examination into all the affairs of [a national bank],<sup>17</sup> and solidified this federal supervisory authority by vesting the OCC with exclusive ‘visitorial powers’ over national banks. These provisions assured, among other things, that the OCC would have comprehensive authority to examine all the affairs of a national bank and protect national banks from potential state hostility by establishing that the authority to examine national banks is vested *only* in the OCC, unless otherwise provided by federal law.<sup>18</sup>”

<sup>17</sup> Act of June 3, 1864, c. 106, § 54, 13 Stat. 116, codified at 12 U.S.C. § 481.

<sup>18</sup>Writing shortly after the Currency Act and National Bank Act were enacted, then-Secretary of the Treasury, and formerly the first Comptroller of the Currency, Hugh McCulloch observed that “Congress has assumed entire control of the currency of the country, and, to a very considerable extent, of its banking interests, prohibiting the interference of State governments.” Cong. Globe, 39<sup>th</sup> Cong., 1<sup>st</sup> Sess., Misc. Doc. No. 100, at 2 (Apr. 23, 1866).

V. How is the OCC Regulating National Banks in the Predatory or Abusive Lending Area?

**2002**

In 2002, the OCC issued two advisory letters containing guidance to national banks pertaining to unfair or deceptive acts or practices and applicability and enforcement of state laws.

1. *Guidance on Unfair or Deceptive Acts or Practice* (OCC Advisory Letter 2002-3)
  - a. The advisory letter advises national banks and their operating subsidiaries pertaining to risks of engaging in lending or marketing practices that may constitute unfair or deceptive acts that would likely mislead a reasonable consumer in a material way. The OCC noted concern that increased competition may have permitted more aggressive marketing by banks to borrowers who cannot afford the terms offered.
  - b. The advisory letter cautions national banks and their operating subsidiaries about the consequences of engaging in unfair or deceptive practices which include litigation, enforcement actions, monetary judgments, penalties and reputational risks.
  - c. Section 5 of the Federal Trade Commission Act (FTC Act), 15 USC 45(a)(1), prohibits “unfair or deceptive acts or practices in or affecting commerce.” Under Section 8 of the Federal Deposit Insurance Act, 12 U.S.C. §1818, the OCC may take appropriate enforcement actions against national banks and their subsidiaries for violations of any law or regulation.
  - d. The advisory letter provides other examples of federal statutes regulating unfair or deceptive practices include “Credit Practices Rule, 12 C.F.R. 227 (Regulation AA); Truth in Lending Act and the Federal Reserve’s Regulation Z; Equal Credit Opportunity Act; Privacy Regulations, 12 C.F.R. 40; and Fair Debt Collection Practices Act.
  - e. The advisory letter provides practical guidelines to assist a bank manage risks in this area and improve consumer information and service.

2. *Questions Concerning Applicability of Enforcement of State Laws: Contacts from State Officials* (OCC Advisory Letter 2002-9)
  - a. The advisory letter reviews general principles to determine if a state law applies to a national bank or its operating subsidiary and provides statutory authority of the OCC to regulate national banks, to examine national banks for compliance with federal and applicable state laws, and to enforce these laws.
  - b. The advisory letter notes that “state retain some power to regulate national banks in areas such as “contracts, debt collection, acquisition and transfer of property, and taxation, zoning, criminal, and tort laws.”
  - c. The advisory letter states that national banks are not subject to state visitorial powers other than as authorized by federal law. The advisory letter requests national banks to consult with the OCC if contacted by state officials.

### 2003

In 2003, the OCC issued two advisory letters containing guidance to national banks to prevent abusive lending practices in connection with direct or brokered loan transactions. In addition, the OCC won a case establishing that its visitorial authority extended to operating subsidiaries of national banks.

1. *Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practice* (OCC Advisory Letter 2003-2)
  - a. The advisory letters provide guidance to national banks and their operating subsidiaries on lending practices that are considered “predatory” or “abusive” to ensure that national banks do not undertake predatory lending.
  - b. National banks should adopt policy and procedures that a borrower has the capacity to make scheduled payments for a loan and the making of a loan to a consumer is not based solely upon the foreclosure value of the collateral.
  - c. National banks and their subsidiaries are cautioned against the following practices which should be addressed in their loan policies that would be considered abusive practices:
    - (i) frequent sequential loan refinancings with little benefit to consumer but generating fees for lender (“loan flipping”);

- (ii) refinancing of special subsidized mortgages (that contain favorable terms which may be lost in a refinancing) (for example, low-interest loans made by governmental or nonprofit lenders to low-income borrowers);
  - (iii) balloon payments to conceal true burden of financing;
  - (iv) “packing” of excessive and sometimes hidden fees;
  - (v) using loan terms such as negative amortization – to make it difficult to repay debt;
  - (vi) targeting elderly or uneducated for abusive loans;
  - (vii) inadequate disclosure of true costs, risks, and appropriateness to the borrower of a loan transaction.
- d. Policies and procedures should prevent customer misunderstanding of the terms and relative costs, risks and benefits of the loan.
  - e. National banks should adopt policies and procedures that provide for reporting of good credit histories to the major credit reporting bureaus.

2. *Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loan* (OCC Advisory Letter 2003-3)

- a. The advisory letter cautions national banks and their operating subsidiaries when purchasing or making loans that are originated through mortgage brokers or other intermediaries, when such loans contain abusive features or reflect predatory lending practices.
- b. National banks and their operating subsidiaries are to have clear procedures for entering into broker and third party originator relationships that delineate any unacceptable characteristics for loans the national bank will acquire.
- c. National banks should perform appropriate due diligence on all third party sources before entering into business arrangements, including background checks on compliance with applicable licensing and consumer protection laws and reviewing litigation, enforcement actions and consumer complaints.

- d. National banks should develop approved lists of brokers and originators with whom it will do business and maintain written agreements with third parties to ensure that loans offered to a national bank abide by the bank's policies and to make best efforts to ensure the loans offered are consistent with the borrower's needs, objectives and financial situation.
  - e. National banks should obtain written agreements between the borrower and broker disclosing the services the broker will provide; contain an acceptance of the services by the borrower and the fees to be paid to the broker including a signed and dated acknowledgement of receipt by the borrower.
  - f. National banks should monitor all broker and third-party loan originations for compliance and take appropriate corrective action where appropriate to include modification of loans and termination of business arrangements with third parties.
3. *Wells Fargo Bank v. Boutris*, 252 F. Supp. 2d 1065 (E.D.Cal. 2003). The California corporations commissioner sought to audit the mortgage loan subsidiary of a national bank. The U.S. District Court held that the exclusive visitorial authority accorded the OCC to inspect and regulate national banks under the National Banking Act extends to national bank operating subsidiaries. Thus, the California corporations commissioner's state law authority to audit mortgage loan subsidiaries of national banks was preempted by federal law.

## 2004

On January 13, 2004, the OCC published two final regulations that the OCC has referred to as the Preemptive Rule and the Visitorial Powers Rule. The Preemptive Rule amends 12 C.F.R. Parts 7 and 34 to add provisions clarifying the applicability of state laws to national banks and their operating subsidiaries. The Visitorial Powers Rule amends 12 C.F.R. Part 7 and clarifies the scope of the OCC's "visitorial powers" over a national bank and its subsidiaries. (The OCC's "Questions and Answers" on these rules is attached.)

### PREEMPTION RULE

Generally, the rule provides that state laws do not apply to national banks if they "obstruct, impair or condition" a national bank's exercise of its federally authorized lending, deposit-taking, and other powers. The rule adopts an anti-predatory lending standard for consumer loans which prohibits national banks from making any type of consumer based loans predominantly on the bank's realization of the foreclosure value of the borrower's collateral without regard to the borrower's ability to repay the loan according to its terms. The rule also invokes Section 5 of the FTC Act to prohibit a national bank from engaging in unfair and deceptive trade practices.

1. The types of state laws that the regulation preempts includes laws regulating loan terms, imposes conditions on lending and deposit relationships, and requires state licenses.

2. The types of laws that are not preempted and do not affect the manner or content of national bank activities such as those dealing with contracts, rights to collect debts, acquisition and transfer of property, torts, taxation, crimes or zoning.

### VISITORIAL POWERS RULE

The visitorial powers rule clarifies issues related to the OCC's exclusive visitorial powers over national banks and their operating subsidiaries, except where federal law authorizes states to act.

1. Visitorial powers refer to the authority to examine, supervise and regulate the affairs of a corporate entity.

2. The OCC has exclusive visitorial powers over national banks, except where federal laws authorize states to act.

3. State authorities may not exercise, indirectly, through the courts, rights of visitation that the statute precludes them from exercising directly.

4. States retain the right to enforce fire codes, environmental laws, zoning ordinances, generally applicable criminal laws, and the like.

### 2005

On February 2, 2005, the OCC issued *OCC Guidelines Establishing Standards for National Banks' Residential Mortgage Lending Practices* (OCC Bulletin 2005-3). The purpose of the guidelines is to ensure that national banks and their operating subsidiaries do not become involved in predatory, abusive, unfair, or deceptive residential mortgage lending practices.

1. Part II of the guideline requires the national bank to manage the various risks associated with residential mortgage lending – including credit, legal, compliance and reputational risks. Additionally, it warns banks not to become involved in abusive, predatory, unfair or deceptive practices directly or indirectly, through mortgage brokers, or other intermediaries or through purchased loans.

2. Part III describes certain standards for the implementation of a residential mortgage lending program.

a. Lending practices inconsistent with sound residential mortgage practices are as follows.

(i) Equity stripping.



- (ii) Fee packing.
  - (iii) Loan flipping.
  - (iv) Refinancing of special subsidized mortgages on terms adverse to consumer.
  - (v) Encouraging a borrower to breach a contract and default on an existing loan in connection with a refinancing.
- b. Cautions banks to use care and heightened diligence when they offer loans that include single premium insurance, negative amortization and mandatory arbitration that may be susceptible to abusive, predatory, unfair or deceptive practices. Heightened diligence is particularly required when loans are to be provided to the elderly, to persons substantially indebted, to persons not financially sophisticated, to persons who have language barriers, to persons who have limited or poor credit histories; or to persons who have other characteristics which limit their credit choices.
  - c. National Banks are also cautioned to always be mindful to mitigate risks as they go forward with real estate lending and to insure that compliance is ongoing on a continuing basis.
  - d. The standards set forth in the guidelines are enforceable under Section 39 of the Federal Deposit Insurance Act (12 U.S.C. §1831 p-1) and the implementing process in the OCC's regulations at 12 C.F.R. 30.
  - e. This final rule is effective April 8, 2005.

## VI. FDIC RULEMAKING.

On March 21, 2005, the FDIC announced a rulemaking to consider preemption of certain state laws. The rulemaking was prompted by a petition from the Financial Services Roundtable, a trade association of large financial institutions. The petition argues that the FDIC should adopt rules that clarify that state banks operating across state lines should be governed by a single framework of law and regulation to the same extent as national banks.

A. Specifically, the petition requests the FDIC to establish preemptive rules for state insured banks "clarifying" the following areas:

1. The law applicable to activities conducted in a host state by a state bank that has an interstate branch in that state;

2. The law applicable to activities conducted by a state bank in a state in which the bank does not have a branch;
3. The law applicable to activities conducted by an operating subsidiary of a state bank;
4. The scope and application of GLBA §104(d) preemption; and
5. Implementation of interest rate exportation under the preemptive authority of FDIA §27.

B. The petitioner asserts that the broad preemptive authority asserted by the OCC and supported by the courts over the last decade have given national banks a significant competitive advantage. The petitioner argues that the survival of the 'dual banking system' depends on clarifying and extending preemptive authority to state banks.

C. Some critics of the proposal, such as New York attorney general Eliot Spitzer, argue that the proposal will diminish a state's ability to regulate financial institutions within their borders, and will result in a "race to the bottom", as some states eliminate regulatory burdens in order to entice banks to establish home offices in their jurisdiction (as South Dakota has done in the credit card business).

D. Other critics believe that the use of federal preemption by FDIC lacks the historic precedent that underlies the OCC's doctrine, which is based on the National Banking Act, and *McCulloch v. Maryland*, 17 U.S. 316 (1819). The adoption of the proposed rules risks the demise of the 'dual banking system', in that most state rules would be subject to preemption, and there would be a very narrow area of activity subject to state banking regulation. In the light of these risks and the lack of established authority, such critics believe that the assertion of such a new preemptive power must be left to Congress.

## VII. CONCLUSION

The OCC continues to zealously assert the doctrine of federal preemption of state laws for national banks and their operating subsidiaries under the National Banking Act as a major advantage of a national bank charter. In apparent response to state bank regulators and consumer groups who charge that the OCC fails to adequately protect consumers from predatory lending, the OCC has initiated a number of advisory letters and rules to ensure that national banks do not engage in abusive consumer practices.

Congress may eventually choose to adopt a comprehensive national lending rule dealing with predatory lending that would, by preempting local authority over predatory lending, create a level playing field for all commercial banks. The importance of ratings agencies in the securitization market is already applying pressure toward a uniform national solution.

The resolution of the recent FDIC petition concerning the use of federal preemption powers for the benefit of state insured banks will have important consequences for the future of the "Dual Banking System."

**List of Exhibits**

- Exhibit A      OCC Preemption Final Rule – Questions and Answers (January 7, 2004)
- Exhibit B      OCC Visitorial Powers Final Rule – Questions and Answers (January 7, 2004)
- Exhibit C      FDIC Petition for Rulemaking to Preempt Certain State Laws, 70 Fed. Reg.  
13413 (March 21, 2005)
- Exhibit D      New York Attorney General Sues National Bank Subsidiary (January 20, 1994)

**Preemption Final Rule  
Questions and Answers  
January 7, 2004**

**I. INTRODUCTION**

***What action is the OCC taking today?***

The OCC is issuing a final rule (Final Rule) amending its regulations to add provisions clarifying the applicability of state law to national banks' lending, deposit-taking, and other operations. The Final Rule identifies types of state laws that are preempted by Federal law and therefore not applicable to national banks. Most of these laws have already been found to be preempted by a Federal court, the OCC, or the Office of Thrift Supervision in its comparable rules applicable to Federal thrifts.<sup>1</sup>

In addition, the Final Rule identifies types of state laws that are not preempted. These types of laws generally create the legal infrastructure that enables or facilitates the exercise of a Federal banking power.

Along with these preemption provisions, we are also adopting important new anti-predatory lending standards governing national banks' lending activities – nationwide.

***What action is the OCC not taking today?***

The OCC is not authorizing any new national bank activities or powers, such as the ability to engage in real estate brokerage.

In addition, although we believe the statute authorizing national banks' real estate lending activities (12 U.S.C. § 371) could permit the OCC to occupy the field of national bank real estate lending through regulation, we have declined to announce such a position in the Final Rule.

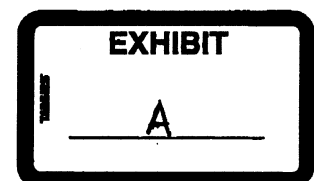
Finally, the Final Rule makes no changes to the OCC's rules governing the activities of operating subsidiaries. As already set out in 12 CFR 5.34, 7.4006, and 34.1(b), national bank operating subsidiaries conduct their activities subject to the same terms and conditions as apply to the parent banks. Therefore, *by virtue of regulations already in place*, the Final Rule applies equally to national banks and their operating subsidiaries.

***What types of state laws will be preempted under the Final Rule?***

The Final Rule sets out types of state statutes that are preempted in the areas of real estate lending, other lending, and deposit taking. For lending, they include licensing laws, laws that address the terms of credit, permissible rates of interest, escrow accounts, and disclosure and advertising. For deposit-taking (in addition to laws dealing with disclosure requirements and

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<sup>1</sup> See attached chart comparing the OCC's regulations with the regulations of the OTS and NCUA.



licensing and registration requirements), they include laws that address abandoned and dormant accounts, checking accounts, and funds availability. These lists reflect OCC opinions, court decisions, comparable rules applicable to Federal thrifts, and the application of traditional, judicially recognized standards of preemption. These lists are not intended to be exhaustive – the OCC may identify, and address on a case-by-case basis, other types of state laws that are preempted.

In addition, with regard to bank operations, the Final Rule states that except where made applicable by Federal law, state laws that obstruct, impair, or condition a national bank's exercise of powers granted under Federal law do not apply to national banks. This provision applies to any national bank power or aspect of a national bank's powers that is not covered by another OCC regulation specifically addressing the applicability of state law.

***What types of state laws will NOT be preempted under the Final Rule?***

The Final Rule also sets out examples of the types of state laws that are not preempted and would be applicable to national banks to the extent that they only incidentally affect the lending, deposit-taking, or other operations of national banks. These include laws on contracts, rights to collect debts, acquisition and transfer of property, taxation, zoning, crimes, and torts. In addition, any other law that the OCC determines to only incidentally affect national banks' lending, deposit-taking, or other operations would not be preempted under the Final Rule.

***What changes have been made in the final rule that differ from the proposal?***

The final rule makes several changes to the anti-predatory lending standard. First, the final rule revises the anti-predatory lending standard so that it expressly prohibits national banks from engaging in unfair and deceptive trade practices under Section 5 of the FTC Act in making any loans. In addition, the final rule revises the anti-predatory lending standard to clarify that it applies to consumer loans only (those for personal, family, and household purposes). Finally, it clarifies that the anti-predatory lending standard is not intended to prohibit legitimate collateral-based loans, such as reverse mortgages, where the borrower understands that it is likely or expected that the collateral will be used to repay the debt.

The final rule states that except where made applicable by Federal law, state laws that "obstruct, impair, or condition" a national bank's exercise of powers granted under Federal law do not apply to national banks. These terms, which are drawn directly from Supreme Court precedents, differ somewhat from the wording in the proposal, but the substantive effect – which is to encapsulate the preemption standards used by the Supreme Court – is the same.

The lists of the types of state laws that are and are not preempted in the final rule are substantially the same as the lists in the proposal.

## **II. REASONS AND AUTHORITY FOR THIS RULE**

### ***Why is the OCC taking this action now?***

Markets for credit, deposits, and many other financial products and services are now national, if not international, in scope, as a result of technological innovations, erosions of legal barriers, and our increasingly mobile society. These changes mean that now, more than ever, the imposition of an overlay of state and local standards and requirements on top of the Federal standards to which national banks already are subject, imposes excessively costly, and unnecessary, regulatory burdens.

In recent years, this burden has been getting worse, as states and localities have increasingly tried to apply state and local laws to national bank activities that are already subject to Federal regulation, curtailing national banks' ability to conduct operations to the full extent authorized by Federal law.

These state and local laws – including laws regulating fees, disclosures, conditions on lending, and licensing – have created higher costs, potential litigation exposure, and operational challenges. As a result, national banks must absorb the costs, pass the costs on to consumers, or discontinue offering various products in jurisdictions where the costs or exposure to uncertain liabilities are prohibitive.

When national banks are unable to operate under uniform, consistent and predictable standards, their business suffers, which negatively affects their safety and soundness. This rulemaking will enable national banks to exercise fully their Federal powers pursuant to uniform standards, applied by the OCC. As a result, national banks will be able to operate with more predictability and efficiency, consistent with the national character of the national banking system, and in furtherance of the safe and sound operations of all national banks.

### ***What authorizes the OCC to issue the Final Rule?***

The OCC's authority to issue the preemption regulation comes from both 12 U.S.C. § 93a (for all activities) and 12 U.S.C. § 371 (specifically relating to real estate lending). In CSBS v. Conover, the D.C. Circuit expressly held that the Comptroller has the authority under § 93a to issue regulations preempting state laws that are inconsistent with the activities permissible under Federal law for national banks and under § 371 to issue a regulation that preempts aspects of state laws regarding real estate lending.<sup>2</sup>

### ***Does the OTS have broader authority under the Home Owners' Loan Act to preempt the application of state laws to federal thrifts than the OCC has for national banks?***

No. While the HOLA uses a different formulation to describe the authority of the OTS, we believe those differences are not material for purposes of our rulemaking authority.

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<sup>2</sup> CSBS v. Conover, 710 F.2d 878 (D.C. Cir. 1983).

The HOLA directs the OTS to "provide for the examination, safe and sound operation, and regulation of savings associations," and authorizes the OTS to issue "such regulations as the Director determines to be appropriate to carry out the responsibilities of the Director or the Office." Elsewhere, the HOLA states that the Director is authorized "to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as Federal savings association and to issue charters therefore, giving primary consideration of the best practices of thrift institutions in the United States."

The National Bank Act, at 12 U.S.C. § 93a, states that, "Except to the extent that authority to issue such rules and regulations has been expressly and exclusively granted to another regulatory agency, the Comptroller of the Currency is authorized to prescribe rules and regulations to carry out the responsibilities of the office, except that the authority conferred by this section does not apply to section 36 of this title [governing branching] or to securities activities of National Banks under the Act commonly known as the 'Glass-Steagall Act.'"

In addition to the general authority vested by section 93a, other statutes vest the OCC with authority to issue regulations to implement a specific statutory grant of authority. For instance, 12 U.S.C. § 371 vests the OCC with the authority to impose "restrictions and requirements" on national banks' authority to make real estate loans. The general rulemaking authority vested in the OCC by section 93a, coupled with the more specific grants of authority in section 371 and elsewhere, provide the OCC with rulemaking authority that is comparably broad to that of the OTS.

***Won't the OCC's preemption rule have the effect of giving national banks a competitive advantage over state-chartered institutions?***

Our actions are part of the OCC's ongoing effort to ensure that national banks are able to meet the needs of their communities in the most effective and efficient manner possible. As part of that effort, we periodically see a need to respond to attempts by states and municipalities to regulate the exercise of Federal powers permitted under the National Bank Act.

States remain free to be the laboratories of change that have led to many significant improvements in the delivery of financial products and services. Each of us is responsible for ensuring that the institutions we regulate remain financially strong and competitive. However, when the states act in a way that conflicts with the powers granted to national banks by Federal law, the Supremacy Clause of the United States Constitution dictates that the state law is preempted.

### **III. PREEMPTION STANDARDS**

***Is the OCC occupying the field with regard to national banks' real estate lending activities?***

No. Part 34 of our rules implements 12 U.S.C. § 371, which provides a broad grant of authority to national banks to engage in real estate lending. The only qualification in the statute is that these Federal powers are subject "to section 1828(o) of this title [which requires the adoption of uniform Federal safety and soundness standards governing real estate lending] and such

restrictions and requirements as the Comptroller of the Currency may prescribe by regulation or order.”

As originally enacted, § 371 contained a limited grant of authority to national banks to engage in real estate lending. Over the years, Congress broadened § 371, giving the OCC the wide-ranging regulatory authority it has today. While we believe the history of § 371 indicates that Congress left open the possibility that the OCC would occupy the field of national bank real estate lending through regulation, the OCC has not exercised the full authority inherent in § 371 in the Final Rule. Thus, in the proposal, we invited comment on whether it would be appropriate to assert occupation of the entire field of real estate lending.

Upon further consideration of this issue and careful review of comments submitted pertaining to this point, we have concluded that the effect of such labeling is largely immaterial, and thus we decline to attach a particular label to the approach reflected in the Final Rule. We rely on our authority under both §§ 93a and 371, and to the extent that an issue arises concerning the application of a state law not specifically addressed in the final regulation, we retain the ability to address those questions through interpretation of the regulation, issuance of orders pursuant to our authority under § 371, or, if warranted by the significance of the issue, by rulemaking to amend the regulation.

***How does the preemption standard included in the Final Rule – “obstruct, impair, or condition” – fit with the United States Supreme Court precedents?***

The preemption standard in the Final Rule is a distillation of the many preemption standards applied by the Supreme Court over the years. These include “obstruct,” “stands as an obstacle to,” “impair the efficiency of,” “condition the grant of power,” “interfere with,” “impair,” “impede,” and so on. Courts have recognized that no one phrase necessarily captures the full range of conflicts that will lead to a preemption of state law. We are not applying a standard that is inconsistent with those applied by the Supreme Court. Rather, we are adopting a standard that captures the essence of the tests used in various Supreme Court decisions. The preamble to the final rule expressly states that we are not trying to create a standard different from what the Court has expressed.

***Is the final rule consistent with the standards of the Riegle-Neal Act, where Congress endorsed the application of state laws to national banks?***

Yes. The Riegle-Neal Act sorted out *which* state’s laws – host state or home state – regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches, would apply to interstate branches of national banks, and provided that the host state’s laws in those areas would apply to national banks **“except when Federal law preempts the application of such State laws to a national bank.”** Potential preemption of state laws thus was expressly recognized as possible in the Riegle-Neal legislation itself.

Legislative history of the Riegle-Neal Act indicates that Congress expected the OCC to apply traditional, recognized preemption standards in deciding preemption issues, which is exactly what the OCC is doing.



The Riegle-Neal Act also specifically provided that the provisions of any state law to which a branch of a national bank is subject under the Act “shall be enforced, with respect to such branch, by the Comptroller of the Currency.”

#### **IV. IMPACT ON THE DUAL BANKING SYSTEM**

*What impact will this rule have on the dual banking system?*

This rule will enhance the dual banking system. This system refers to the chartering, powers, and supervision of state-chartered banks by state authorities and the chartering, powers, and supervision of national banks by Federal authority, the OCC. By its very nature, the dual banking system represents and embraces differences in national and state bank powers and in the supervision and regulation of national and state banks.

One of the key differences between national and state banks is that national banks operate pursuant to a Federal grant of national bank powers, subject to uniform national standards, administered by a Federal regulator. Preemption is a key principle that enables national banks to operate nationwide, under uniform national standards, subject to the oversight of a Federal regulator, just as Congress intended it. This distinction between national and state banks is one of the defining characteristics of the dual banking system.

The national and state charters each have their own distinct advantages. But many national banks engage in multi-state businesses that require the efficiency of a uniform, nationwide system of laws and regulations. Customers of national banks enjoy protections that are as strong as -- and in some cases stronger than -- those available to customers of state banks. But they also benefit from the efficiencies of the national banking system, which lead to lower costs and expanded product offerings. It is important to remember that the dual banking system offers American consumers a choice -- those who believe the state system offers greater protections can vote with their pocketbooks.

#### **V. IMPACT ON CONSUMERS**

*Isn't federal preemption of state laws inconsistent with consumer protection?*

Absolutely not. Today's action is fully consistent with the twin goals of promoting consumer protection and ensuring a safe, sound, and competitive, national banking system. Because of the Supremacy Clause of the U.S. Constitution, many state standards do not apply to national banks. The OCC's action will not leave a void, but instead promote consumer protections for customers of national banks.

Rather than being subject to varying state standards, when they exist, under the new OCC regulations, all national banks and their operating subsidiaries are made subject to uniform, consistent, and predictable rules of fair conduct wherever they do business throughout the United States. National banks and their operating subsidiaries are subject to comprehensive supervision, OCC-administered supervisory standards (for example to prevent predatory, unfair, or deceptive lending practices), and vigorous and effective enforcement of these consumer protection laws,

rules, and standards. The OCC's new regulations and supervisory approach offer real benefits to consumers. State consumer protection laws, by contrast, cannot effectively protect consumers in a similarly comprehensive, uniform, or nationwide basis.

As a result of the OCC's regulations, consumers will benefit from consistent, comprehensive protection against predatory, unfair, or deceptive lending practices, regardless of the state in which they live, *when they do business with a national bank or national bank operating subsidiary*. The OCC's recent actions also are complementary to state protection of consumers who deal with state-regulated lenders: while customers of national banks will be protected under the uniform federal consumer protections adopted by the OCC, customers of state-regulated lenders will continue to be protected to the extent that consumer protection laws exist in their home state that apply to their transactions.

***Predatory lending is said by many to be an inherently local issue. Why is a national standard better in this area? Aren't states in a better position than is the OCC to understand the problems consumers encounter with abusive lending practices and, therefore, better able to fashion responses that are tailored to particular problems?***

If taken to its logical conclusion, this position would lead to the regulation of abusive lending practices at the municipal level. However, many state antipredatory lending laws – such as the Georgia Fair Lending Act – prohibit municipalities from regulating in areas covered by the state law. In this way, a state is able to avoid subjecting institutions within its jurisdiction to inconsistent obligations, an objective shared by the OCC for national banks.

In the few instances where national banks have engaged in abusive lending practices, the problems have been specific to the bank in question and were not prevalent throughout a geographic region. Thus, we believe it is appropriate to focus on a given institution's lending practices to determine whether there are problems that require attention. This bank-specific focus, against the backdrop of an extensive array of Federal consumer protections, enables the OCC to identify and respond to consumer problems when they arise.

To the extent that it is a local issue, it is worth remembering that the OCC's examination staff of more than 1,800 is housed in field offices in every state in the country and on-site in our largest banks, giving us a very strong local presence.

***How do the OCC's new regulations protect consumers?***

First, the OCC regulations *prohibit* a national bank from making *any* consumer loan -- including any form of mortgage loan, automobile loan, and student loan – that is based predominantly on the bank's expectation that it will be repaid through foreclosure or liquidation of collateral that the consumer used to secure the loan. This rule targets a fundamental characteristic of predatory lending – lending to consumers who cannot be expected to be able to make the payments required under the terms of the loan, and will be effective in ensuring that home equity stripping, auto title lending, and other forms of abusive credit practices that injure individual consumers and communities will not occur in the national banking system.

As a result of this regulation, national banks are subject to the most comprehensive federal anti-predatory lending standard in existence today: unlike HOEPA, the OCC rules are not limited to "high cost" home mortgages, but instead apply to all types of consumer loans and mortgages made by national banks. Consequently, they will have a substantially broader reach than not only HOEPA, but also state predatory lending laws.

Second, the OCC regulations also explicitly prohibit a national bank from engaging in unfair or deceptive practices that violate the Federal Trade Commission Act (FTC Act) in connection with any consumer loan, including mortgages. While the OCC does not have the authority under the Federal Trade Commission Act to adopt rules defining particular acts or practices as unfair or deceptive under that Act (that authority is only conferred on the Federal Reserve Board), we do have authority to take enforcement action where we find unfair or deceptive practices. OCC case-by-case enforcement actions under the FTC Act have had a real and meaningful impact on correcting abuses and helping consumers by providing hundreds of millions of dollars in restitution to consumers who have been harmed by unfair, deceptive, or abusive lending practices. The OCC's new regulations provide greater clarity to the application of this prohibition to all lending by national banks and their operating subsidiaries.

***What federal consumer protection standards apply to national banks and national bank operating subsidiaries in the absence of state laws?***

National banks and national bank operating subsidiaries are subject to extensive federal consumer protection laws and regulations, administered and enforced by the OCC. OCC examinations of national banks and national bank operating subsidiaries are conducted to ensure and enforce compliance with these laws and regulations, and supplemental OCC supervisory standards. Federal consumer protection laws and regulations that apply to national banks and to national bank operating subsidiaries include:

- Federal Trade Commission Act
- Truth in Lending Act
- Home Ownership and Equity Protection Act
- Fair Housing Act
- Equal Credit Opportunity Act
- Real Estate Settlement Procedures Act
- Community Reinvestment Act
- Truth in Savings Act
- Electronic Fund Transfer Act
- Expedited Funds Availability Act
- Flood Disaster Protection Act
- Home Mortgage Disclosure Act
- Fair Housing Home Loan Data System
- Credit Practices Rule
- Fair Credit Reporting Act
- Federal Privacy Laws
- Fair Debt Collection Practices Act

- OCC anti-predatory lending rules in Parts 7 and 34;
- OCC rules imposing consumer protections in connection with the sales of debt cancellation and suspension agreements;
- OCC standards on unfair and deceptive practices (<http://www.occ.treas.gov/ftp/advisory/2002-3.doc>); and
- OCC standards on preventing predatory and abusive practices in direct lending and brokered and purchased loan transactions (<http://www.occ.treas.gov/ftp/advisory/2003-2.doc> and <http://www.occ.treas.gov/ftp/advisory/2003-3.doc>).

***What will protect consumers who receive real estate loans from national banks now that various state laws are preempted?***

Consumers will continue to be protected by an extensive array of Federal protections, enforced by the OCC (see above). Preemption of state laws governing national banks' real estate lending certainly does not mean that such lending would be unregulated. On the contrary, national banks' real estate lending is highly regulated under Federal standards and subject to comprehensive supervision. In addition to the many standards that apply to national banks under various Federal laws, the OCC recently issued comprehensive supervisory standards to address predatory and abusive lending practices, OCC Advisory Letter 2003-2, *Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices* and OCC Advisory Letter 2003-3, *Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans*.

Moreover, the final rule adds an explicit safety and soundness-based anti-predatory lending standard to the general statement of authority concerning lending. The regulation states that a national bank shall not make a consumer loan subject to 12 CFR part 34 based predominantly on the bank's realization of the foreclosure or liquidation value of the borrower's collateral, without regard to the borrower's repayment ability, including current and expected income, current obligations, employment status, and other relevant financial resources. The regulation further provides that, in making any real estate loan, a national bank shall not engage in unfair or deceptive practices within the meaning of section 5 of the Federal Trade Commission Act and regulations promulgated thereunder. As described in the preamble to the regulation, the OCC's pioneering commitment to using the FTC Act to address consumer abuses is demonstrated by a number of recent actions against national banks that have resulted in the payment of hundreds of millions of dollars in restitution to consumers.

The new anti-predatory lending standard and the multitude of other existing Federal laws such as the Truth in Lending Act (TILA), the Real Estate Settlement Procedures Act (RESPA), and the Equal Credit Opportunity Act (ECOA), ensure that national banks are subject to consistent and uniform Federal standards, administered and enforced by the OCC, that provide strong and extensive customer protections and appropriate safety and soundness-based criteria for their real estate lending activities.

***What does the rule mean for consumer protection in non-real estate loans?***

The Final Rule regarding non-real estate lending contains the same safety and soundness-based anti-predatory lending standard included in the real estate lending portion of the Final Rule.

Together, this new prudential standard, and Federal laws such as TILA and the FTC Act, ensure that national banks are subject to consistent and uniform Federal standards, administered and enforced by the OCC, that provide strong and extensive customer protections and appropriate safety and soundness-based criteria for their lending activities.

***How does the OCC supervise national banks and national bank operating subsidiaries for compliance with consumer protection laws and standards?***

The OCC supervises national banks' compliance with consumer protection laws and anti-predatory lending standards through programs of ongoing supervision that are tailored to the size, complexity and risk profile of different types of banks, and through targeted enforcement actions. National banks and national bank operating subsidiaries are subject to comprehensive – and in the case of the largest banks, *continuous* – supervision. With a network of approximately 1,800 examiners, the OCC conducts risk-based examinations of national banks and national bank operating subsidiaries throughout the United States. Thus, for example, whether a national bank conducts its mortgage lending business in a department of the bank, in a branch, or in an operating subsidiary, OCC supervision focuses on that line of business wherever and however the bank conducts it.

The OCC's Customer Assistance Group (CAG) in Houston, Texas, also plays an important role in helping to identify potential violations of consumer protection law and unfair or deceptive practices. CAG provides immediate assistance to consumers and also collates and disseminates complaint data that help direct OCC examination resources to banks, activities, and products that present compliance risks and that require further investigation. In addition to information obtained in on-site examinations and through consumer complaints, the OCC evaluates information about abusive lending and illegal practices by national banks and their subsidiaries that it obtains from other sources, including community organizations and state enforcement agencies.

Where violations of law are found, the OCC takes appropriate action to remedy the problem and to address consumer harm. In this regard, the OCC is the first and only federal banking agency to take action to combat unfair and deceptive lending practices by enforcing the Federal Trade Commission Act. For example, the OCC recently entered into a consent agreement with a bank that the OCC concluded had engaged in predatory mortgage lending practices, including making a loan without regard to the borrower's ability to repay the loan, "equity stripping," and "fee packing." See, *In the Matter of Clear Lake National Bank, San Antonio, TX, Enforcement Action 2003-135* (November 6, 2003), available at <http://www.occ.treas.gov/ftp/eas/ea2003-135.pdf>. No other federal banking agency has taken enforcement action to address predatory mortgage lending or deceptive marketing practices affecting subprime borrowers. The OCC's enforcement actions have provided over \$300 million in restitution thus far to consumers of modest means and limited or impaired credit histories who have been harmed by abusive practices.

It also is our hope that states will cooperate with the OCC to try to maximize the protection of consumers. If the states and the OCC work together, we can leverage all of our resources to combat abusive financial providers. The OCC has adopted special procedures to expedite

referrals of consumer complaints regarding national banks from state Attorneys General and state banking departments, and we have offered to enter into formal information-sharing agreements with states to formalize these arrangements. We recently concluded the first of these arrangements and hope that other states will soon follow suit.

***How can the OCC assure that customers of national bank operating subsidiaries are adequately protected if the OCC has not provided a list of those operating subsidiaries?***

The OCC supervises the activities of national banks and their operating subsidiaries based on a line of business approach, not based on the corporate form in which it is conducted. For example, the OCC will apply a comprehensive approach to supervising a bank's mortgage banking activities whether they are conducted in departments of the bank, branches, or one or more operating subsidiaries. We do not maintain an aggregate count of national bank operating subsidiaries just as we do not maintain an aggregate count of the number of departments banks use to do business. Operating subsidiary information is available to OCC supervisors at the individual bank level, is included in our supervisory data system for community and Mid-Size banks, and for Large Banks, all significant subsidiaries are listed in the quarterly risk analysis prepared by each bank's examiner-in-charge.

Most national bank operating subsidiaries use names that clearly identify them with their parent bank, thus a customer with a complaint would know they are dealing with a bank-related business and could expect that he or she could lodge the complaint by contacting the OCC's Customer Assistance Group. In some instances, however, the operating subsidiary may have a name that does not readily connect it with its parent bank. In order to better address those situations, the OCC will be establishing a link from the Consumer Assistance web page to a searchable database of national bank subsidiaries that do business directly with consumers, and that are *not* functionally regulated by other regulators. We are compiling this information from our various databases and will begin with a listing of these types of subsidiaries of our Large Banks.

***The OCC's traditional mission has been to audit banks for safety and soundness. How does the OCC's preemption rule further safety and soundness?***

To the extent that the question implies that preemption will result in a lack of consumer protections, we would disagree. It is not a question of whether national banks will be subject to consumer protection laws, but only a question of which laws apply. National banks are subject to a comprehensive regimen of Federal consumer protection laws and regulations, including the new anti-predatory lending standard included in this rulemaking.

We examine our banks to ensure that they are complying with these protections and, where we find that a bank is not, we take appropriate action against that bank. This approach enables us to tailor the regulatory response to the problem, rather than impose a one-size-fits-all rule that prohibits all national banks from offering certain financial products. In this way, banks are free to offer products and services that meet the needs of their customers and communities, in a manner that is consistent with safe and sound banking practices.

**Visitorial Powers Final Rule  
Questions and Answers  
January 7, 2004**

**I. INTRODUCTION**

***What are "visitorial powers"?***

The term "visitorial powers" refers to the power of a regulator or superintendent to inspect, examine, supervise, and regulate the affairs of an entity.

***What is the effect of your recently published final rule amending your visitorial powers regulation ?***

The final rule clarifies two points concerning our *existing* regulation regarding the OCC's exclusive visitorial authority under 12 U.S.C. § 484. The Federal statute that addresses this area, 12 U.S.C. § 484, states that "[n]o national bank shall be subject to any visitorial powers except as authorized by Federal law, vested in the courts of justice or such as shall be, or have been exercised or directed by Congress or by either House thereof or by any committee of Congress or of either House duly authorized."

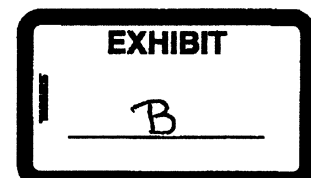
Our regulation clarifies that the scope of the OCC's exclusive visitorial authority applies to the content and conduct of national bank activities authorized under Federal law. In other words, the OCC is the exclusive supervisor of a national bank's banking activities; the OCC does not enforce fire codes, environmental laws, etc.

Our final rule also clarifies that the exception to the OCC's exclusive visitorial powers for "visitorial powers...vested in the courts of justice" in section 484 pertains to powers inherent in the judiciary and does not grant state or other governmental authorities any right that they do not otherwise possess to inspect, superintend, direct, regulate, or compel compliance by a national bank with any law regarding the content or conduct of activities authorized for national banks under Federal law.

***What changes have been made in the final rule that differ from the proposal ?***

We have amended the language in § 7.4000(a)(3) to simplify it. This provision clarifies that the OCC has exclusive visitorial powers just with respect to the content and conduct of activities that are authorized for national banks under Federal law.

We have also amended the regulation text in the final rule concerning the "visitorial powers...vested in the courts of justice" exception. This provision no longer makes reference to specific powers of the courts of justice "to issue orders or writs compelling the production of information or witnesses" since that description may be too limiting. This provision now simply states that the exception pertains to powers inherent in the judiciary. The language that stated



that the exception for courts of justice does not authorize states or other governmental entities to exercise visitorial powers over national banks also has been simplified.

***What does the final rule not do?***

The rule does not prevent state officials from enforcing state laws that do not pertain to a national bank's banking activities, such as environmental laws, fire codes, zoning ordinances or criminal laws of general applicability.

The final rule makes no change to the treatment of operating subsidiaries. An existing OCC regulation, 12 C.F.R. § 7.4006, states that "[u]nless otherwise provided by Federal law or OCC regulation, State laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank." Thus, states generally can exercise visitorial powers over operating subsidiaries only to the extent that they could exercise visitorial powers over a national bank.

The final rule does not change the ability of states to seek a declaratory judgment from a court as to whether a particular state law applies to the Federally-authorized business of a national bank or is preempted.

## **II. IMPACT ON DUAL BANKING SYSTEM**

***Isn't the final rule inconsistent with the dual banking system?***

No. The dual banking system refers to the chartering and supervision of state-chartered banks by state authorities and the chartering and supervision of national banks by Federal authority, the OCC. By its very nature, the dual banking system represents and embraces differences in national and state bank powers and in the supervision and regulation of state and national banks. Dual banking does not mean that national banks are subject to state supervision or regulation of activities they are authorized to conduct under Federal banking law.

***Is it the case, as certain state officials suggest, that this rule would disrupt the current system under which states enforce consumer compliance laws?***

No. There may have been some misunderstanding over the years about the limits of state visitorial authority. For 140 years, the national banking statutes have said that no national bank shall be subject to any visitorial powers except as authorized by Federal law. Federal law – at 12 U.S.C. § 484 -- clearly vests the OCC with exclusive visitorial powers over the business of banking conducted by national banks. Equally clearly, courts have stated that visitorial powers include the power to enforce compliance with applicable law. With certain narrow exceptions, Federal law does not grant visitorial authority over national banks to the states. In fact, in the area of consumer protection, Congress stated explicitly, in the Riegle-Neal Act, that *the OCC enforces any state consumer protection law that applies to interstate branches of national banks.*

Recent debate about enforcement has centered recently on the ability of states to enforce their laws against operating subsidiaries of national banks. Operating subsidiaries are Federally authorized means through which national banks can conduct business. The only court cases to decide the issue of the OCC's visitorial authority over national bank operating subsidiaries have



held that our exclusive visitorial authority – including the authority to enforce compliance with applicable law – extends to operating subsidiaries. Thus, while states are free to enforce consumer compliance laws as they apply to institutions within their primary jurisdiction, they are not free to do so in the context of national banks or their operating subsidiaries, except where Federal law authorizes them to do so.

***What role may states play under the final rule?***

The states have a crucial role to play. It is our hope that states will cooperate with the OCC to try to maximize the protection of consumers. If the states and the OCC work together, we can leverage all of our resources to combat abusive financial providers. The OCC has adopted special procedures to expedite referrals of consumer complaints regarding national banks from state Attorneys General and state banking departments, and we have offered to enter into formal information-sharing agreements with states to formalize these arrangements. We recently concluded the first of these arrangements and hope that other states will soon follow suit.

***Isn't it true that the Household case recently concluded by the New York Attorney General would not have been possible if the preemption rule had been in effect?***

No. There have been several actions against financial entities that are within the Household corporate family. One such action was brought by the OCC, against Household Bank (SB), N.A. In that action, the court stated that “[t]he restitution and remedial action ordered by the OCC is comprehensive and significantly broader in scope than that available through these state court proceedings. The OCC Agreement [with the bank] provides significantly more relief to Arizona consumers than this Court finds a legal basis for imposing under state law.”

The State of New York also recently concluded an action against Household International, the parent company of Household Finance Corporation and Beneficial Finance Corporation. Those entities are outside the jurisdiction of the OCC, and will remain so after this rule becomes effective. Thus, our actions in this rulemaking *will not affect in any way* the state’s ability to bring the enforcement action in question.

### **III. AUTHORITY FOR THE RULE**

#### **A. National banks**

***On what does the OCC base its conclusion that its visitorial authority is exclusive?***

Federal law. Section 484 explicitly states that “[n]o national bank shall be subject to any visitorial powers except as authorized by Federal law, vested in the courts of justice or such as shall be, or have been exercised or directed by Congress or by either House thereof or by any committee of Congress or of either House duly authorized.” The statute first sets forth a complete prohibition, then subjects that prohibition to certain exceptions. In other words, the prohibition applies unless a visitorial power is covered by one of the enumerated exceptions. *None* of the exceptions in the statute allows for the allocation of any general bank supervisory

responsibility to the states. Further, such an allocation to the states would be inconsistent with the history and purpose of the National Bank Act and judicial precedent interpreting the Act.

## **B. Operating subsidiaries**

***By what authority do you claim that the OCC has exclusive visitorial power over national bank operating subsidiaries ?***

Federal law. Pursuant to their authority under 12 U.S.C. § 24(Seventh), national banks have long used separately incorporated entities as a means to engage in activities that the bank itself is authorized to conduct. When established in accordance with OCC regulations and approved by the OCC, an operating subsidiary is a Federally authorized, Federally licensed means by which a national bank may conduct Federally authorized activities.

Courts have consistently treated operating subsidiaries as equivalent to national banks, unless *Federal* law requires otherwise. As a matter of Federal law, operating subsidiaries conduct their activities subject to the same terms and conditions as apply to the parent bank, including being subject to the exclusive visitorial authority of the OCC.

Courts that have considered the issue have confirmed recently that the OCC has exclusive visitorial authority over national bank operating subsidiaries. In *Wells Fargo Bank, N.A. v. Boutris*, a Federal district court issued a permanent injunction enjoining the California Department of Corporations from exercising visitorial powers over a national bank operating subsidiary. The court noted the existing case law and concluded that the OCC's operating subsidiary regulation is within the agency's authority delegated to it by Congress and is a reasonable interpretation.

***Didn't GLBA make clear that operating subsidiaries are explicitly NOT to be treated as part of their parent bank ?***

No, to the contrary. Section 121 of GLBA recognizes the authority of national banks to own subsidiaries that engage "solely in activities that national banks are permitted to engage in directly and are conducted *subject to the same terms and conditions that govern the conduct of such activities by national banks.*" This underscores the point that an operating subsidiary is treated, for regulatory and supervisory purposes, the same as its parent bank.

***Why shouldn't states have jurisdiction over entities that are created under state law – namely, operating subsidiaries?***

States do have jurisdiction over operating subsidiaries for matters concerning the corporate existence or corporate governance of operating subsidiaries. However, the states' jurisdiction stops at the point of regulating Federally-authorized banking activities that the operating subsidiary conducts.

Under Federal law, a national bank may exercise the Federal banking powers available to it either directly in the bank or indirectly through an operating subsidiary. If the bank elects to use

an operating subsidiary, the bank is required to obtain a Federal license to do so pursuant to the procedures set forth in the OCC's regulations. Once the license is obtained, the activity will be subject to the same terms and conditions that would apply if the bank conducted the activity directly.

#### IV. IMPACT ON CONSUMERS

*Why isn't it better to have more than one cop on the beat looking out for consumers? The OCC has relatively little experience in investigating banks for compliance with consumer protection laws. Why not accept help from the state AGs, which have a great deal of experience in this area?*

Under Federal law, only the OCC can examine or bring action against a national bank. And, in fact, the system works best when we each focus on our separate jurisdictions, as was demonstrated recently by a joint action taken against Security Trust Company and three of its executives by the OCC, the New York Attorney General, and the Securities and Exchange Commission.

The OCC is well equipped to handle enforcement matters for entities within our jurisdiction. Through a network of approximately 1,800 examiners located throughout the U.S., we monitor conditions and trends in individual banks and groups of banks. Our supervisory activities home in on risks identified by surveillance tools and subject matter experts. In the consumer area, consumer complaint information is used to identify potential problems in a bank's dealings with customers.

As part of our ongoing supervision of national banks, examiners look at bank policies and procedures. These policies and procedures are reviewed to evaluate if they adequately address the particular risks that the bank may face, given the nature and scope of its business. Depending on the nature of that business, we would expect bank policies and controls to reflect the considerations we have identified in our two advisories on how national banks should avoid becoming involved in predatory lending practices.

Our Customer Assistance Group in Houston, Texas (CAG) plays an important role in helping to identify potentially unfair and deceptive practices. In addition to providing immediate assistance to consumers, the CAG collates and disseminates complaint data that help point our field examiners toward banks, activities, and products that require further investigation.

We obtain additional valuable insight and surveillance from community and consumer groups, internal and external auditors, other Federal, state and local authorities, and competing banks.

Thus, national banks' compliance with applicable laws is subject to comprehensive – and in the case of the largest national banks, *continuous* – supervision. Where violations of law are found, we take appropriate action to remedy the problem and to address consumer harm.

As previously noted, it is our hope that states will cooperate with the OCC to try to maximize the protection of consumers. We have encouraged states to work with us to expedite referrals of

consumer complaints regarding national banks from state Attorneys General and state banking departments, and have offered to enter into formal information-sharing agreements with states to formalize these arrangements.

***Has the OCC ever brought a case charging predatory lending?***

In fact, we are the first – and thus far, only – Federal banking regulator to bring enforcement actions under section 5 of the Federal Trade Commission Act against financial institutions for abusive lending practices. The most recent case, against Clear Lake National Bank, involved home equity loan terms that we considered to be unfair to consumers. We required the bank to reimburse the borrowers in question. We have brought five other cases since 2001 under the FTC Act that have led to restitution of affected consumers. Moreover, we have moved aggressively to require national banks to terminate their relationships with “payday lenders.” We share the states’ concerns about the impact of predatory and abusive lending practices on consumers, and have moved aggressively to stop it whenever it is located in an institution we supervise.

Even the state Attorney Generals have acknowledged that it has not been a widespread problem inside the regulated banking industry. Having said that, however, the OCC has a strong track record of taking quick and decisive action against lenders that engage in abusive practices.

***The OCC’s traditional mission has been to audit banks for safety and soundness. How does the OCC’s visitorial powers rule further safety and soundness?***

To the extent that the question implies that preemption will result in a lack of consumer protections, we would disagree. It is not a question of *whether* national banks will be subject to consumer protection laws, but only a question of *which* laws apply. National banks are subject to a comprehensive regimen of Federal consumer protection laws and regulations, including the new anti-predatory lending standard included in this rulemaking.

We examine our banks to ensure that they are complying with these protections and, where we find that a bank is not, we take appropriate action against that bank. This approach enables us to tailor the regulatory response to the problem, rather than impose a one-size-fits-all rule that prohibits all national banks from offering certain financial products. In this way, banks are free to offer products and services that meet the needs of their communities, in a manner that is consistent with safe and sound banking practices.

**COMPARISON OF THE OCC'S PREEMPTION RULES  
WITH THE OTS'S AND NCUA'S CURRENT RULES  
JANUARY 7, 2004**

<b>Types of State Laws Generally Preempted</b>	<b>OCC Rules</b>	<b>OTS Current Rules</b>	<b>NCUA Current Rules</b>
Abandoned and dormant accounts (deposit-taking)	✓	✓	✓
Aggregate amount of funds that may be lent on the security of real estate	✓*		
Checking/share accounts (deposit-taking)	✓	✓	✓
Covenants and restrictions necessary to qualify a leasehold as security property for a real estate loan	✓*		
Access to, and use of, credit reports	✓	✓	
Terms of credit	✓*	✓	✓
Creditor's ability to require or obtain insurance of collateral or other risk mitigants/credit enhancements	✓	✓	
Due-on-sale clauses	✓	✓	✓
Escrow, impound, and similar accounts	✓	✓	
Funds availability (deposit-taking)	✓	✓	
Interest rates	✓**	✓	✓
Fees	✓***	✓	✓
Licensing, registration, filings and reports	✓	✓	
Loan-to-value ratios	✓*	✓	✓
Mandated statements and disclosure requirements	✓	✓	✓
Mortgage origination, processing and servicing	✓	✓	
Disbursements and repayments	✓*	✓	✓
Savings account orders of withdrawal (deposit-taking)	✓	✓	
Security property, including leaseholds	✓	✓	✓
Special purpose saving services (deposit-taking)	✓	✓	

\* Already preempted by the OCC's existing real estate lending regulation at 12 C.F.R. Part 34.

\*\* National banks' authority to charge interest is established by 12 U.S.C. § 85, and the OCC's existing regulation at 12 C.F.R. § 7.4001.

\*\*\* National banks' authority to charge fees is already addressed by the OCC's existing regulations at 12 C.F.R. § 7.4002.

<b>Types of State Laws Generally NOT Preempted:</b>	<b>OCC Rules</b>	<b>OTS Current Rules</b>	<b>NCUA Current Rules</b>
Contracts	✓	✓	
Commercial		✓	
Torts	✓	✓	
Criminal law	✓	✓	
Homestead laws specified by Federal statute	✓	✓	
Debt collection	✓		
Acquisition and transfer of real property	✓	✓	✓
Taxation	✓		
Zoning	✓		
Collections costs and attorneys' fees			✓
Plain language requirements			✓
Default conditions			✓
Insurance			✓
Incidental effect only	✓	✓	

defined in the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*), because the majority of applicants (grain industry) that apply for these official services, and are subjected to GIPSA supervision fees, do not meet the requirements for small entities. This rule will affect entities engaged in shipping grain to and from points within the United States and exporting grain from the United States. GIPSA estimates there are approximately 9,500 off-farm storage facilities and 18 export elevators in the United States that could receive services from delegated States or designated agencies. Official services are available from 7 delegated States and 49 designated agencies. For clarification, any and all grain that is exported from the U.S. export port locations must, as required by the USGSA, be inspected and/or weighed. These services are either performed by GIPSA or delegated States. Further, some grain exported from interior locations may also require inspection and/or weighing services unless the services are waived as provided in section 800.18 of the regulations. These services are provided by designated agencies. The USGSA does not require inspection or weighing services for grain marketed within the U.S. Consequently, these services are permissive and may be performed by official agencies. The USGSA (7 U.S.C. 71 *et seq.*) authorizes GIPSA to provide supervision of official grain inspection and weighing services, and to charge and collect reasonable fees for performing these services. The fees collected are to cover, as nearly as practicable, GIPSA's costs for performing these services, including related administrative and supervisory costs.

GIPSA realizes that any increase in supervision fees will be charged by official agencies to the users (grain industry) of the official grain inspection and weighing system. Although, the overall effect of this proposal will be passed on to the users of official grain inspection and weighing services, mostly large corporations, David R. Shipman, Deputy Administrator, GIPSA, has determined that this proposed rule will not have a significant impact on a substantial number of small entities as defined in the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*).

#### List of Subjects in 7 CFR Part 800

Administrative practice and procedure, Grain.

For the reasons set out in the preamble, 7 CFR part 800 is proposed to be amended as follows:

## PART 800—GENERAL REGULATIONS

1. The authority citation for part 800 continues to read as follows:

Authority: Public Law 94-582, 90 Stat. 2867, as amended (7 U.S.C. 71 *et seq.*)

2. In §800.71(a), Schedule C is amended by removing Table 1 and adding introductory text in its place as set forth below, and by redesignating Table 2 as Table 1.

### § 800.71 Fees assessed by the Service.

(a) \* \* \*

#### Schedule C—Fees for FGIS Supervision of Official Inspection and Weighing Services Performed by Delegated States and/or Designated Agencies in the United States.

The supervision fee is charged at \$0.011 per metric ton inspected and/or weighed.

\* \* \* \* \*

David R. Shipman,

Acting Administrator, Grain Inspection, Packers and Stockyards Administration.

[FR Doc. 05-5501 Filed 3-18-05; 8:45 am]

BILLING CODE 3410-EN-P

## FEDERAL DEPOSIT INSURANCE CORPORATION

### 12 CFR Chapter III

#### Petition for Rulemaking to Preempt Certain State Laws

AGENCY: Federal Deposit Insurance Corporation (FDIC).

ACTION: Notice of public hearing.

**SUMMARY:** This document announces a public hearing on a petition for rulemaking ("Petition") that would preempt certain state laws. Generally, the Petition asks the FDIC to issue a rule that preempts the application of certain state laws to the interstate operations and activities of state banks. The stated purpose of the requested rulemaking is to establish parity between state-chartered banks and national banks in interstate activities and operations. A copy of the Petition is attached to this document. The FDIC has scheduled a hearing to obtain the public's views on the issues presented by the Petition. This document sets forth the date, time, location, and other details of the hearing; it also summarizes the Petition and highlights several issues that participants in the hearing may wish to address. Opportunities to make an oral presentation at the hearing are limited, and not all requests may be granted. Attendance at the hearing is not

required in order to submit a written statement.

**DATES:** The hearing will be held on Tuesday, May 24, 2005, from 8:30 a.m. to 5 p.m. Anyone wishing to make an oral presentation at the hearing must (i) deliver a written request to the Executive Secretary of the FDIC, no later than 5 p.m. on Monday, May 9, 2005; and (ii) deliver a copy of his or her written statement plus a two-page (or less) summary of the statement to the Executive Secretary no later than 5 p.m. on Monday, May 16, 2005. All limited-appearance statements submitted in lieu of an oral presentation must be received by the Executive Secretary no later than 5 p.m. on Monday, May 16, 2005.

**ADDRESSES:** The hearing will be held in the Board room at the FDIC's headquarters, 550 17th Street, NW., Washington, DC.

You may submit a written request to make an oral presentation at the hearing, a copy of the written statement you will present, and the two-page (or less) summary, or a limited-appearance statement by any of the following methods:

- Agency Web site: <http://www.FDIC.gov/regulations/laws/federal/propose.html>. Click on *Submit Comment*.
- E-mail: [comments@FDIC.gov](mailto:comments@FDIC.gov).
- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments/Legal ESS, Room 3060, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.
- Hand Delivered/Courier: The guard station at the rear of the 550 17th Street Building (located on F Street), on business days between 7 a.m. and 5 p.m.
- Public Inspection: All statements and summaries may be inspected and photocopied in the FDIC Public Information Center, Room 100, 801 17th Street, NW., Washington, DC, between 9 a.m. and 4:30 p.m. on business days.
- Internet Posting: Statements and summaries received will be posted without charge to <http://www.FDIC.gov/regulations/laws/federal/propose.html>, including any personal information provided.

**FOR FURTHER INFORMATION CONTACT:** For questions regarding the conduct of the hearing: contact Valerie Best, Assistant Executive Secretary, (202) 898-3812; for questions regarding substantive issues: contact Robert C. Fick, Counsel, (202) 898-8962; or Joseph A. DiNuzzo, Counsel, (202) 898-7349, Legal Division, Federal Deposit Insurance Corporation, Washington, DC 20429.

**SUPPLEMENTARY INFORMATION:**

**EXHIBIT**

C

## I. Overview of the Rulemaking Petition

The Financial Services Roundtable, a trade association for integrated financial services companies ("Petitioner"), submitted the Petition to the FDIC. The Petition asks that the FDIC adopt rules concerning the interstate activities of insured state banks and their subsidiaries that are intended to provide parity between state banks and national banks. Generally, the requested rules would provide that a state bank's home state law governs the interstate activities of state banks and their subsidiaries to the same extent that the National Bank Act ("NBA") governs a national bank's interstate activities. A copy of the entire Petition is appended to this notice. The Petitioner requests that the FDIC adopt rules with respect to the following areas:

- The law applicable to activities conducted in a host state by a state bank that has an interstate branch in that state,
- The law applicable to activities conducted by a state bank in a state in which the state bank does not have a branch,
- The law applicable to activities conducted by an operating subsidiary ("OpSub")<sup>1</sup> of a state bank,
- The scope and application of section 104(d) of the Gramm-Leach-Bliley Act ("GLBA") regarding preemption of certain state laws or actions that impose a requirement, limitation, or burden on a depository institution, or its affiliate, and
- Implementation of section 27 of the Federal Deposit Insurance Act ("FDI Act") (which permits state depository institutions to export interest rates).

The Petitioner argues that it is both necessary and timely for the FDIC to adopt rules that clarify the ability of state banks operating interstate to be governed by a single framework of law and regulation to the same extent as national banks. According to the Petitioner, over the last decade the federal charters for national banks and federal thrifts have been correctly interpreted by the Office of the Comptroller of the Currency ("OCC") and the Office of Thrift Supervision ("OTS"), with the repeated support of the federal courts, to provide broad federal preemption of state laws that might otherwise apply to the activities or operations of federally-chartered banking institutions within a state. The result, it asserts, is that national banks and federal savings associations now can do business across the country

<sup>1</sup> Generally, an operating subsidiary is subsidiary of a bank or savings association that only engages in activities that its parent bank or savings association may engage in.

under a single set of federal rules. In contrast, the Petitioner believes that there is widespread confusion and uncertainty with respect to the law applicable to state banks engaged in interstate banking activities. Furthermore, it argues, this uncertainty produces the potential for litigation and enforcement actions, deters state banks from pursuing profitable business opportunities, and causes substantial expense to a state bank that decides to convert to a national bank in order to gain greater legal certainty. Finally, the Petitioner asserts that the FDIC has the authority, tools and responsibility to correct this imbalance.

## II. The FDIC's Approach to the Petition

The FDIC will hold a hearing to obtain the public's views on the Petition. The FDIC believes that public participation will provide valuable insight into the issues presented by the Petition and will assist the FDIC in deciding how to respond to the rulemaking request. The FDIC's options include: (i) Denying the entire Petition, (ii) granting the entire Petition, (iii) granting the Petition in part and denying the Petition in part, and (iv) seeking further clarification of the Petition from the Petitioner. If the FDIC grants all or part of the Petition, a notice of proposed rulemaking will be published in the *Federal Register*, and an additional opportunity for public comment will be provided. The FDIC is interested in obtaining the views of the financial institutions industry, consumer groups, state financial institution supervisors, other state authorities, industry trade groups and the general public on the legal, policy, and other issues raised in the Petition.

## III. Issues Presented by the Petition

Although the FDIC is particularly interested in obtaining the public's views on the general and specific issues highlighted in this notice, we also are interested in the public's views on any other legal or policy issues implicated by the Petition. As a result, the FDIC encourages interested parties to address not only the highlighted issues, but also all other issues raised by the Petition.

### A. General Issues

With respect to the general issues raised by the Petition, the FDIC requests the public's views on the following:

G-1. Is a preemptive rule in these areas necessary to preserve the dual banking system?

G-2. What would be the impact on consumers if a preemptive rule were issued in these areas?

G-3. What are the implications of rulemaking in these areas for state banking regulation?

G-4. Would the measures urged by Petitioner achieve competitive balance between federally-chartered and state-chartered financial institutions as advocated by the Petitioner?

G-5. Are there alternative mechanisms available that would achieve the policy goals advocated by the Petitioner?

G-6. Should the issue of competitive parity in interstate operations be left to Congress?

G-7. If the FDIC determines that it has the legal authority to proceed with a preemptive rule, are there reasons why the FDIC should decline to do so? If so, what are they?

G-8. What would be the negative impact, if any, of the FDIC adopting a preemptive regulation as suggested by the Petitioner?

G-9. Do the states have a legitimate interest in how banks conduct business within their borders that would be undermined by the Petitioner's request?

G-10. Can state banks be expected to benefit if the FDIC were to preempt state law in the area of interstate banking operations? If so, how?

G-11. What considerations should the FDIC take into account that either support or challenge the proposition that Congress intended to provide the comprehensive parity envisioned by the Petition?

G-12. Is there a need for clarification on what law applies to the interstate operations of state banks?

### B. Specific Issues

Each of the five subject areas addressed by the Petition is described in summary fashion below. However, you are encouraged to read the Petition itself (which is attached) to gain complete details on the requested action. Each of the five subject areas is followed immediately by specific issues upon which the FDIC requests public input.

1. The law Applicable to Activities Conducted in a Host State by a State Bank That has an Interstate Branch in That State

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal I)<sup>2</sup> generally established a federal framework for interstate branching for both state banks and national banks. Both Riegle-Neal I and amendments made to Riegle-Neal I by the Riegle-Neal Amendments Act of

<sup>2</sup> Public Law 103-328, 108 Stat. 2338 (1994) (codified to various sections of title 12 of the United States Code).



1997 ("Riegle-Neal II")<sup>3</sup> contain express preemption provisions regarding which host state laws apply to a branch of an out-of-state bank.

The Petitioner asserts that Congress enacted Riegle-Neal II to provide competitive equality between state banks and national banks with respect to interstate banking. Riegle-Neal II revised the language of section 24(j)(1) of the FDI Act to read as follows:

The laws of the host state, including laws regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches, shall apply to any branch in the host state of an out-of-state state bank to the same extent as such state laws apply to a branch in the host state of an out-of-state national bank. To the extent host state law is inapplicable to a branch of an out-of-state state bank in such host state pursuant to the preceding sentence, home state law shall apply to such branch.

Riegle-Neal II, therefore, provides that host state law does not apply to a branch in the host state of an out-of-state, state bank to the same extent that host state law does not apply to a branch in the host state of an out-of-state national bank. When host state law does not apply, Riegle-Neal II provides that home state law applies. The Petitioner raises the issue of what law applies to activities of an out-of-state, state bank in a host state in which the bank maintains a branch, when those activities are conducted by the bank directly, or through an OpSub, or by some means other than the branch. The Petitioner argues that the FDIC should issue a rule that provides that home state law applies uniformly to all business of the bank in that State, whether by the bank directly, through the host state branch, through a loan production office ("LPO"), or through some other non-branch office, or through an OpSub.

The FDIC requests the public's views on the following specific issues:

1-1. What considerations should the FDIC take into account that either support or challenge the proposition that Congress granted the FDIC the authority to make home state law apply to all business conducted by a state bank in a host state in which the bank has a branch, whether conducted directly, or through a branch, a loan production office (an LPO), other office, or OpSub?

1-2. If the FDIC were to adopt a rule as requested, who should determine for each state whether the NBA and OCC rules would preempt host state law for national banks?

<sup>3</sup> Public Law 105-24 (1997).

1-3. If the FDIC were to adopt a rule as requested, how should the applicable home state law be determined when the home state statute law is silent?

2. The law Applicable to Activities Conducted by a State Bank in a State in Which the State Bank Does Not Have a Branch

The Petitioner requests that the FDIC adopt rules to provide that the home state law of a state bank will apply to its activities in other states (i.e., any state other than its home state) to the same extent as the NBA applies to the activities of national banks. The Petitioner cites Riegle-Neal II and section 104(d) of GLBA as an indication of Congressional intent on this issue. In addition, Petitioner refers to principles of administrative law that permit an agency to reasonably fill in statutory gaps and address the application of existing laws to new developments.

The FDIC requests the public's views on the following specific issue(s):

2-1. What considerations should the FDIC take into account that either support or challenge the proposition that an out-of-state, state bank should be able to operate in a state where the bank has no branches under the bank's home state law to the same extent that an out-of-state national bank can operate under the NBA and OCC rules?

3. The law Applicable to Activities Conducted by an Operating Subsidiary ("OpSub") of a State Bank

The Petitioner requests that FDIC adopt a rule that expressly provides that an OpSub of a state bank will be governed by the same law that is applicable to its parent state bank, except when state law applies to an OpSub of a national bank.

The FDIC requests the public's views on the following specific issues:

3-1. What considerations should the FDIC take into account that either support or challenge the proposition that an OpSub should be able to operate under the bank's home state law to the same extent that an OpSub of a national bank can operate under the NBA and OCC rules?

3-2. What considerations should the FDIC take into account that either support or challenge the proposition that an OpSub should be deemed equivalent to a division of the bank itself?

3-3. If the FDIC were to adopt the requested rule, what requirements should the subsidiary meet in order to be considered an OpSub, e.g., should it be wholly-owned, majority-owned, or just controlled by the bank?

4. The Scope and Application of Section 104(d) of GLBA Regarding Preemption of Certain State Laws or Actions That Impose a Requirement, Limitation, or Burden on a Depository Institution, or Its Affiliate

Section 104 of the GLBA ("section 104")<sup>4</sup> is titled "Operation of State Law." It expresses the intent of Congress that the McCarran-Ferguson Act which is entitled "An Act to express the intent of Congress with reference to the regulation of the business of insurance"<sup>5</sup> "remains the law of the United States." (Section 104(a)). In addition, it: (a) Addresses insurance licensing requirements for persons engaged in the business of insurance; (b) addresses the extent to which a state may regulate affiliations between depository institutions and insurers; (c) addresses the extent to which states may impose restrictions on insurance sales by depository institutions; (d) indicates that states may not prevent or restrict depository institutions or their affiliates from engaging in activities authorized or permitted under GLBA;<sup>6</sup> and (e) limits the ability of states to discriminate between depository institutions engaged in insurance activities authorized or permitted by GLBA or other federal law and others engaged in such activities.

The Petitioner contends that section 104(d) expressly preempts state laws or actions that discriminate against "depository institutions" or their affiliates. It urges the FDIC to exercise its authority under sections 8 and 9 of the FDI Act to adopt rules to make it clear that state laws, rules, or actions are preempted under section 104(d) when they provide for disparate treatment between an out-of-state national bank or in-state bank and an out-of-state state bank, or its affiliates. The Petitioner suggests, alternatively, that the FDIC adopt a statement of policy addressing the scope and effect of section 104(d) for state banks. The Petitioner asserts that although state banks subject to FDIC regulation are the intended beneficiaries of this express preemption, the preemption is not being utilized by state banks because the statute is relatively new and complex and the relevant provisions have not been construed by any

<sup>4</sup> 15 U.S.C. 6701.

<sup>5</sup> 15 U.S.C. 1011 *et seq.* Among other things, the McCarran-Ferguson Act provides that "the business of insurance, and every person engaged therein, should be subject to the laws of the several states which relate to the regulation or taxation of such business." (15 U.S.C. 1012(a)) and that "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance \* \* \* unless such Act specifically relates to the business of insurance." (15 U.S.C. 1012(b)).

<sup>6</sup> See section 104(d)(1).

agency or court. It states that rules are needed in view of the complexity and general lack of understanding of section 104(d).

The Petitioner argues that the breadth of section 104(d) preemption and its purpose to reach state law or actions that would provide disparate treatment for any type of depository institution (including an out-of-state state bank) in relation to its competitors is evident from section 104(d)'s language.

The Petitioner has described certain actions that if taken by the FDIC will, in its opinion, clarify by regulation or policy statement that state laws, rules, or actions cannot differentiate between in-state and out-of-state banks. The Petitioner specifically requests that the FDIC issue a rule or policy statement: (a) Stating that the section 104 preemption applies to insured banks and their subsidiaries, affiliates and associated persons; (b) defining a "person" to include a depository institution, subsidiary, affiliate, and associated person; (c) stating that the word "restrict" in section 104(d)(1) includes any state law, rule, interpretation or action that calls for any limitation or requirement; (d) addressing each of the four non-discrimination provisions in section 104(d)(4) to confirm that each is a distinct test and that any state law or action that fails one test is preempted; (e) addressing the scope of "actions" in section 104(d)(4) to include all types of formal or informal administrative actions by any state or local governmental entity, including decisions with respect to civil enforcement of state rules; (f) addressing section 104(d)(4)(D)(i) in light of the terms used in subparagraph (ii) to specify that paragraph (i) addresses treatment under state law of an out of state, state bank which would be an "insured depository institution," that is different from the treatment of any national bank or in-state state bank which would be an "other person engaged in the same activity" under these provisions; and (g) defining "state law" to include laws, ordinances and rules of political subdivisions, including any counties and municipalities.

The FDIC requests the public's views on the following specific issues:

4-1. GLBA is a not codified as part of the FDI Act, is silent as to rulemaking and applies to all insured depository institutions. What barriers, if any, would there be to the FDIC adopting a regulation or policy statement implementing section 104?

4-2. What considerations should the FDIC take into account that either support or challenge the proposition

that section 104 preempts state law in the manner described by Petitioner?

4-3. What barriers, if any, would there be to the FDIC adopting a regulation or policy statement applicable to all insured depository institutions based on section 104?

4-4. Is it reasonable for the FDIC to read section 104 as having some application to interstate banking operations in general?

4-5. The areas of section 104 Petitioner identifies for rulemaking are very discrete but taken together may have a broad impact. What are the overall implications (favorable as well as negative) of adopting the section 104 regulatory guidance suggested by the Petitioner?

5. Implementation of Section 27 of the FDI Act (Which Permits State Depository Institutions To Export Interest Rates)

Section 27 of the FDI Act ("section 27")<sup>7</sup> establishes the maximum amount of interest that a state-chartered insured depository institution or insured branch of a foreign bank (collectively, "state bank") may charge its borrowers. Generally, the statute authorizes a state bank to charge interest at the greater of the rate allowed by the laws of the State, territory, or district where the bank is located or not more than one percentage point above the discount rate on 90-day commercial paper at the Federal Reserve bank for the Federal Reserve district where the bank is located.<sup>8</sup> The statute also specifies that state banks may charge the rates authorized by the statute "notwithstanding any State constitution or statute which is hereby preempted for the purposes of this section."<sup>9</sup> As is the case under section 85 of the NBA for national banks, section 27 allows state banks to charge out-of-state borrowers interest at the rates allowed by the law of the State where the bank is located, even if such rates exceed the usury limitations imposed by the borrower's state of residence.<sup>10</sup>

Section 27 contains two subsections which are patterned after provisions in the NBA. Subsection (a) corresponds to section 85 of the NBA ("section 85"),<sup>11</sup> which addresses the interest rates that

national banks are authorized to charge their borrowers. Subsection (b) corresponds to section 86 of the NBA ("section 86"),<sup>12</sup> which addresses penalties and limitations of actions for charging interest in excess of the amount allowable under section 85.

Because section 27 was enacted to provide state banks "competitive equality" with national banks and is patterned after the corresponding provisions in the NBA, the FDIC and the courts have construed section 27 in virtually the same manner as the OCC and the courts have construed sections 85 and 86. For example, in General Counsel's Opinion No. 10 ("GC Opinion No. 10"),<sup>13</sup> the FDIC's General Counsel concluded that section 27 and section 85 should be construed in *pari materia* and that the term interest, for purposes of section 27, includes those charges that a national bank is authorized to charge under section 85 and the OCC's interpretive rule defining interest for purposes of section 85.<sup>14</sup> In General Counsel's Opinion No. 11 ("GC Opinion No. 11")<sup>15</sup> the FDIC's General Counsel interpreted section 27 as applying to state banks operating interstate branches in a manner similar to the OCC's interpretation of the application of section 85 to national banks operating interstate branches. In GC Opinion No. 11 it was observed that, like an interstate national bank under section 85, a state bank is "located" in the state where it is chartered and in each state where it has a branch. GC Opinion No. 11 also addressed the criteria for determining when the state laws imposed by the bank's home state or host state should govern the amount of interest authorized on a loan transaction. In addition, the FDIC has interpreted section 27 as providing state banks: (a) The same "most favored lender" status under section 27 as national banks are provided under section 85; (b) the same right to export interest authorized by the state laws of the state where the bank is located to out-of-state borrowers; and (c) the same exclusive remedy for usury violations as is provided national banks under section 86.<sup>16</sup>

<sup>12</sup> 12 U.S.C. 86.

<sup>13</sup> GC Opinion No. 10, 63 FR 19258 (Apr. 17, 1998).

<sup>14</sup> 12 CFR 7.4001(a).

<sup>15</sup> CC Opinion No. 11, 63 FR 27282 (May 18, 1998).

<sup>16</sup> FDIC Advisory Opinion No. 81-3, February 3, 1981, reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,008; FDIC Advisory Opinion No. 81-7, March 17, 1981, reprinted in [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,008; FDIC Advisory Opinion No. 02-06, December 19, 2002, reprinted in Fed. Banking L. Rep. (CCH) ¶ 82-256.

<sup>7</sup> 12 U.S.C. 1831d.

<sup>8</sup> Section 27 was added to the FDI Act by section 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMCA").

<sup>9</sup> Section 27(a) of the FDI Act; see generally *Greenwood Trust Co. v. Commonwealth of Massachusetts*, 971 F.2d 818 (1st Cir.), cert. denied, 506 U.S. 1052 (1993).

<sup>10</sup> This ability to charge interest at the rates allowed by the state where the bank is located is often referred to as the "exportation doctrine."

<sup>11</sup> 12 U.S.C. 85.

The Petitioner observes that the OCC and OTS have adopted rules codifying the scope of the relevant parallel interest provisions<sup>17</sup> contained in their respective statutes.<sup>18</sup> Therefore, the Petitioner requests that the FDIC adopt parallel provisions by rule to allow state banks to operate in a matching legal framework under section 27.

Therefore, the FDIC requests the public's views on the following specific issues:

5-1. Should the FDIC adopt a parallel rule implementing section 27 for state banks similar to 12 CFR 7.4001 and 12 CFR 560.110?

5-2. Should any other issues be addressed by rulemaking to provide state banks competitive equality with national banks regarding section 27? For example, 12 CFR 7.5009 addresses the location under section 85 of national banks operating exclusively through the Internet. Is a similar rule needed for state banks under section 27?

Under section 525 of the Depository Institutions Deregulation and Monetary Control Act states may "opt-out" of coverage under section 27 at any time.<sup>19</sup> The FDIC believes that Iowa, Puerto Rico, and Wisconsin are the only jurisdictions that have exercised this authority and not rescinded it.

Therefore, the FDIC requests the public's views on the following specific issue:

5-3. What effect would the exercise of the authority to opt-out of coverage under section 27 have on the rule or rules the Petitioner is requesting?

#### IV. Public Hearing

The FDIC will hold a hearing to obtain the public's views on all issues raised by the Petition. The hearing will be held on Tuesday, May 24th, 2005 from 8:30 a.m. to 5 p.m. in the Board room at the FDIC's headquarters, 550 17th Street, NW., Washington, DC. Hearing Officers designated by the FDIC will preside over the hearing. The hearing will be informal, and the rules of evidence will not apply. However, only the Hearing Officers may question a participant during a presentation. Each participant making an oral presentation at the hearing will be limited to 15 minutes. While oral presentations are limited to 15 minutes,

<sup>17</sup> 12 CFR 7.4001; 12 CFR 560.110.

<sup>18</sup> The relevant parallel interest provision for the OTS is section 4(g) of the Home Owners Loan Act (12 U.S.C. 1463(g)), which was derived from section 522 of DIDMCA.

<sup>19</sup> Section 525 of DIDMCA, like section 528 that provides lenders a choice of interest rates, is contained in various notes in the United States Code following the various sections that they affect. See, e.g., 12 U.S.C. 1831d (note).

there is no limit on the length of a participant's written statement.

Anyone wishing to make an oral presentation at the hearing must (i) deliver a written request to the Executive Secretary, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429 no later than 5 p.m. on Monday, May 9th, 2005; and (ii) deliver a copy of his or her written statement plus a two-page (or less) summary to the Executive Secretary no later than 5 p.m. on Monday, May 16th, 2005. Anyone wishing to submit a written statement of his or her views without making an oral presentation at the hearing may submit a limited-appearance statement. All limited-appearance statements must be received by the Executive Secretary no later than 5 p.m. on Monday, May 16th, 2005. Attendance at the hearing is not required in order to submit a written statement. Each request to make an oral presentation and each participant's statement must include the participant's name, address, telephone number, e-mail address, and, if applicable, the name and address of the institution or organization the participant represents.

Opportunities to make an oral presentation at the hearing are limited, and not all requests may be granted. The FDIC will notify each person who has submitted a request to make an oral presentation at the hearing whether the FDIC will be able to accommodate his or her request. The notice for each person whose request has been granted will include the time scheduled for his or her presentation and a tentative agenda. Depending upon the number of participants requesting an oral presentation, participants may be organized into panels of two or three to accommodate as many participants as possible.

The hearing will be transcribed. The FDIC will provide attendees with any auxiliary aids (e.g., sign language interpretation) required for this meeting. Those attendees needing such assistance should call (202) 416-2089 (Voice); or (202) 416-2007 (TTY), to make necessary arrangements.

Dated in Washington DC, this 16th day of March, 2005.

Federal Deposit Insurance Corporation.  
Robert E. Feldman,  
Executive Secretary.

**Appendix: Petition for FDIC Rulemaking Providing Interstate Banking Parity for Insured State Banks**, by Letter From the Financial Services Roundtable, 1001 Pennsylvania Ave., NW., Suite 500 South, Washington, DC 20004, Tel 202-289-4322, Fax 202-628-2507, dated March 4, 2005

March 4, 2005

Robert E. Feldman,  
Executive Secretary, Federal Deposit Insurance Corporation, 550 Seventeenth Street, NW., Washington, DC 20429.

Re: Petition for FDIC Rulemaking Providing Interstate Banking Parity for Insured State Banks

Dear Mr. Feldman: The Financial Services Roundtable<sup>1</sup> ("Roundtable") respectfully petitions the Federal Deposit Insurance Corporation ("FDIC") to promulgate rules under the Federal Deposit Insurance ("FDI") Act and Section 104(d) of the Gramm-Leach-Bliley ("GLB") Act, 15 U.S.C. 6701, to provide parity for state banks and national banks. Specifically, the proposed rule would provide that a state bank's home state law governs the interstate activities of insured state banks and their subsidiaries to the same extent that the National Bank Act governs a national bank's interstate business.

The FDIC has ample authority to take each of the requested actions pursuant to the broad delegation of authority in the FDI Act. It is now clear that FDIC action is required to achieve the result that Congress sought in the 1997 amendment to the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 ("Riegle-Neal I"), Pub. L. 103-328, 108 Stat. 238. See Riegle-Neal Amendments Act of 1997, Pub. L. 105-24 (1997) (amending 12 U.S.C. 1831a(j)) ("Riegle-Neal II"). The requested rulemaking would implement the historic decision of Congress in 1997 to provide competitive equality for state banks and national banks in interstate banking.

The Roundtable submits that it is both necessary and timely for the FDIC to adopt rules making clear the ability of state banks operating interstate to be

<sup>1</sup> The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Roundtable member companies provide fuel for America's economic accounting directly for \$18.3 trillion in managed assets, \$678 billion in revenue, and 2.1 million jobs.

governed by a single framework of law and regulation to the same extent as national banks. Such an action would ensure the continued vitality of the dual banking system. Accordingly, the Roundtable requests that the FDIC promulgate rules that:

1. Clarify that the governing law applicable to activities conducted in a host state by a state bank that has an interstate branch in that state is its home state law to the same extent that host state law is preempted by the National Bank Act. The FDIC should make clear that "home" state law applies to an out-of-state state bank in a "host" state to the same extent as the National Bank Act applies to an out-of-state national bank, whether the business of the bank is conducted by the bank through the host state branch, by or through an operating subsidiary, or by any other lawful means.

2. Clarify that the governing law applicable to activities conducted by a state bank in a state in which the state bank does not have a branch is its home state law to the same extent that host state law is preempted by the National Bank Act. The FDIC should make clear that a state bank may operate under home state law in any other state to the same extent that an out-of-state national bank may operate under the National Bank Act or under rules promulgated by the Comptroller of the Currency ("OCC"). Such a rule would give effect to the policy underlying Riegle-Neal II and the preemption of discriminatory state law provided in Section 104(d) of the Gramm-Leach-Bliley ("GLB") Act ("Section 104(d)"), 15 U.S.C. 6701(d).

3. Clarify that the law applicable to activities conducted by an operating subsidiary of a state bank is the same law applicable to the bank itself. The FDIC should clarify that when a state bank has established an "operating subsidiary" pursuant to its home state law, that subsidiary will be treated under FDIC rules as if it were the state bank itself. Thus, the operating subsidiary will be subject to state law outside its home state in the same manner as its bank parent is subject to such state law. Such rules would allow state bank operating subsidiaries to engage in interstate business under the same uniform rules as its parent bank, just as national bank operating subsidiaries operate under uniform OCC rules.

4. Adopt rules construing the scope and application of Section 104(d) to make clear that a state law or action is expressly preempted under Section 104(d) when it imposes a requirement, limitation, or burden on a state bank, or its affiliate, that does not also apply to

an out-of-state national bank or in-state bank. Section 104(d) expressly preempts state laws or actions that discriminate against "insured depository institutions," or their affiliates, as defined in the FDI Act. Accordingly, Section 104(d) provides independent basis and support for each of the above requests. Moreover, through implementing rules, the FDIC would provide greater certainty to insured state banks with respect to the scope of this express federal preemption in general. This provision is not well understood and we believe that a rulemaking, not litigation, is the appropriate means to carry out Congressional intent and achieve needed clarity.

5. Implement Section 27 of the FDI Act by adopting a rule parallel to the rules promulgated by the OCC and Office of Thrift Supervision ("OTS"). The scope and implementation of the express preemption for the "interest rate" charged in interstate lending transactions by state and national banks under Section 27 of the FDI Act and Section 85 of the National Bank Act has been authoritatively addressed by the courts and in agency interpretations. The OCC and OTS have adopted rules codifying the scope of the respective statutory provisions for federal institutions. The FDIC should adopt a parallel rule for insured state banks and thus codify existing agency interpretations.

In this letter, we will address (A) the urgent need for the requested rulemaking and the real costs of inaction, (B) the FDIC's authority to promulgate rules of the scope requested, (C) the legislative history demonstrating that Congress specifically intended in Riegle-Neal II to prevent erosion of the dual banking system and in Section 104(d) to prevent disparate treatment and ensure that all banks could compete on relatively equal terms in today's interstate financial services marketplace, and (D) the scope of the proposed rule provisions in greater detail. The Roundtable appreciates the FDIC's consideration of this petition.

#### A. A Rulemaking Is Necessary and the Costs of Inaction Will Be Significant

The requested FDIC action in this petition is necessary to complete the task of restoring balance in the dual banking system that Congress sought to achieve in 1997. Riegle-Neal II reversed a decision in 1994 to treat state and national banks differently with respect to "applicable law." In Riegle-Neal I, state and national banks were under the same rules for the establishment of interstate branches. However, Riegle-Neal I provided that when a national

bank branched interstate into a host state, it was in effect generally subject to the National Bank Act,<sup>2</sup> while the state bank in a parallel case was made subject to host state law. While interstate national banks could operate under a single law, interstate state banks were subjected to multiple state laws.

That disparity led Congress in 1997 to amend Riegle-Neal to adopt an applicable law provision for state banks that closely tracked the national bank provision in Section 36(f) of the National Bank Act.<sup>3</sup> The purpose of the 1997 amendment, which was stated repeatedly by its sponsors, was to provide parity between state banks and national banks with respect to interstate banking.<sup>4</sup> By "parity," they plainly meant the ability of state banks to do business interstate under a uniform law (home state law) just as national banks were authorized to do under Riegle-Neal.<sup>5</sup>

Over the last decade, the federal charters for national banks and federal thrifts have been correctly interpreted by the OCC and OTS, with the repeated support of the federal courts, to provide broad federal preemption of state laws that might appear to apply to the activities or operations of a banking institution in that state. The result is that, in general, national banks and

<sup>2</sup> The Riegle-Neal applicable law provision for national banks states: "(A) In general The laws of the host State regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches shall apply to any branch in the host State of an out-of-State national bank to the same extent as such State laws apply to a branch of a bank chartered by that State, except—(i) when Federal law preempts the application of such State laws to a national bank; or (ii) when the Comptroller of the Currency determines that the application of such State laws would have a discriminatory effect on the branch in comparison with the effect the application of such State laws would have with respect to branches of a bank chartered by the host State." 12 U.S.C. 36(f)(1)(A). The effect of this provision is that any host state law, including a community reinvestment, consumer protection, fair housing, or intrastate branching law, that is preempted under the National Bank Act does not apply to the national bank branch (or the bank) in the host state.

<sup>3</sup> Compare 12 U.S.C. 1831a(f)(1) (text in footnote 9) with 12 U.S.C. 36(f)(1)(A) (text in footnote 2).

<sup>4</sup> As stated by the lead sponsor in the House, Rep. Roukema: "The essence of this legislation is to provide parity between state-chartered banks and national banks." 143 Cong. Rec. H3088 (daily ed. May 21, 1997).

<sup>5</sup> See, e.g., statements by the principal sponsors of the 1997 Amendment, Rep. Roukema ("\* \* \* we have \* \* \* with this action, protected the dual banking system while at the same time gaining the advantages of interstate banking"), 143 Cong. Rec. H4231 (daily ed. June 24, 1997), and Chairman D'Amato ("Enactment of H.R. 1306 also would bolster efforts of New York and other states to make sure that State[-]chartered banks have the powers they need to compete efficiently and effectively in an interstate environment"), 143 Cong. Rec. S5637 (daily ed. June 12, 1997).

federal thrifts now can do business across the country under a single set of federal rules. This framework is appropriate for these federal entities in a national financial marketplace. At the same time, in this marketplace a uniform national bank system based on preemption and interstate banking undoubtedly presents a major challenge to the dual banking system and state banks.

In contrast to the general certainty enjoyed by federal institutions, there is widespread confusion and uncertainty with respect to applicable law governing state banks engaged in interstate banking activities. The current uncertainty governing the interstate activities of state banks has had, and will continue to have, several significant adverse effects. Uncertainty carries the potential for litigation and enforcement actions arising from disagreements between regulators, or between a host state regulator and a state bank engaged in interstate activity. Regulatory uncertainty deters state banks from pursuing profitable business opportunities. When a state bank converts to a national charter to gain greater legal certainty, it incurs substantial expense. Each of these consequences has economic significance for state banks and direct implications for the FDIC's enforcement and safety-and-soundness responsibilities.

Moreover, a series of recent major merger and conversion transactions has resulted in an unprecedented migration of assets to the national banking system. It is now apparent that, absent a more certain federal regulatory environment, the state charter will continue to be perceived as less competitive than a national bank charter.

This is the very result that Congress intended to prevent.<sup>6</sup> In 1994, 1997 and 1999 Congress took bold and historic actions to provide uniform federal rules to govern all interstate banking and to ensure that individual state laws could not disfavor any type of depository institution in the multistate financial services marketplace. It is now apparent that the express terms of these statutes have not on their own force been able

<sup>6</sup> The statement by Rep. LaFalce before final House passage of the 1997 amendments captures the purpose to redress the negative effects of the 1994 Riegle-Neal applicable provision for state banks: "Why [must we act now]? Well, it is due to the fact that the national bank regulator has the authority to permit national banks to conduct operations in all the states with some level of consistency. In contrast, under the existing interstate legislation, state banks branching outside their home state must comply with a multitude of different state banking laws in each and every state in which they operate." 143 Cong. Rec. H3094 (daily ed. May 27, 1997). See the discussion of the legislative history in the next section.

to ensure, as Congress intended in enacting Riegle-Neal II, that state banks can participate in interstate banking business on a par with national banks and that state banks face significant state law obstacles when they seek to do business outside their home state. As a consequence, the state banking system, as we have known it, is fundamentally threatened.

In the national financial services marketplace, consumers and providers benefit when banks can provide products and services under a single legal framework applicable across state lines. At the same time, bank customers and the economy also benefit from the diversity, innovation and checks provided by a strong and dynamic dual banking system involving large, regional, and small banks. From the perspective of all parties—consumers, financial institutions, and regulators—further development of a framework of state bank regulation and supervision that is effective, efficient, and seamless across state lines is the right goal. In today's multistate system, that is an essential goal. A banking system in which virtually all interstate banks have national charters and state banks are overwhelmingly local is not the dual banking system this country has historically enjoyed. The dual banking system will retain the dynamic vitality that has made it a mainspring for progress and strength in banking only if it can provide meaningful interstate competitive parity for all interstate state banks, whether cross-border, regional, or national. Significant and unacceptable disparity exists today.

The FDIC has the authority, tools, and responsibility under the FDI Act to correct this imbalance. To implement Congressional intentions it now must promptly provide a uniform interstate applicable law regime for state banks and give practical reality to the express preemption of discriminatory state laws.

#### **B. The FDIC Has Authority To Adopt the Requested Rules**

The FDIC has ample rulemaking authority to address each of the Roundtable's requests. Section 9 of the FDI Act vests the FDIC with broad authority to adopt rules "it may deem necessary to carry out the provisions of this Act or of any other law which it has the responsibility of administering or enforcing." 12 U.S.C. 1819.<sup>7</sup>

<sup>7</sup> The FDIC's rulemaking authority parallels the OCC's authority. See 12 U.S.C. 93(a) ("the Comptroller of the Currency is authorized to prescribe rules and regulations to carry out the responsibilities of the office"). The statutory provision authorizing the OCC to issue rules is directly analogous to Section 9 of the FDI Act.

The FDIC is vested with responsibility for administering Sections 24 and 27 of the Act to accomplish what Congress intended. Congress, through Section 9, has vested the FDIC with authority to carry out Sections 24 and 27. Moreover, under basic principles of administrative law, agency rules that fill or address a statutory gap generally are afforded considerable deference by courts. See *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 865 (1984) ("Chevron"). Section 9's "generally conferred authority" makes it apparent "that Congress would expect the agency to be able to speak with the force of law when it addresses ambiguity in the statute or fills a space in the enacted law, even one about which 'Congress did not actually have an intent' as to a particular result." *United States v. Mead*, 533 U.S. 218, 229 (2001) (quoting *Chevron*, 467 U.S. at 845).

Riegle-Neal I and II fundamentally changed federal law for state and national banks by authorizing banks to engage fully in banking transactions in other states through interstate branching.<sup>8</sup> As a corollary, Riegle-Neal I provided federal "applicable law" statutes to govern the new interstate banking regime. As originally enacted, the respective applicable law provisions treated national and state banks differently. Riegle-Neal II sought to redress that disparity and provided substantively the same rule for state banks as was originally provided for national banks.<sup>9</sup> The FDIC plainly has authority to implement Riegle-Neal II.

Compare 12 U.S.C. 1819 (FDIC vested with authority "to prescribe \* \* \* such rules and regulations as it may deem necessary to carry out the provisions of this chapter or of any other law which it has the responsibility of administering or enforcing \* \* \*").

<sup>8</sup> Prior to enactment of Riegle-Neal, neither state nor national banks could establish branches outside their home state. Moreover, except with respect to interest charges under 12 U.S.C. 85 and 12 U.S.C. 1831d, federal law did not provide guidance to either state banks or national banks regarding the law applicable to transactions that banks made with customers outside their home states.

<sup>9</sup> See generally section 24(j):

(j) ACTIVITIES OF BRANCHES OF OUT-OF-STATE BANKS.—

(1) APPLICATION OF HOST STATE LAW.—The laws of a host State, including laws regarding community reinvestment, consumer protection, fair lending, and establishment of intrastate branches, shall apply to any branch in the host State of an out-of-State national bank. To the extent host State law is inapplicable to a branch of an out-of-State bank in such host State pursuant to the preceding sentence, home State law shall apply to such branch.

(2) ACTIVITIES OF BRANCHES.—An insured State bank that establishes a branch in a host State may conduct any activity at such branch that is permissible under the laws of the home State of

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The FDIC also has the authority to implement the nondiscrimination provisions of Section 104(d) insofar as the GLB Act addresses state insured depository institutions and to construe the express preemption of discriminatory state law provided in Section 104(d). Section 9 vests the FDIC with authority to promulgate rules to carry out any statute the FDIC is responsible for administering or enforcing. The provisions of the GLB Act that touch upon state depository institutions fall within the regulatory ambit of the FDIC.

A statutory gap, or a clarification of a statute to effect Congressional intent, can be—and should be—addressed by an agency rule. Where, as here, a statute is ambiguous regarding its application to “a particular result” (Mead, 533 U.S. at 229), courts have long recognized that agencies with rule-making authority must be permitted to address the statutory gap as “necessary for the orderly conduct of its business.” *United States v. Storer Broadcasting Co.*, 351 U.S. 192, 202–03 (1956) (finding also that the statute “must be read as a whole and with appreciation of the responsibilities of the body charged with its fair and efficient operation”), *National Petroleum Refiners Ass’n*, 482 F.2d at 681. (“[T]here is little question that the availability of substantive rule-making gives any agency an invaluable resource-saving flexibility in carrying out its task of regulating parties subject to its statutory mandate.”). Courts have consistently applied these administrative law principles—and extended Chevron deference—to rules and regulations issued by the FDIC under its broad rulemaking authority.<sup>10</sup>

such bank, to the extent such activity is permissible either for a bank chartered by the host State (subject to the restrictions in this section) or for a branch in the host State of an out-of-State national bank.

(3) SAVINGS PROVISION.—No provision of this subsection shall be construed as affecting the applicability of—

(A) any State law of any home State under subsection (b), (c), or (d) of section 44; or

(B) Federal law to State banks and State bank branches in the home State or the host State.

(4) DEFINITIONS.—The terms “host State”, “home State”, and “out-of-State bank” have the same meanings as in section 44(f). 12 U.S.C. 1831a(j).

<sup>10</sup> See, e.g., *National Council of Savings Institutions v. FDIC*, 664 F.Supp. 572 (D.D.C. 1987) (sustaining FDIC regulation governing the proper relationship between FDIC-insured banks and their securities-dealing “subsidiaries” or “affiliates”) See also *Wells Fargo Bank, N.A. v. FDIC*, 310 F.3d 202, 208 (D.C. Cir. 2002) (affording Chevron deference to FDIC rule for “second generation” transactions, because statute was silent as to treatment of these transactions and rule would “implement Congressional intent because it prevents financial institutions from manipulating the system”); *America’s Community Bankers v. FDIC*, 200 F.3d 822, 834 (D.C. Cir. 2000) (upholding FDIC denial of

There can be little doubt that Section 9 of the FDI Act vests the FDIC with authority to address these issues.<sup>11</sup>

There is no reason that a rulemaking by the FDIC similar to ones conducted by the OCC should be analyzed any differently. The National Bank Act does not expressly address the law applicable to a national bank outside states where it has branches. Prior to the adoption of the OCC rules, a number of courts determined that national banks were subject to state laws that did not conflict with the provisions of the National Bank Act.<sup>12</sup> Nonetheless, the courts have upheld the OCC rules and determinations that make clear that national banks and their operating subsidiaries are governed by the National Bank Act wherever they do business. These OCC rules have generally received Chevron deference.<sup>13</sup>

Further, under Section 8 of the FDI Act, an insured bank may be subject to an enforcement action of the FDIC if “in the opinion of the appropriate Federal banking agency, any insured depository institution, depository institution which has insured deposits, or any institution-affiliated party is engaging or has engaged, or the agency has reasonable cause to believe that the depository institution or any institution-affiliated party is about to engage, in an unsafe or unsound practice in conducting the business of such depository institution, or is violating or has violated, or the agency has reasonable cause to believe that the depository institution or any institution-affiliated party is about to violate, a law, rule, or regulation.” 12 U.S.C. 1818(b)(1). The FDIC has

refund assessment under Chevron, where statute merely stated that FDIC could utilize “any other factors” to “set” the assessment amount and thus was “facially ambiguous”); *Federal Deposit Ins. Corp. v. Sumner Financial Corp.*, 451 F.2d 898, 902–903 (5th Cir. 1971) (affording “great deference” to FDIC interpretation of FDI Act through regulation concerning advertising by regulated banks).

<sup>11</sup> Riegle-Neal I and II provide express ability for a state bank to establish a branch in a host state, to thus gain the ability to engage in any or all of its permitted activities in that host state, and to apply its home state law (unless a national bank, and thus the state bank, must apply host state law) to that branch. But the statutory text does not directly address the governing law applicable to the state bank’s activities permitted in the host state under the authority provided by Riegle-Neal, but conducted by the bank outside of its branch, by an operating subsidiary or another means. An ordinary task of a regulatory agency is to construe such a statutory provision in a rule.

<sup>12</sup> See *National State Bank v. Long*, 630 F.2d 981 (3d Cir. 1980); *Perdue v. Crocker National Bank*, 702 P.2d 503 (Cal. 1985); *Best v. U.S. National Bank*, 739 P.2d 554 (Or. 1987).

<sup>13</sup> See, e.g., *NationsBank of N.C. v. VALIC*, 513 U.S. 251 (1995); *Barnett Bank of Marion County v. Nelson*, 517 U.S. 25, 33 (1996); *Wachovia Bank, N.A. v. Watters*, 334 F. Supp. 2d, 957, 963–65 (W.D. Mich. 2004); *Wachovia v. Burke*, 319 F. Supp. 2d 275 (D. Conn. 2004).

authority to adopt rules with respect to legal compliance by insured banks that provide guidance to those banks and agency staff charged with making supervisory, enforcement and examination decisions. That can be accomplished by using authority under Section 9 to address issues of compliance with state law, including the meaning and scope of Section 104.<sup>14</sup>

### C. The Requested Rulemakings Would Advance the Congressional Purpose To Prevent Erosion of the Dual Banking System by Maintaining Parity Between State and National Banks

Beginning with the enactment of Section 27, Congress has taken bold and historic action on more than one occasion to preempt a wide range of state laws so that state banks can operate on a par with national banks in the multistate financial services marketplace that has come into existence in recent decades. The broad sweep of what Congress intended to accomplish is evident in the terms and legislative history of Riegle-Neal II and Section 104(d). Those statutes further the decades-old principle of competitive equality embodied in federal law and repeatedly recognized by the courts and the FDIC.<sup>15</sup> The requested FDIC rule would implement these Congressional purposes.

The principle of fundamental competitive parity has been woven by Congress and the courts into the very fabric of the dual banking system. The dual system was created when Congress created the national bank system alongside the state banking system. In the Federal Reserve Act, Congress expressly provided for state banks, as well as national banks, to be member

<sup>14</sup> The FDIC previously has engaged in a rulemaking in comparable circumstances. In 1982, the FDIC adopted a Statement of Policy addressing the applicability of the Glass-Steagall Act to securities activities of subsidiaries of insured nonmember banks. 47 FR 38984, September 3, 1982. That Statement of Policy construed Section 20 of the Glass-Steagall Act and concluded that the restrictions in that section on securities affiliates of insured banks did not prevent insured nonmember banks subject to the FDIC’s regulation and supervision from having “bona fide” securities affiliates or subsidiaries. The provisions of Glass-Steagall construed in the Statement of Policy (like the provisions of GLB at issue here) were not part of the FDI Act, but the FDIC issued a rule to provide clear guidance to insured state banks, and the exercise of the FDIC’s rulemaking authority in that case was upheld. See *National Council of Savings Institutions v. FDIC*, 664 F.Supp. 572 (D.D.C. 1987). Issuing guidance to state insured banks concerning the scope of Section 104 of the GLB Act is a necessary and appropriate exercise of the FDIC’s authority to carry out its regulatory mandate.

<sup>15</sup> See *First Nat’l Bank v. Walker Bank & Trust Co.*, 385 U.S. 252 (1966); *First Nat’l Bank in Plant City v. Dickinson*, 396 U.S. 122 (1969); FDIC Advisory Letter 00–5.

banks. The McFadden Act as passed and as amended in the 1930s embodied a federal policy of competitive equality in branching. In the FDI Act, deposit insurance was made available to all state and national banks.

Since 1980, Congress has amended the FDI Act to ensure state-national bank parity, to ensure a strong and balanced dual banking system, and to prevent discriminatory state laws from favoring one type of charter over another. In 1980, in response to the challenges presented by the 1978 Marquette case, Congress provided interstate usury parity for state banks in Section 27 of the FDI Act.<sup>16</sup> See 12 U.S.C. 1831d(a). In 1991, Congress addressed state laws providing state banks more expansive powers than national banks, a disparity in favor of state banks that Congress believed had implications for safety-and-soundness, bank competitiveness, and the dynamic for change in the dual banking system. That enactment provided that state bank activities would be limited to activities permissible for national banks, unless the FDIC determined that for a state bank to engage in an otherwise impermissible activity would not pose a significant risk to the deposit insurance fund. See 12 U.S.C. 1831a(a)-(e). This policy of parity was continued in Riegle-Neal and the GLB Act.

**1. The Legislative History of Riegle-Neal Amendments Demonstrates Congressional Purpose to Provide Parity Between National Banks and State Banks**

In Riegle-Neal, Congress reversed more than 150 years of federal policy and enacted comprehensive federal laws governing interstate banking for all banks. Except for the applicable law provisions, Riegle-Neal as originally enacted gave parallel treatment to state and national banks. In 1997, Congress recognized that the original state bank applicable law provision was placing state banks at a substantial disadvantage and was undermining the state system. It acted swiftly to redress the state-national bank balance in Riegle-Neal II. The specific drafting approach, the underlying policy and the express purpose of that 1997 statute all sought to ensure that state banks would operate under a uniform interstate "applicable law" regime based on home state law parallel to the national bank regime. It sought to ensure parity in the dynamic interstate banking environment.

The legislative history of Riegle-Neal II makes clear that Congress' goal was to

facilitate competitive equality for state banks and national banks in interstate banking. The 1997 amendments originated in the House Banking Committee. At final passage, the principal sponsor of the bill, Rep. Marge Roukema (R-NJ), chair of the Subcommittee on Financial Institutions, and senior members of the House Banking Committee, on a bipartisan basis, expressed the intent to provide a level playing field, not narrowly in terms of competition between state and national bank branches, but broadly in terms of the ability of state banks to match national banks in doing business across the country.

As Rep. Roukema stated when introducing the bill for vote on the House floor: "The essence of this legislation is to provide parity between state-chartered banks and national banks. \* \* \* This legislation is critical to the survival of the dual banking system. \* \* \* [A] strong state banking system is necessary for the economic well-being of the individual States and for innovation in financial institutions." In her final statement before final passage, she repeated the necessity and purpose of the bill: "[W]e have \* \* \* with this action, protected the dual banking system while at the same time gaining the advantages of interstate banking."<sup>17</sup> No contrary statement was made by any House or Senate member during the floor debates preceding final passage.

Representative Roukema's statements were echoed and reinforced by senior members from each political party. On the Republican side, Rep. Mike Castle (R-DEL) addressed state bank's competitive needs "across the Nation": "As we enter the age of interstate banking and branching, it is necessary to ensure that state banks can compete fairly with national banks as more banking is done between States and across the Nation. This legislation will ensure that there is a level playing field between state and national banks."<sup>18</sup> Rep. Doug Bereuter (R-NEB) emphasized the benefits for the state system, "This Member was intimately involved in the original Riegle-Neal Act and was concerned at that time that States' rights were protected. \* \* \* This Member believes that this measure actually reinforces States' rights by maintaining the viability of the state charter by ensuring parity with the national bank charter \* \* \* [and] urges his colleagues to join him in approving

this important protection of the dual banking system."<sup>19</sup>

A senior Democrat, Rep John LaFalce (D-NY), articulated the purpose clearly: "\* \* \* I do believe [the bill's] passage is vital to maintain the dual banking system. It is the dual banking system that by giving banks a choice of Federal or state charters has helped to ensure that our U.S. banking industry has remained strong and competitive. \* \* \* [In 1994, Congress did not adequately anticipate the negative impact the interstate law would have on state banks.] Why so? Well, it is due to the fact that the national bank regulator has the authority to permit national banks to conduct operations in all the states with some level of consistency. In contrast, under the existing interstate legislation, state banks branching outside their home state must comply with a multitude of different state banking laws in each and every state in which they operate."<sup>20</sup>

When the Riegle-Neal II bill was considered in the Senate, concern also was expressed about the erosion of the dual banking system caused by the disparity in applicable law enacted in Riegle-Neal. In his floor statement preceding final Senate passage, Senate Banking Committee Chairman Alphonse D'Amato (R-NY) stated the importance of Riegle-Neal II for the continued vitality of the dual banking system:

[T]he trigger date for nationwide interstate branching has passed—June 1, 1997. This important legislation will preserve the benefits of the dual banking system and keep the state banking charter competitive in an interstate environment. \* \* \*

The bill is necessary to preserve confidence in a state banking charter for banks with such a charter that wish to operate in more than one state. In addition, it will curtail incentives for unnecessary Federal preemption of State laws. Finally, the bill will restore balance to the dual banking system by ensuring that neither charter operates at an unfair advantage in this new interstate environment. \* \* \*

New York has more than 90 State [-]chartered banks. \* \* \* Without this

<sup>16</sup> Id. at H3094. Rep. Spencer Bacchus (R-ALA) similarly stated: "\* \* \* we have heard almost unanimous testimony that the unfortunate and unintended consequences of our failure to make these clarifications will be the devaluation of state banking charters in favor of national charters and the gradual decline of the state banking system \* \* \*". Id. at H3095.

<sup>20</sup> Id. at H3094. Rep. Bruce Vento (D-MN) similarly stated: "The legislation will maintain the dynamic balance between the chartering of national and state banks and banking systems. This is a necessary measure. It must be enacted to clarify and ensure the viability of America's dual banking system." Id. at H3093.

<sup>16</sup> See Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299 (1978).

<sup>17</sup> See 143 Cong. Rec. H3086 (daily ed. May 21, 1997), H4231 (daily ed. June 24, 1997).

<sup>18</sup> 143 Cong. Rec. H3095 (daily ed. May 27, 1997).

legislation, the largest of these institutions may be tempted to convert to a national charter in order to operate in more than one State. \* \* \*

The current law may be unclear as to whether consistent rules are used to determine what laws and powers apply to the out-of-state branches of state and federally chartered banks. \* \* \*

[Summary of the bill's terms omitted]

Enactment of H.R. 1306 also would bolster efforts of New York and other states to make sure that State[-]chartered banks have the powers they need to compete efficiently and effectively in an interstate environment.<sup>21</sup>

**2. Section 104 of the GLB Act Reflects Congress' Intent To Preempt Discriminatory State Laws Adversely Affecting Any Depository Institution**

Congress enacted Section 104 as part of the GLB Act in 1999 to address state laws providing competitive inequalities among entities offering the same financial products and services. Section 104 originated as a provision intended to sweep away a variety of state laws that had blocked or imposed special requirements or conditions on banks seeking to engage in insurance activities permitted under their charter law. During the legislative process, the section was expanded to provide express preemption of not just state insurance laws, but any state law that placed impediments or burdens on any insured depository institution seeking to provide financial services across the country. Even though the non-insurance provisions of Section 104(d) are far less detailed than the insurance provisions of Section 104, the Congressional purpose and breadth of preemption with respect to non-insurance activities are express in the nature and scope of the words used.

Congress determined that in a national financial services marketplace individual states should not be able to impose burdens or requirements adversely affecting any depository institution, or its affiliates. As enacted, Section 104(d) provides broad preemption of discriminatory state laws adversely affecting any type of depository institution or any affiliate of a depository institution. It was enacted for the purpose of ensuring that no insured depository institution—including a state bank and its financial affiliates—would be disadvantaged competitively by the operation of state law when it engages in a financial activity, whether on its own, with an affiliate or with "any other person."

<sup>21</sup> 143 Cong. Rec. S5637 (daily ed. June 12, 1997).

The legislative history of Section 104(d), and particularly the paragraph (4) nondiscrimination provisions, is sparse, and thus its purpose and intent are best drawn from its terms. It is important to note that Section 104 addresses how banking organizations conduct the full range of permitted financial activities, whether by the depository institution itself or by an affiliate, including both "traditional" affiliates such as mortgage or finance companies and the new affiliations permitted under the GLB Act. It focuses on state laws that affect how depository institutions or its affiliates engage in any of their permitted activities. This focus is evident in the Senate Banking Committee report in 1999. That Committee had taken the lead role in fashioning Section 104 in the form ultimately enacted. Its report expressly addressed the section's broad, preemptive purpose with respect to state laws that impinge on how financial activities are conducted: "[T]he Committee is aware that some States have used their regulatory authority to discriminate against insured depository institutions, their subsidiaries and affiliates. The Committee has no desire to have State regulation prevent or otherwise frustrate the affiliations and activities authorized or permitted by this bill. Thus, Section 104 clarifies the application of State law to the affiliations and activities authorized or permitted by the bill (or other Federal law), and ensures that applicable State law cannot prevent, discriminate against, or otherwise frustrate such affiliations or activities."<sup>22</sup>

Section 104(d) has a purpose parallel to Riegle-Neal II—to ensure that depository institutions will be able to compete across the country on equal terms and to prevent state laws or actions from providing disparate treatment that would disadvantage any bank vis-à-vis its competitors. When an out-of-state state bank is subject to a state law imposing any requirement, limitation, or burden to which a national bank or in-state bank is not subject, Section 104(d) by its literal terms preempts that state law.

**D. In the Requested Rulemaking, the FDIC Should Clarify the Applicable Law Governing the Interstate Activities of State Banks To Provide Parallel Uniformity for State Banks With National Banks**

In light of the FDIC's authority under its statute and the express purposes and policies of Congress enacted in recent

<sup>22</sup> S. Rept. 106-44 (April 28, 1999) at 11 [Senate Banking Committee] (emphasis added).

statutes, the Roundtable believes that the FDIC can, and should, adopt rules so that state banks can operate interstate under uniform rules based on home state law and thus parallel to national banks. We now address in turn the specific parts of the requested rulemaking.

**1. The FDIC Should Clarify That in General Home State Law Is the Governing Law Applicable to All Activities Conducted in a Host State by a State Bank That Has an Interstate Branch in That State to the Same Extent That Host State Law Is Preempted by the National Bank Act**

This petition seeks a rule addressing the appropriate applicable law to govern the activities of a state bank when it has entered a host state with a branch as permitted by Riegle-Neal and thus has a federal law authorization to transact all its legally permissible activities within that host state. The requested rule would expressly permit a state bank to apply home state law uniformly to all its business done in a host state parallel to the ability of national banks to apply the National Bank Act under OCC rules. Riegle-Neal II plainly provides that if the National Bank Act preempts host state law for national banks, home state law is the applicable law when the out-of-state bank engages in any or all of its permissible activities in or through its host state branch. The Riegle-Neal applicable law provisions for both state and national banks are silent, however, with respect to the governing law applicable to a transaction that the bank could conduct through its branch, but is effecting without any involvement by the host state branch.

Riegle-Neal I authorized the bank to engage in any or all of its permitted activities in the host state once it has a single branch there and to apply its home state law. The only question under Riegle-Neal II is whether Congress intended different law to apply depending on the means used by the bank to conduct its permitted business in the host state or the structure of the transaction (that is, whether use of home state law as the applicable law depends on some actual branch involvement in the bank's transaction).<sup>23</sup> The legislative purpose is clear: Congress was focused on the

<sup>23</sup> For example, although the statutory text directly addresses the law applicable to a Tennessee bank with a branch in Oklahoma that makes a loan to an Oklahoma resident through its Oklahoma branch (Tennessee law applies), the text does not speak directly to the governing law applicable to the identical loan originated by the Tennessee bank from its home office in Tennessee (or through an operating subsidiary).



bank's interstate activities, not the means used by the bank. By adopting the requested rule, the FDIC will achieve the result Congress intended.

The FDIC should fill the statutory gap and clarify the application of home state law to host state activities by adopting a rule for state banks that provides for uniform application of home state law whenever a national bank can apply the National Bank Act. The FDIC rule should make it clear that the state bank's home state law will apply to all of the bank's activities in a host state whenever a host state law would be preempted by OCC rules for a national bank.

Specifically, the rule should make it plain that any host state statute, rule, order, etc., that would be preempted under the terms of the OCC preemption rule, or an OCC interpretive letter, would also be preempted for a state bank. If there is any uncertainty about the application of the OCC rules in any case, the rule might allow the home state regulator, or the FDIC, to determine in writing whether OCC rules would provide preemption for national banks. The FDIC should reserve the ability to make any final determination (with consultation with the OCC as needed). In parallel fashion, the rule should provide that if home state statute law is silent, the home state regulator can determine by rule, order, or interpretative statement/letter what applicable home state law is. In general, the home state regulator's written determinations, whether by rule, order, or interpretative statement/letter, should govern, but could be subject to review by the FDIC, upon request of the host state regulator or upon the FDIC's own initiative.

The rule might also address another Riegle-Neal provision addressing the home-host state relationship. Section 10(h)(3) of the FDI Act expressly provides that the "State bank supervisors from 2 or more States may enter into cooperative agreements to facilitate State regulatory supervision of State banks, including cooperative agreements relating to the coordination of examinations and joint participation in examinations." The state regulators, through the Conference of State Bank Supervisors, have entered into a landmark nationwide cooperative agreement, as well as agreements involving a specific bank by the states where that bank has branches. The FDIC rule could provide guidance on the effect of Section 10(h)(3).

*2. The FDIC Should Clarify That Home State Law is the Governing Law Applicable to Activities Conducted by a State Bank in a State in Which the State Bank Does Not Have a Branch to the Same Extent That State Law Is Preempted by the National Bank Act*

The Roundtable requests that the FDIC adopt parallel rules under its Section 9 authority to provide that the home state law of a state bank will apply to its activities in other states to the same extent as the National Bank Act applies to the activities of national banks. The rule should provide that whenever a state law is preempted by the National Bank Act or OCC rules, it also would not apply to an out-of-state insured bank, which would be governed by its home state charter law. The requested rule thus would implement the terms and policies of Section 104(d) and the policies of Riegle-Neal II and address gaps in existing law. Like the parallel OCC rules, the requested rules would reduce legal risk, guide legal compliance by insured banks, and aid the FDIC in making enforcement decisions under Section 8 of the FDI Act. Further, by promoting operating efficiency and competitiveness in interstate banking and by reducing the real costs arising from legal uncertainty and risk, the proposed rule would contribute to the safe and sound operation of state banks.

To a large extent, the Riegle-Neal and GLB legislation confirmed the existence of a robust interstate marketplace for financial services and provided a federal legal framework for the conduct of this interstate commerce. Although the express purpose of Riegle-Neal II was to provide state banks competitive equality with national banks in interstate banking, it did not by its terms address the law applicable to banks outside states where they maintain a branch. The GLB Act addressed the entire financial services marketplace and, like Riegle-Neal I and II, adopted broad federal rules to implement the goal of a "level playing field". In Section 104(d) Congress plainly recognized the need for financial services providers, including insured depository institutions, that operate across the country to do so under uniform rules and not to be subject to individual state rules or actions that would disadvantage some or all depository institutions. Accordingly, Congress provided the very broad express preemption stated in Section 104(d) to address this perceived need.

As is often the case, Congress did not address in those acts every issue presented by the developments and

problems it was considering, nor did it address future developments. Under established principles of administrative law, as discussed above, the federal agencies that administer and implement statutory grants of authority have an important role in adopting rules that implement Congressional purposes, reasonably fill in statutory gaps and address the application of existing laws to new developments and contexts.

The policy of Section 104 has a similar goal as Riegle-Neal II, but plainly addresses a different aspect of the same problem—discriminatory state laws that disadvantage depository institutions, including state banks, seeking to compete in interstate financial service markets. Section 104(d) thus directly informs and supports this requested rule. Under Section 104(d), when state law provides for a different result for out-of-state state banks compared to national and in-state state banks, that law is preempted. Given Section 104(d) and the FDIC's authority to address compliance with law under FDI Act Section 8, the FDIC can adopt a rule consistent with the logic and policy of Riegle-Neal II that will provide state banks competitive equality in every state so that no insured state bank will be required to comply with a state law unless a national bank also would be subject to that law.

OCC rules have provided national banks substantial certainty and clarity concerning the law governing national bank activities across the country.<sup>24</sup> These OCC actions have had the effect of making national banks more competitive and efficient in interstate

<sup>24</sup> The Comptroller has addressed the reality of multistate banking by adopting rules that provide that a national bank and its operating subsidiaries operate solely under the National Bank Act and OCC rules wherever they do business across the country. The OCC rules expressly provide that the National Bank Act, not state law, governs the deposit, lending, and other activities of national banks, except as specifically provided in the OCC rules. See 12 CFR 7.4007-7.4009. The National Bank Act does not expressly address the law applicable to a national bank outside states where it has branches. Indeed, prior to the adoption of OCC rules addressing these issues in recent years, a number of courts determined that national banks were subject to state laws that did not conflict with the provisions of the National Bank Act. E.g., *National State Bank v. Long*, 630 F.2d 981 (3d Cir. 1980); *Perdue v. Crocker National Bank*, 702 P.2d 503 (Cal. 1985); *Best v. U.S. National Bank*, 739 P.2d 554 (Or. 1987). Nevertheless, the courts including the U.S. Supreme Court, have upheld OCC rules and determinations since 1944 that flesh out the National Bank Act and spell out the ability of national banks and their operating subsidiaries to apply the National Bank Act wherever they do business. These OCC determinations have generally received Chevron deference. E.g., *NationsBank of N.C. v. VALIC*, 513 U.S. 251 (1995), *Barnett Bank of Marion County v. Nelson*, 517 U.S. 25, 33 (1996), *Wachovia Bank, N.A. v. Watters*, 334 F. Supp. 2d, 957, 963-65 (W.D. Mich. 2004).

banking and have reduced legal risk. These rules, as supplemented by interpretations and guidance issued by the OCC, also have clarified the scope of the OCC's compliance and enforcement responsibilities and standards with respect to the safe and sound operation of national banks. The FDIC has authority to provide a parallel result for state banks in its rules.

**3. The FDIC Should Clarify That Home State Law Governs the Activities of an Operating Subsidiary of a State Bank to the Same Extent as Home State Law Applies to the Parent Bank**

In a 1996 rulemaking, which codified existing interpretations, and in subsequent modifications, the OCC has adopted comprehensive rules concerning the establishment and operation of operating subsidiaries. See 12 CFR 5.34; 69 FR 64478 (Nov. 5, 2004). The OCC rules as amended in 2001 further specify that state law applies to a national bank operating subsidiary to the same extent state law would apply to the national bank itself. See 12 CFR 7.4006. The FDIC should similarly make clear that an operating subsidiary established by a state bank under its home state law, like the operating subsidiary of a national bank, will be governed by the same law as would its insured state bank parent, except when a state law would apply to the activities of a national bank operating subsidiary.

The Roundtable recognizes that the authority of an insured state bank to establish an operating subsidiary must arise under its charter law. Whether a state bank can have an "operating subsidiary" will be determined by appropriate home state authorities under the bank's charter law. Nevertheless, the FDIC plainly has authority to determine that a state bank operating subsidiary that is treated for all purposes as if it were a division of the bank will be subject to the FDI Act and FDIC rules in the same way as its insured bank parent, parallel to a national bank operating subsidiary. The OCC rules concerning operating subsidiaries were adopted without the existence of any express provision in the National Bank Act.<sup>25</sup>

The FDIC has discretion under Section 9 and Section 24(f) to determine by rule that a subsidiary that is an operating subsidiary under home state law will be treated under the FDI Act as

<sup>25</sup> When the authority for a national bank to establish a financial subsidiary was authorized under the GLB Act in 1999, new Section 24a in the National Bank Act implicitly confirmed the existing OCC approach to establishing operating subsidiaries. See 66 FR 34784, 34788 (July 2, 2001).

if it were a division or branch of the state bank.<sup>26</sup> This rule provision would thus allow a state bank operating subsidiary to engage in interstate banking activities in host states and other states on the same terms on which its state bank parent operates.

**4. The FDIC Should Adopt Rules Construing the Scope and Application of Section 104(d) To Make Clear that State Laws, Rules, or Actions Are Preempted Under Section 104(d) When They Provide for Disparate Treatment Between an Out-of-State National Bank or In-State Bank and an Out-of-State State Bank, or an Affiliate Thereof**

The Roundtable also requests that the FDIC provide greater clarity and certainty to insured state banks with respect to the scope of the federal preemption provided in Section 104(d) of the GLB Act. In view of the complexity of Section 104(d) and the general lack of understanding of its provisions, FDIC rules are needed. Moreover, a rulemaking is a preferable means for providing needed clarity than either litigation or an enforcement proceeding.

Section 104(d) provides express federal preemption of certain state laws that affect "insured depository institutions", as defined in the FDI Act. Insured state banks subject to FDIC regulation are the intended beneficiaries of the Section 104(d) preemption. Yet state banks today are not utilizing this preemption, because the statute is relatively new and complex and the relevant provisions have not been construed by any agency or court. Given the complexity of the Section 104(d) provisions, FDIC guidance would provide much needed clarity and certainty. Accordingly, we request the FDIC to exercise its authority under FDI Act Sections 8 and 9 to adopt rules that specify the scope of the express preemption provided under Section 104(d) for insured state banks. Alternatively, the FDIC might adopt a statement of policy addressing the scope and effect of Section 104(d) for state banks.

<sup>26</sup> The FDIC has recognized in Advisory Letter 99-5 that a state bank operating subsidiary may be treated the same as a state bank branch if the operating subsidiary engages in activities that would require a branch designation. Advisory Letter 99-5 recognizes that because a bank established and controls its operating subsidiary, the offices of an operating subsidiary are similarly "established" by the bank for branching purposes. This result is also consistent with the terms of Section 1813(o) of the FDI Act, in which a "domestic branch" is defined to include any "additional office" of a bank. The FDIC thus has recognized the concept underlying the "operating subsidiary" and thus can apply it more uniformly to all state bank activities by rule.

The breadth of the Section 104(d) preemption and its purpose to reach state law or actions that would provide disparate treatment for any type of depository institution, including the distinct class of out-of-state state banks, vis-à-vis its competitors are evident in the language of the statute. Section 104(d)(4)(D) provides four distinct nondiscrimination tests for any state law or action that "restricts" any depository institution or any affiliate.<sup>27</sup> These provisions of Section 104 were carefully drafted and the text demonstrates that Congress made careful distinctions when determining whether state discrimination between competitors should be impermissible, and thus and preempted, under federal law.<sup>28</sup> The distinctions in the statutory

<sup>27</sup> The pertinent portions of Section 104(d) are as follows:

(d) Activities.

(1) In general. Except as provided in paragraph (3), and except with respect to insurance sales, solicitation, and cross marketing activities, which shall be governed by paragraph (2), no State may, by statute, regulation, order, interpretation, or other action, prevent or restrict a depository institution or an affiliate thereof from engaging directly or indirectly, either by itself or in conjunction with an affiliate, or any other person, in any activity authorized or permitted under this Act and the amendments made by this Act. \* \* \*

(4) Financial activities other than insurance. No State statute, regulation, order, interpretation, or other action shall be preempted under paragraph (1) to the extent that—

(A) It does not relate to, and is not issued and adopted, or enacted for the purpose of regulating, directly or indirectly, insurance sales, solicitations, or cross marketing activities covered under paragraph (2);

(B) It does not relate to, and is not issued and adopted, or enacted for the purpose of regulating, directly or indirectly, the business of insurance activities other than sales, solicitations, or cross marketing activities, covered under paragraph (3);

(C) It does not relate to securities investigations or enforcement actions referred to in subsection (f); and

(D) it—

(i) Does not distinguish by its terms between depository institutions, and affiliates thereof, engaged in the activity at issue and other persons engaged in the same activity in a manner that is in any way adverse with respect to the conduct of the activity by any such depository institution or affiliate engaged in the activity at issue;

(ii) As interpreted or applied, does not have, and will not have, an impact on depository institutions, or affiliates thereof, engaged in the activity at issue, or any person who has an association with any such depository institution or affiliate, that is substantially more adverse than its impact on other persons engaged in the same activity that are not depository institutions or affiliates thereof, or persons who do not have an association with any such depository institution or affiliate;

(iii) Does not effectively prevent a depository institution or affiliate thereof from engaging in activities authorized or permitted by this Act or any other provision of Federal law; and

(iv) Does not conflict with the intent of this Act generally to permit affiliations that are authorized or permitted by Federal law. 15 U.S.C. 6701(d).

<sup>28</sup> Compare the "other person" language in subparagraphs (i) and (ii). Subparagraph (i)

language permit the FDIC to address the meaning of Section 104(d) for a state bank confronting state laws outside its home state that disadvantage it by putting it in a different legal or competitive position than its national bank or in-state state bank competitors.

The following specific items might be covered in an FDIC rule or statement of policy:

- The rule should state that the Section 104(d) preemption applies to insured banks, and to their subsidiaries, affiliates and associated persons.

- The rule should define a "person" to include a depository institution, subsidiary, affiliate, and associated person.

- The rule should state that in view of the breadth of the nondiscrimination requirements stated in Section 104(d) the word "restrict" in Section 104(d)(1) is to be read broadly to include any state law, rule, interpretation or action that calls for any limitation or requirement. Any state law that "restricts" but is nondiscriminatory under Section 104(d)(4) is not preempted under Section 104(d). By the same token, any state law that "restricts" and is discriminatory under Section 104(d)(4) is preempted under Section 104(d).

- The rule should address each of the four nondiscrimination provisions in Section 104(d)(4) to confirm that each is a distinct test and that any state law or action that fails any one test is preempted.

- The rule should address the scope of "actions" in Section 104(d)(4) to include all types of formal or informal administrative actions by any state or local governmental entity, including decisions with respect to civil enforcement of state rules.

- The rule should address Section 104(d)(4)(D)(i) in light of the terms used in subparagraph (ii) to specify that subparagraph (i) addresses treatment under state law of an out-of-state insured state bank, which is plainly an "insured depository institution," that is different from the treatment of any national bank or in-state state bank and banks, which is an "other person engaged in the same activity" under these provisions. It should also specify that this discrimination can take various forms, including state laws, rules, or "actions" that treat out-of-state state banks or their subsidiaries differently from in-state or federal institutions, whether expressly (*e.g.*, through a state law exemption for federal institutions,

but not out-of-state state banks insured institutions), by operation of law (*e.g.*, when state law is preempted for national banks or federal thrifts, and federal credit unions, but not for out-of-state state banks), or by an administrative determination to enforce a state rule against an out-of-state state bank or affiliate, but not against a federal entity. The rule could give examples.

- The rule should define "state law" to include laws, ordinances, rules, etc. of political subdivisions (including any county, municipality, etc.).

#### 5. *The FDIC Should Implement Section 27 of the FDI Act by Adopting a Rule Parallel to the Rules Promulgated by the OCC and OTS*

The scope and implementation of the express preemption for the "interest rate" charged in interstate lending transactions by state and national banks under Section 27 of the FDI Act and Section 85 of the National Bank Act have been authoritatively addressed by the courts<sup>29</sup> and in agency interpretations.<sup>30</sup> Nevertheless, both the OCC and OTS have adopted rules codifying the scope of the respective statutory provisions. We request that the FDIC adopt parallel provisions by rule so that state banks will operate in a matching legal framework under these parallel statutes.

\* \* \* \* \*

The Roundtable appreciates the FDIC's consideration of this petition. We recognize that it is very broad and asks the FDIC to undertake a major rulemaking. We believe that such an effort is urgently needed to preserve a strong dual banking system, to maintain safety and soundness, and to ensure that it is attractive to both large and small banks. Such a system is an integral, essential part of the framework for banking in the United States. While we strongly support the development of interstate banking and federal preemption over the last decade, we believe that the modernization of American banking requires a parallel modernization of the state half of the dual banking system. Since the issues concern interstate business and preemption, the needed actions must come at the federal level. As discussed above, we believe that Congress has given the FDIC both the tools and responsibility to address these needs.

The Roundtable and its members stand ready to work with the FDIC and

its staff to achieve these important objectives. If you have any further questions or comments, please do not hesitate to contact me or John Beccia at (202) 289-4322.

Sincerely,

Richard M. Whiting,  
Executive Director and General Counsel.  
cc: Chairman Donald E. Powell, William F. Kroener III, Esq.

[FR Doc. 05-5499 Filed 3-18-05; 8:45]

BILLING CODE 6714-01-P

## ENVIRONMENTAL PROTECTION AGENCY

### 40 CFR Parts 52 and 81

[AZ131-0078; FRL-7887-1]

### Approval and Promulgation of Implementation Plans and Designation of Areas for Air Quality Planning Purposes; Arizona

AGENCY: Environmental Protection Agency (EPA).

ACTION: Proposed rule.

**SUMMARY:** EPA is proposing to approve the Arizona Department of Environmental Quality's submittals of revisions to the Arizona state implementation plan that include substitution of the clean fuel fleet program requirement with the cleaner burning gasoline program, adoption of the serious area 1-hour ozone plan, and adoption of the 1-hour ozone maintenance plan for the Phoenix (Arizona) metropolitan 1-hour ozone nonattainment area. We are also proposing to approve Arizona's request to redesignate the Phoenix metropolitan 1-hour ozone nonattainment area from nonattainment to attainment. EPA proposes these actions pursuant to those provisions of the Clean Air Act that obligate the agency to take action on submittals of revisions to state implementation plans and requests for redesignation. In addition, under section 107 of the Clean Air Act, we are proposing to revise the boundary of the Phoenix metropolitan 1-hour ozone nonattainment area to exclude the Gila River Indian Reservation. EPA is proposing this last action consistent with the Federal trust responsibility to the Tribes and for the purpose of relieving the Agency or the Gila River Indian Community of the need to promulgate and implement plans and measures for the Community that are not needed for attainment or maintenance of the 1-hour or 8-hour ozone national ambient air quality standard.

addresses "other persons engaged in the same activity", while Subparagraph (ii) addresses "other persons engaged in the same activity that are not depository institutions or affiliates thereof."

<sup>29</sup> *Greenwood Trust Co. v. Mass.*, 971 F.2d 818 (1st Cir. 1992), *Smiley v. Citibank*, 517 U.S. 735 (1996).

<sup>30</sup> See FDIC General Counsel Opinions 10 and 11.

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# NY SUES NATIONAL BANK SUBSIDIARY FOR ILLEGAL PRACTICES

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## Illegal Foreclosure Case May Test Feds' New Preemption Rules

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Attorney General Eliot Spitzer today announced he has sued a subsidiary of a national bank for illegally threatening to foreclose on the home of a Rensselaer County homeowner.

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The move by Spitzer is designed help a consumer who is facing the loss of his home. The action is also a direct challenge to federal banking regulators who have sought to insulate national banks from state consumer protection laws.

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"The bank's actions in this case are preposterous," Spitzer said. "The consumer paid off his mortgage, but the bank continued to bill him for years, and now threatens to foreclose."

"The case also underscores the misguided policies of the Office of the Comptroller of the Currency (OCC), which has directed national banks to ignore state regulators attempting to enforce long-standing consumer protection laws."

The case arises out of a 1974 mortgage loan issued by Mechanics Exchange Savings Bank to a resident of East Greenbush in Rensselaer County. The loan was for \$27,000 at 8.5 percent interest, to be paid over a period of 25 years at \$201.31 per month. The loan was assigned several times, and since 1995 has been held by First Horizon Home Loan Corporation, a Texas-based subsidiary of First Tennessee Bank, a national bank.

The consumer made all 300 payments due under the loan. Since 1995, the consumer made payments to First Horizon by automatic debit from his checking account. Despite the fact that the final payment was made on October 15, 1999, First Horizon continued to debit \$201.31 each month from the consumer's account.

The consumer was unaware that he was making payments in excess of those required under the mortgage because he thought mistakenly that his mortgage was for 30 years. In May 2003, First Horizon notified the consumer, for the first time, that because of an alleged error by Mechanics Savings in 1974, he should have been paying \$16 more per month. Based on this alleged error, First Horizon advised the consumer that it was extending the maturity date of his mortgage to March 2010, thus requiring him to pay an additional \$25,163.75.

EXHIBIT

D

## NY Sues National Bank Subsidiary For Illegal Practices

The consumer, who had already paid \$9,461.57 over the amount required under the mortgage, stopped the automatic debits going to First Horizon. The bank responded by threatening to foreclose on the home if the consumer did not pay \$12,320.49 within 30 days.

The Attorney General's action seeks to halt First Horizon's illegal collection and foreclosure efforts. The action also seeks an order requiring First Horizon to make restitution to the consumer and provide him with a satisfaction of mortgage, as required by state law. The Attorney General also seeks civil penalties against the bank for its illegal and deceptive practices.

Prior to filing the lawsuit, Spitzer's office had attempted to resolve the matter with First Horizon. But when an attorney from Spitzer's office contacted the bank, bank officials said they could not discuss the matter because the OCC had issued a directive advising its officials not to talk to state attorneys general.

That directive, issued in November 2002, marked the beginning of OCC's effort to preempt state enforcement of consumer protection laws. Just last week, the OCC issued final regulations designed to prevent state attorneys general from enforcing most state laws against national banks. Spitzer and other attorneys general denounced the OCC the move and pledged to continue aggressive enforcement of state consumer protection laws.

This case is being handled by Assistant Attorneys General Mark Fleischer and Matthew Barbaro of the Bureau of Consumer Frauds and Protection.

### Related Item:

- People of the State of New York vs. First Horizon Home Loan Corp.

**INTRODUCTION TO THE FINANCIAL CRIMES  
ENFORCEMENT NETWORK (FinCEN)**

*Lea Pauley Goff  
Stoll, Keenon & Park, LLP  
Louisville, Kentucky*

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**SECTION H**



**INTRODUCTION TO THE FINANCIAL CRIMES  
ENFORCEMENT NETWORK (FinCEN)**

**INTRODUCTION & OVERVIEW ..... H-1**

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**RIGGS BANK N.A. CONSENT ORDER OF CIVIL MONEY PENALTY-  
MAY 13, 2004 ..... H-27**





# INTRODUCTION TO THE FINANCIAL CRIMES ENFORCEMENT NETWORK (FinCEN)<sup>1</sup>

**Lawrence R. Ahern, III<sup>2</sup>**

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As a network, the Financial Crimes Enforcement Network (FinCEN) functions as a vehicle for bringing people and information together to fight the complex problem of money laundering. The mission of FinCEN is to safeguard the financial system from the abuses of financial crime, including terrorist financing, money laundering, and other illicit activity.<sup>3</sup> Created in 1990, FinCEN has worked to maximize information sharing among law enforcement agencies and its other partners in the regulatory and financial communities. Through cooperation and partnerships, FinCEN's network approach is designed to encourage cost-effective and efficient measures to combat money laundering domestically and internationally. This is the objective of at least four areas of activity:

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<sup>1</sup> Some of the summary information contained in this introductory paper is based on information posted on the website of the Financial Crimes Enforcement Network (FinCEN), <<http://www.fincen.gov/>>, last visited March 27, 2005.

<sup>2</sup> Mr. Ahern was Visiting Professor at Cumberland School of Law, Fall, 2002, teaching Secured Transactions and Banking. He is a graduate of Vanderbilt University Law School, where he has served as Adjunct Professor of Law, teaching Secured Transactions, since 1998. He serves on the Advisory Board of the St. John's Law School Bankruptcy LL.M. program.

<sup>3</sup> See <[http://www.fincen.gov/af\\_mission.html](http://www.fincen.gov/af_mission.html)>, last visited March 27, 2005.

1. FinCEN administers the Bank Secrecy Act ("BSA"),<sup>4</sup> which authorizes the collection, analysis and dissemination of financial information related to the prevention of money laundering and terrorist financing.

a. FinCEN has been designated by the Department of the Treasury as one of the primary agencies to establish, oversee and implement policies to detect and prevent money laundering and terrorist financing.<sup>5</sup> The Secretary is authorized to delegate such responsibilities to FinCEN.<sup>6</sup>

b. FinCEN has authority<sup>7</sup> to examine financial institutions for compliance with the BSA and regulations promulgated under the BSA,<sup>8</sup> as well as to take enforcement actions for violation of the BSA and the implementing regulations.<sup>9</sup>

c. The Secretary has delegated BSA examination authority, but not enforcement authority, to the Office of the Comptroller of the Currency and the Office of Thrift Supervision. In addition, examination authority is shared by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the National Credit Union Administration. All of those federal banking agencies share information about administration of the BSA. They have separate authority to ensure that banking organizations comply with all laws and

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<sup>4</sup> 12 U.S.C. § 1829b; 12 U.S.C. §§ 1951-59; 31 U.S.C. §§ 5311-32.

<sup>5</sup> See Treasury Order 108-01, Sept. 26, 2002.

<sup>6</sup> 31 U.S.C. § 310(b)(2)(I) & (J).

<sup>7</sup> 31 U.S.C. § 5318(a)(3).

<sup>8</sup> 31 C.F.R. Part 103.

<sup>9</sup> 31 U.S.C. §§ 5320-23.

regulations.<sup>10</sup> Each agency that performs FinCEN's delegated examination authority is required by regulation to make periodic reports to FinCEN.<sup>11</sup>

2. FinCEN thus supports law enforcement, intelligence, and regulatory agencies through sharing and analysis of financial intelligence.

3. FinCEN also builds global cooperation with counterpart financial intelligence units.

4. FinCEN networks people, ideas, and information.

An organization chart appears as an addendum to this material. The FinCEN organization consists of approximately 200 employees, the majority of whom are intelligence professionals, specialists from the financial industry and technology experts. In addition, there are approximately 40 long-term detailees from 20 different law enforcement and regulatory agencies. The fourth Director of FinCEN is William J. Fox. He was appointed by Treasury Secretary John Snow December 1, 2003.

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<sup>10</sup> 12 U.S.C. §§ 1786 & 1818.

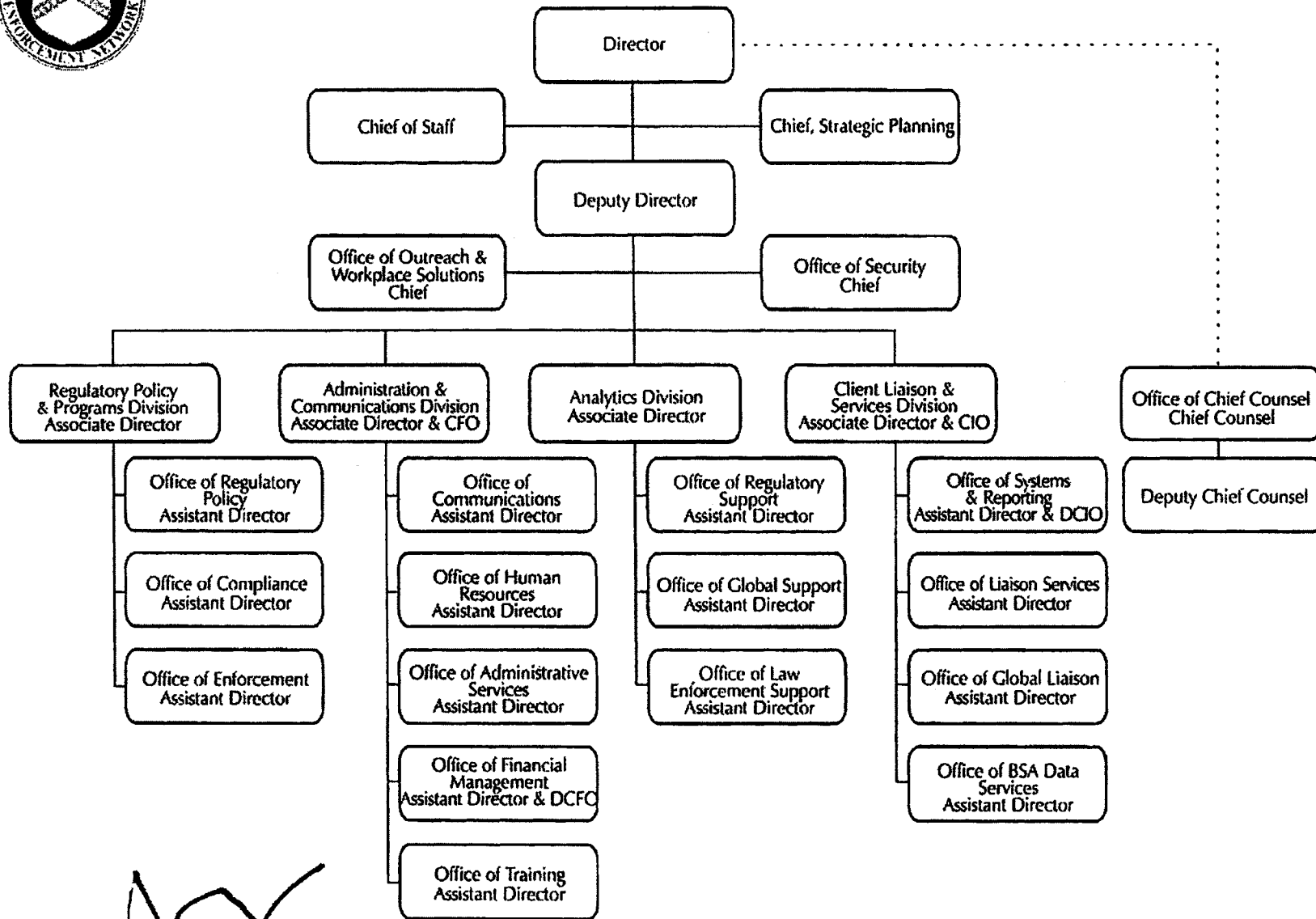
<sup>11</sup> 31 C.F.R. § 103.56(e).



**FinCEN**  
**ORGANIZATION**  
**CHART**



# Financial Crimes Enforcement Network



H-6

Approved: \_\_\_\_\_

Date: \_\_\_\_\_

27-AUG-2004

**FinCEN**  
**STRATEGIC PLAN**  
**2003-2008**



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## MISSION, VISION, AND VALUES

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### INTRODUCTION

The Financial Crimes Enforcement Network (FinCEN) plays a critical role in combating money laundering and the financing of terrorist activity. FinCEN's network links the law enforcement, financial, and regulatory communities, domestically and internationally, for the common purpose of preventing, detecting, and prosecuting financial crime.

FinCEN was established in April 1990, by the U. S. Department of the Treasury (Treasury Order Number 105-08), to provide a government-wide, multi-source intelligence and analytical network. FinCEN's operation was broadened in 1994 to include regulatory responsibilities. In October 2001, the USA PATRIOT Act elevated FinCEN to bureau status and emphasized its role in fighting terrorist financing.

Today, FinCEN is one of three entities (including the Office of Foreign Assets Control and the Internal Revenue Service Criminal Investigation Division) within the U.S. Department of the Treasury responsible for combating money laundering and terrorist financing. These entities work collaboratively with the Executive Office of Terrorist Financing and Financial Crimes under Treasury's Deputy Secretary.

FinCEN works to accomplish its mission in two ways. First, FinCEN administers the Bank Secrecy Act (BSA), our nation's comprehensive anti-money laundering statute, and is responsible for expanding the regulatory framework to industries vulnerable to money laundering, terrorist financing, and other crime. Second, FinCEN analyzes and shares the BSA information with U.S. law enforcement at the federal, state, and local levels, and its international counterparts, to help them identify and track the financial aspects of criminal investigations. Because it both collects and analyzes the BSA data, FinCEN is able to assess and demonstrate the value of the data and suggest ways to increase its value. FinCEN seeks to strike a balance between meeting law enforcement's information needs, minimizing the burden on regulated industry, and protecting individual privacy.

## MISSION

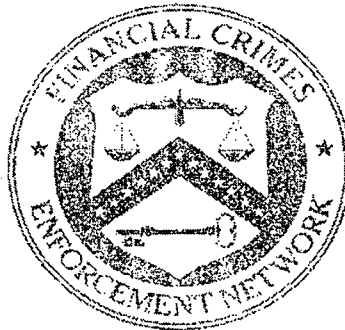
*FinCEN's mission is to collect, analyze, and share information needed to combat the financial aspects of criminal activity worldwide.*

## VISION

*FinCEN will use innovative methods and state-of-the-art technology to collect, analyze, and deliver valuable information to its customers.*

## VALUES

- *Partnerships – We listen to our stakeholders and work closely with them.*
- *Teamwork – We support each other and work together as a team.*
- *Innovation – We encourage creativity and out-of-the-box thinking in order to constantly improve our processes, products, and services.*
- *Respect – We respect differences in people and ideas; we treat each other and those we serve with fairness, dignity, and respect; we encourage individual opportunity and growth.*
- *Excellence – We strive to achieve the highest level of performance and are results driven.*



## STRATEGIC AREAS AND CHALLENGES

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### STRATEGIC AREAS

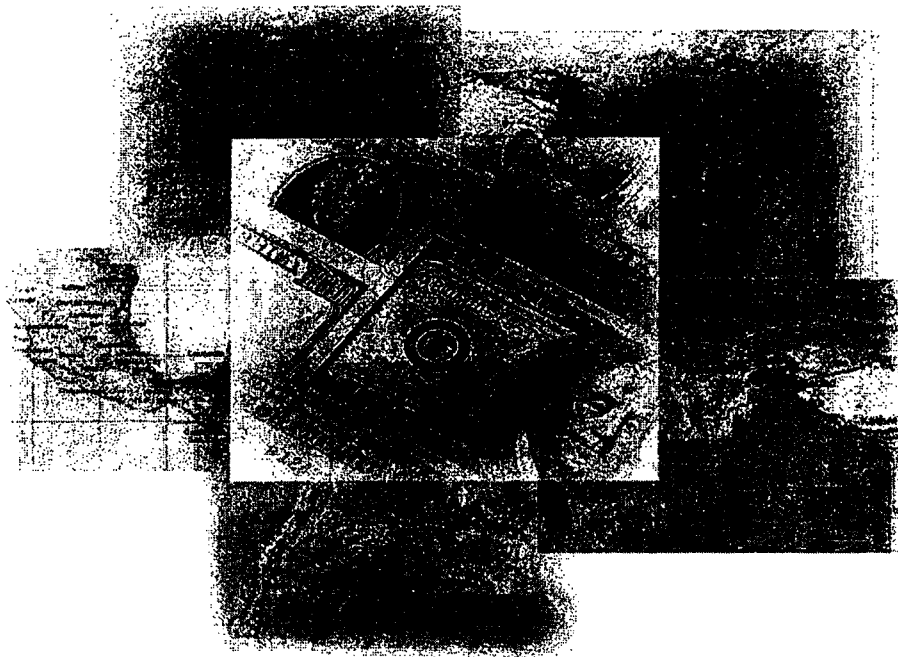
In FY 2003, FinCEN was appropriated \$51.4 million to support a workforce of over 300 employees and contractors and carry out its program, "Combat Financial Aspects of Criminal Activity." Within the program are three strategic areas:

#### *Extending the Regulatory Framework*

FinCEN is the nation's central clearinghouse for broad-based financial intelligence and information sharing. The Bank Secrecy Act (BSA), originally enacted in 1970, authorizes Treasury to require covered financial institutions to file certain reports (e.g., suspicious activity reports and currency transaction reports) and keep records of certain types of financial transactions. As the administrator of the BSA, FinCEN

promulgates regulations, provides outreach and guidance to the regulated industries, and initiates regulatory enforcement actions in certain circumstances. FinCEN relies on its federal regulatory partners to examine financial institutions within their respective jurisdictions regarding compliance with the BSA.

Because money laundering and terrorist financing do not stop at the U.S. borders, FinCEN is actively involved in strengthening regulatory regimes overseas. FinCEN provides training and technical assistance to a broad spectrum of foreign government officials, financial regulators, law enforcement personnel, and bankers on various aspects of developing and operating a Financial Intelligence Unit (FIU), such as FinCEN.



*Collecting and Sharing Information*

As the administrator of the BSA, FinCEN is also responsible for managing the information filed by the regulated industries. FinCEN has relied on the Internal Revenue Service (IRS) as the primary service provider for the collection, processing, and retrieval of BSA information. This arrangement has been viewed as an effective way for FinCEN to leverage limited resources.

In order to accelerate the flow of valuable information to law enforcement, FinCEN is working to modernize the systems and processes used to collect, maintain, and access BSA information. One example is the new PATRIOT Act Communication System (PACS), initiated in FY 2003, which allows participating financial institutions to quickly and securely file BSA reports over the Internet. This system will allow BSA data to be processed and made available to law enforcement on an expedited basis, as well as decrease the volume of paper filings.

FinCEN continues to promote the use of its Gateway process, which enables federal, state, and local law enforcement agencies and financial industry regulators to have direct access to records filed under the BSA. This access is provided through a secure web-based network. The Gateway process empowers FinCEN's law enforcement customers to conduct their own routine queries of BSA records rather than rely on FinCEN's analytical resources.

*Providing Analytical Services and Products*

FinCEN adds value to financial investigations by providing two types of analysis: (1) investigative case research, and (2) identification of foreign and domestic money laundering and terrorist financing trends, patterns, and techniques.

First, FinCEN supports the financial aspects of investigations by providing quality and timely investigative case support to its customers. FinCEN's in-house analysts provide case support to U.S. law enforcement at the federal,

Treasury Strategic Goal	Treasury Strategic Objective	FinCEN General Goal in Treasury Strategic Plan	FinCEN Strategic Goal
Preserve the integrity of financial systems	Disrupt and dismantle financial infrastructure of terrorists, drug traffickers, and other criminals and isolate their support networks	Collect, analyze and share information needed to combat the financial aspects of criminal activity worldwide.  <i>Program: Combat Financial Aspects of Criminal Activity</i>	<b>Regulatory Framework:</b> Support efforts to eliminate safe havens for money laundering and terrorist financing worldwide. <b>Information Collection and Sharing:</b> Modernize the collection, maintenance and retrieval of BSA information. <b>Analytical Services and Products:</b> Enhance the value of FinCEN's analytical services and products.

state, and local levels, and to their international counterparts, by preparing reports based on data collected under the BSA, and other commercial and law enforcement information. These reports link together business associates, bank accounts, property records, and other information to assist law enforcement in conducting more complete financial investigations. FinCEN also helps law enforcement customers coordinate their investigations by signaling when two or more agencies have an interest in the same subject.

Second, FinCEN provides strategic analytical support to law enforcement, regulators, policymakers, and the intelligence community. FinCEN analysts, working closely with law enforcement, regulators, and intelligence analysts in the field, add value to BSA data and other financial intelligence to identify trends, patterns, and techniques associated with money laundering, terrorist financing, and other financial crimes, worldwide. FinCEN disseminates this information in a wide range of products, including geographic threat assessments, money flow studies, industry studies, statistical and issues analyses, and bulletins and advisories. FinCEN also provides feedback, bi-annually, to the financial community on the value of their Suspicious Activity Reports to investigations.

## PERFORMANCE MANAGEMENT

As shown in the diagram below, FinCEN's Strategic Plan links directly to the Treasury Strategic Plan through FinCEN's General Goal. FinCEN's Strategic Plan presents the strategies

used to achieve Treasury's and FinCEN's goals and the measures used to monitor progress towards them. The three goals presented in FinCEN's Strategic Plan will be reflected as Performance Goals in the Annual Performance Plan and the budget. The Annual Performance Report will measure FinCEN's progress towards achieving annual targets set for each strategy in FinCEN's Strategic Plan.

## STRATEGIC CHALLENGES

Several external factors could affect achievement of FinCEN's goals:

- Technology - Staying abreast of advanced technologies and their impact on financial crime trends and patterns. Understanding technology and how it can be used internally to improve service efficiency and customer satisfaction.
- Legislation - Addressing any new legislative initiatives through various efforts, such as rulemaking and outreach programs.
- Human Capital - Assessing how changing economic conditions, both nationally and locally, could affect FinCEN's ability to attract and retain the technical expertise required to meet its goals.
- Reorganization - Maintaining the focus and ensuring the integrity of FinCEN's mission within the new federal law enforcement structure.

# GOAL 1: SUPPORT EFFORTS TO ELIMINATE SAFE HAVENS FOR MONEY LAUNDERING AND TERRORIST FINANCING WORLDWIDE

## DISCUSSION

FinCEN's goal is to support Treasury's efforts to expand the financial regulatory framework, both domestically and internationally, for the purpose of eliminating safe havens for money laundering and terrorist financing. Identifying vulnerable industries and bringing them under the regulatory umbrella reduces the financial avenues available to money launderers and other criminals, including those involved in terrorist financing.

Efforts to strengthen the U.S. regulatory framework have been greatly accelerated since September 11<sup>th</sup> and the subsequent passage of the USA PATRIOT Act. FinCEN has worked closely with policymakers to put in

place a wide array of new regulations extending anti-money laundering program requirements to five additional industries (see table below). Suspicious Activity Reporting (SAR) requirements have also been expanded beyond depository institutions to money services businesses, casinos, card clubs, and broker-dealers. Between FY 2004 and FY 2005, FinCEN anticipates extending the regulatory framework to cover five more industries, and to examine the possibility of covering travel agencies, vehicle sales, and real estate, as appropriate. SAR requirements will also be extended to additional financial institutions. FinCEN, in conjunction with the regulatory agencies, will provide the oversight and outreach

*Industries Covered by Anti-Money Laundering Regulations*

FY 2001	FY 2003 estimated	FY 2005 projected
Depository institutions Casinos Card clubs	Depository institutions Casinos Card clubs Money services businesses Broker-dealers Credit card operators Mutual funds Futures commission merchants	Depository institutions Casinos Card clubs Money services businesses Broker-dealers Credit card operators Mutual funds Futures commission merchants Insurance companies Precious metals, stones & jewels Commodity trading advisors Unregistered investment companies Investment advisors

activities essential to ensuring compliance with the new reporting requirements. At the same time, FinCEN will continue to assess the value of the information it collects and seek ways to minimize the burden on regulated industries.

Although FinCEN is responsible for administering anti-money laundering regulations and reporting requirements, it depends on a wide array of Federal agencies (i.e., the Federal Reserve Board, Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration, the Securities and Exchange Commission, and the IRS) to enforce compliance. Over the next several

years, FinCEN will be working with these regulators to develop a strategy for evaluating the levels of industry compliance and the effectiveness of efforts to promote compliance.

Internationally, FinCEN will continue to encourage the adoption of comprehensive anti-money laundering regulations worldwide. The expansion of anti-money laundering regimes has accelerated in the last few years, with the number of Financial Intelligence Unit (FIU) counterparts overseas growing from 58 countries/jurisdictions in FY 2001 to 84 in FY 2003. To support this growth, FinCEN anticipates it will need to continue to expand its efforts to provide or coordinate training and technical assistance.

## PERFORMANCE MEASURES

How FinCEN Will Assess Progress in Achieving This Strategic Goal	Baseline 2003	Target Date	Target Amount
1. Number of vulnerable industries covered by anti-money laundering regulations	8	2005	13
2. Share of customers satisfied with FinCEN's regulatory guidance	77%	2005	80%
3. Percentage reduction in CTR filings	Baseline	2008	30%
4. BSA compliance - (percentage and quality)	TBD	2008	TBD



## STRATEGIES

**Strategy 1-1: Expand the U.S. regulatory framework to cover, as appropriate, all vulnerable industries.**

FinCEN will continue to work with Treasury to complete the regulations required to implement the anti-money laundering provisions of Title III of the USA PATRIOT Act. FinCEN will also work with Treasury to assess how the new regulations are working in practice and what adjustments are needed to achieve the government's anti-money laundering goals.

FinCEN supports the extension of the regulatory framework by providing guidance to the regulated industries in a variety of ways. Information is provided via FinCEN's website, through presentations at industry and association conferences, in FinCEN publications, such as the bi-annual *SAR Activity Review—Trends, Tips and Issues*, and in response to direct queries.

**Strategy 1-2: Maximize regulatory effectiveness while minimizing the burden on industry.**

FinCEN is working in partnership with the regulated industries to identify ways for encouraging them to use current statutory exemption provisions as a way of reducing the submission of Currency Transaction Reports that have little or no value for law enforcement purposes.

**Strategy 1-3: Ensure effective and uniform enforcement of anti-money laundering regulations.**

FinCEN will enhance nationwide compliance with anti-money laundering regulations by reaching out to other regulatory organizations and industry representatives to strengthen public-private partnerships. FinCEN will work with federal and state regulators to determine the level of compliance with the BSA regulations and examine the effectiveness and uniformity of current enforcement programs and measures. FinCEN will also examine options for delegating portions of the enforcement responsibilities to its federal regulatory partners.

**Strategy 1-4: Promote the adoption of anti-money laundering and terrorist financing policies globally.**

FinCEN works closely with other components of the U.S. government and its partners around the world to promote the adoption of international anti-money laundering standards and the formation of FIUs. In addition, FinCEN works with the Department of State and Treasury's Office of Technical Assistance to provide training and technical assistance to nations seeking to establish FIUs or enhance fully functional FIUs. Over the next five years, FinCEN anticipates increased demand from FIUs for information technology assistance.

## GOAL 2: MODERNIZE THE COLLECTION, MAINTENANCE, AND RETRIEVAL OF BSA INFORMATION.

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### DISCUSSION

FinCEN's goal is to accelerate the flow of valuable financial information from regulated industries, and provide that information in a timely, efficient, and secure manner to law enforcement. There are several modernization efforts directed at improving the collection, maintenance, and retrieval processes. FinCEN is expediting the collection and processing of BSA information through the PATRIOT Act Communication System (PACS) and examining ways to enhance the paper collection and BSA form editing processes. Plans are also underway to redesign the data retrieval systems and processes to make the BSA data more easily accessible and understandable to users.

These improvements will be key to achieving the targeted growth in Gateway, the process by which users directly access records filed under the BSA. FinCEN anticipates expansion of the Gateway user base from less than 1,000 users, currently, to more than 3,000 in FY 2005. Part of the expansion will result from encouraging current FinCEN customers to conduct their own queries of BSA records, using Gateway, rather than

relying on FinCEN's analytical staff. The largest growth in the Gateway user base will result from consolidating direct access to the BSA data through the Gateway process. This effort will enhance FinCEN's ability to: (1) assure that agencies with interests in the same investigative subjects are networked, thereby avoiding overlapping investigations; (2) collect statistics on the usage of SARs in order to provide feedback to the regulatory community and improve overall BSA reporting; and (3) audit BSA data usage.

FinCEN plays a key role in fostering the secure exchange of information among FIUs. FinCEN developed and maintains a secure Internet website, the Egmont Secure Web, which permits connected FIUs to communicate with one another via secure e-mail, and to post and access information related to money laundering trends, analytical tools, and technological developments. Over the next five years, FinCEN is likely to face technological constraints and increased vulnerabilities in connecting an increasing number of new FIUs from less developed countries.

### PERFORMANCE MEASURES

How FinCEN Will Assess Progress in Achieving This Strategic Goal	Baseline 2003	Target Date	Target Amount
1. Share of BSA filings submitted electronically	3%	2005	40%
2. Number of users directly accessing BSA data through FinCEN's Gateway process	900 (estimated)	2005	3,000
3. Survey results regarding "value" of direct access to law enforcement	TBD	2008	80%

## STRATEGIES

### **Strategy 2-1: Enhance the timeliness, accuracy, and ease of filing and processing BSA forms.**

The collection of BSA data is being expedited using a highly secure network to allow financial institutions to file BSA reports electronically. This new system, PACS, is designed to allow participating financial institutions to quickly and securely file BSA reports over the Internet and reduces a financial institution's costs in filing BSA reports (i.e., elimination of magnetic tape handling, routing paper forms for approval, and shipping costs). PACS also accelerates the delivery of BSA information to federal and state law enforcement and reduces the cost to the government of processing paper forms.

Efforts are also under consideration to modernize the paper collection and BSA form editing processes. There is a need to examine possible workflow enhancements and to adopt technologies to automate paper form processing.

### **Strategy 2-2: Implement BSA data retrieval system that supports expansion of the Gateway user base.**

In order to allow effective use of the BSA data, FinCEN is planning to put in place a secure, web-based system that will provide a user-friendly interface with query, retrieval, reporting, and data analysis capabilities. Over the next two years, FinCEN plans to build and maintain, with contractor support, a BSA data retrieval system, known as BSA Direct. By using modern technology, the new system will accommodate the anticipated expansion of the user base, while providing users with easier access to the data and more sophisticated analytic tools.

### **Strategy 2-3: Expand access to BSA data through the Gateway process.**

FinCEN will continue to encourage law enforcement and regulators to conduct their own basic queries of BSA data using Gateway, as well as to consolidate access to BSA data through the Gateway process. To cost-effectively support an expanded Gateway user base, FinCEN will automate the processes used to audit usage of the BSA data, network customer queries, and provide customer support and training.

### **Strategy 2-4: Strengthen on-line information sharing among FIUs**

To facilitate the secure exchange of information among the FIUs, FinCEN's goal is to have all FIUs hooked up to the Egmont Secure Web. The system has encouraged unprecedented cooperation between FIUs due to security, ease of use, and quick response time.

FinCEN is also sponsoring the Egmont Group's new public Internet site to further encourage international partnerships. This site will be especially useful for other international organizations focusing on money laundering and terrorist financing issues and for countries developing anti-money laundering regimes.

## GOAL 3: ENHANCE THE VALUE OF FINCEN'S ANALYTICAL SERVICES AND PRODUCTS

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### DISCUSSION

FinCEN's goal is to continually enhance its analytic capability—both for investigative case research and strategic analysis. FinCEN seeks feedback from its customers to identify areas for improvement. In a recent survey, although customers were very satisfied overall with the investigative case reports prepared by FinCEN, timeliness was an issue. FinCEN is working to enhance timeliness by developing a case information system that will allow for the more efficient development and tracking of case reports.

FinCEN also seeks to enhance the quality and value of its strategic analytical services. FinCEN provides a broad range of short and long-term analytical products to law enforcement, regulators, and the regulated industries. These products are aimed at identifying U.S. and global trends, patterns, and techniques associated with money laundering and terrorist financing, and providing feedback on the use and utility of SARs. FinCEN will continually be challenged to

develop or acquire increasingly powerful tools that will allow its analysts to uncover trends and patterns, or investigative targets, from large volumes of data. Increasingly, such analyses will be conducted jointly with other law enforcement agencies at home and abroad, reflecting the growing complexity and interconnectivity of terrorist financing and money laundering schemes.

Recently, FinCEN has embarked on a new effort to support law enforcement investigations. In response to provision 314 of the USA PATRIOT Act, FinCEN has developed the Law Enforcement and Financial Institution Information Sharing (LEFIIS) system, which permits law enforcement to get expedited feedback from financial institutions on subjects of money laundering or terrorism investigations. This new system is providing law enforcement with timely and valuable information about investigative subjects, as well as further opportunities for coordinating investigations.

### PERFORMANCE MEASURES

How FinCEN Will Assess Progress in Achieving This Strategic Goal	Baseline 2003	Target Date	Target Amount
1. Share of FinCEN's customers rating its investigative case reports as valuable	79%*	2005	85%
2. Average time to complete advanced analytical case reports	42-45 days	2008	25-30 days
3. Share of FinCEN's customers rating its strategic analytical services and products as valuable	TBD	2008	80%

\* FY 2002 rating. The FY 2003 survey will be conducted in the last quarter of FY 2003.

## STRATEGIES

### **Strategy 3-1: Provide valuable investigative case support.**

FinCEN will continue to enhance the timeliness and value of its products and the efficiency of the processes used to develop those products. FinCEN will begin an investigative case report work process review in FY 2004 to identify opportunities for increasing the efficiency of the process and the timeliness of the product. FinCEN will also evaluate the potential of an electronic Case Information System (CIS) that would allow FinCEN's customers to submit a request for research to FinCEN electronically and receive the resulting case report back electronically.

Foreign requests for investigative research are increasing rapidly, reflecting the growth in FIUs. FinCEN is examining various strategies for enhancing its ability to meet the special needs of foreign requests.

### **Strategy 3-2: Provide valuable investigative targets.**

An increase in information sharing among federal agencies since the enactment of the USA PATRIOT Act has progressively enhanced FinCEN's proactive initiatives. Various elements of information are collectively analyzed, along with BSA data, using unique analytical linking techniques. This process yields valuable leads for law enforcement and government task forces in their efforts to combat terrorist financing, money laundering, and financial crimes. FinCEN is examining several methods for expanding its capacity to develop pro-active investigative targets.

### **Strategy 3-3: Provide valuable analyses on U.S. and global money laundering and terrorist financing trends.**

To assist partners in the improvement of money laundering and terrorist financing prevention and detection programs, and to keep pace with the evolution of systemic money laundering threats, FinCEN has created new resource centers, such as its Geographic Threat Assessment and Non-Traditional Methodologies Sections. These sections produce geographic threat assessments for law enforcement and provide information to FinCEN's partners on the emerging methods for money laundering and terrorist financing. Over the next few years, FinCEN will be developing a strategy for measuring and enhancing the value of these products.

### **Strategy 3-4: Enhance and accelerate information sharing among law enforcement and financial institutions regarding potential terrorist financing or money laundering schemes.**

FinCEN continues to enhance its new LEFIIS system – a combination of e-mail and blast fax – that can quickly transmit names of suspects to financial institutions and get back reports of matches within days. FinCEN has also devised a system for qualifying financial institutions to share information with other similarly qualified institutions regarding individuals and entities suspected of engaging in terrorist financing or money laundering. This information cannot be used for any other purpose, and its security and confidentiality are carefully safeguarded.

**Strategy 3-5: Ensure that FinCEN's analysts have the latest tools and training.**

The extension of the SARs requirement to the money services businesses, securities and futures industries, broker-dealers, and casinos is generating an increasing volume of filings. FinCEN needs sophisticated tools to review and analyze these reports for money laundering and other criminal activities. FinCEN is developing a strong research and development orientation that will enable it to exploit emerging technologies and identify new techniques for "mining" large amounts of information.

## FINCEN MANAGEMENT PRIORITIES

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Underlying the success of FinCEN's strategic goals are key management initiatives or priorities. These initiatives address how FinCEN will implement the President's Management Agenda (PMA).

**Strategy 4-1: Re-engineer the FinCEN processes and approaches for "doing IT" in order to meet changing requirements and maximize limited IT resources.**

FinCEN will refine its Information Technology (IT) governance system as outlined in the PMA. As part of this process, FinCEN will develop a modernization blueprint (Enterprise Architecture) that fits within the overall Treasury Enterprise Framework and ensures that IT spending is focused on high priority modernization initiatives. The governance process will assure continued improvement in overall project management. It will incorporate tools, such as modular and performance-based contract methods, to ensure that projects are developed in manageable units to reduce overall risk. Project development will also adhere to electronic government principles and involve partnering with other agencies as appropriate to avoid redundancies and achieve overall efficiencies.

FinCEN will ensure that major IT projects are within 10 percent of cost/schedule/performance objectives, and IT systems are certified and accredited within one year of deployment.

**Strategy 4-2: Develop and retain a high-performing, diverse workforce.**

FinCEN will continue its efforts to meet the PMA objectives in this area. Those efforts include: continued development of an effective leadership cadre; implementation of a performance management system that links individual performance to organizational goals; continued reduction in diversity gaps within the organization by enhancing efforts to recruit and retain a diverse workforce; and enhancement of tools and processes necessary to measure and rate performance.

**Strategy 4-3: Maximize business results through efficient and effective business practices.**

As part of a maturing organization, FinCEN will continue to identify ways to integrate its functional areas and reduce the "silo" nature of its operations. FinCEN will also evaluate FinCEN's business processes and culture and identify opportunities and approaches to instill more mature corporate processes and culture.

FinCEN will also continue its efforts to meet the PMA objectives in this area. FinCEN will successfully complete the Office of Management and Budget's Program Assessment Rating Tool (PART) process in FY 2004. Management will review financial and performance information periodically and use it to make informed budget decisions, justify funding requests, and direct program improvements. The results of program evaluations, which began in FY 2003, will provide a critical and continuing source of performance information.

## APPENDIX A. USE OF PROGRAM EVALUATIONS

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### *Prosperous and Stable American and World Economies*

<i>Issue</i>	<i>Evaluations</i>
Regulatory Framework	Options to reduce Low Value Currency Transaction Reports: A report was submitted to Congress recommending ways to encourage institutions to use the filing exemption process for CTRs. FinCEN will chair a public-private working group to identify workable mechanisms to achieve the desired 30 percent reduction in CTR filings.
Analytical Services & Products	Investigative Case Support Work Processes: A work process review will begin in FY 2004, in anticipation of the development of an electronic document management system.
Customer Satisfaction	Customer Satisfaction Surveys: FinCEN will continue to conduct customer satisfaction surveys, on a rotating basis, for its key program areas. In FY 2003, a follow-up survey will be conducted on investigative case reports, and in FY 2005 on regulatory support. In FY 2004, plans are to develop a baseline survey for strategic analysis products.
Employee Satisfaction	Employee Satisfaction Survey: FinCEN conducted a baseline employee satisfaction survey in FY 2002. Recommendations based on the survey are being addressed and a follow-up survey will be conducted in FY 2004.
Program & Internal Control Reviews	Efficiency and Effectiveness of Programs: FinCEN will review at least one program annually to identify ways to improve efficiency and effectiveness. Additionally, FinCEN will continue reviews in support of its overall management control program.



## APPENDIX B. GLOSSARY OF TERMS AND ACRONYMS

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**Bank Secrecy Act (BSA) of 1970** – Act that authorizes the Secretary of the Treasury to require financial institutions to keep records and submit reports the Secretary deems useful for criminal, tax, and regulatory investigations and proceedings. In 1994, the Secretary delegated the BSA regulatory authority to FinCEN.

**Case Information System (CIS)** – System that will allow FinCEN to replace its current case receipt, investigative case research, and case report dissemination processes with a fully-integrated electronic process.

**Currency Transaction Report (CTR)** – Report filed by financial institutions regarding currency transactions of more than \$10,000 by, through, or to the financial institution.

**Egmont Secure Web (ESW)** – A virtual private network maintained by FinCEN. The network connects Egmont FIUs, allowing information to be passed securely among them via e-mail.

**Financial Intelligence Units (FIUs)** – Specialized government agencies created by a number of countries over the last decade to serve as focal points for national anti-money laundering programs. Since 1995, a number of FIUs began working together in an information organization known as the Egmont Group, to provide a forum for FIUs around the world to improve support to their respective governments in the fight against financial crimes.

**Law Enforcement and Financial Institution Sharing (LEFIIS)** – System implemented by FinCEN, in accordance with Section 314 (a) of the USA PATRIOT Act, to facilitate the sharing of information between federal law enforcement agencies and financial institutions regarding terrorism or money laundering targets.

**Money Laundering** – Process by which criminals or criminal organizations seek to disguise the illegal origin of their proceeds. Crimes such as drug trafficking, smuggling, computer fraud schemes, and embezzlement can produce substantial profits, creating an incentive to legitimize the gains through money laundering.

**Money Services Businesses (MSBs)** – Term used to define over 150,000 entities such as money transmitters; issuers, redeemers, and sellers of money orders and traveler's checks; check cashers; and currency exchangers.

**[USA] PATRIOT Act Communication System (PACS)** – System designed to allow participating financial institutions to file BSA reports quickly and securely over the Internet.

**President's Management Agenda (PMA)** – An aggressive strategy, announced in the summer of 2001, for improving the management of the Federal government. It focuses on five management areas: Human Capital, Budget and Performance Integration, Competitive Sourcing, E-Government, and Financial Management.

**Program Assessment Rating Tool (PART)** – A systematic, consistent process for developing program performance ratings and then using that information to make budget decisions. Developed by OMB, the PART is composed of assessment criteria on program performance and management. The PART establishes a “good government” standard of performance and will be used to rate programs in an open, public fashion.

**Strategic Goals** – Overarching statements of aim or purpose for key FinCEN functions.

**Strategies** – Statements regarding how FinCEN will achieve its Strategic Goals. These strategies cover the major functions and operations.

**Suspicious Activity Report (SAR)** – Report filed by financial institutions covered by the Bank Secrecy Act to identify suspicious transactions relevant to possible violations of the law.

**Terrorist financing** – Process used to fund terrorist acts. This process shares most of the fundamental attributes of money laundering (e.g., the need for fundraising, funds transfers, and obfuscation of funds origins and beneficiaries) and uses similar methods for moving and laundering money, engaging money professionals such as currency exchangers, bankers, accountants, and lawyers.

**USA PATRIOT Act of 2001 (Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism)** – Legislation seeking to strengthen U.S. anti-money laundering laws by focusing on offshore banking and related facilities that protect anonymity, enabling criminals to move funds; correspondent banking which is susceptible to manipulation by money launderers; and private banking, which is susceptible to manipulation by corrupt foreign government officials. The Act also expands the Bank Secrecy Act to include additional sectors of financial services industry. FinCEN was directed to implement 23 of the 44 provisions of Title II – International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001.

## COMMENTS OR QUESTIONS?

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Comments or questions regarding FinCEN's Strategic Plan can be sent to:

Deputy Chief Financial Officer  
Financial Crimes Enforcement Network  
P.O. Box 39  
Vienna, Virginia 22183

Comments can also be e-mailed to: [webmaster@fincen.treas.gov](mailto:webmaster@fincen.treas.gov)

For more information on FinCEN, please visit our website at:  
[www.fincen.gov](http://www.fincen.gov)

**RIGGS BANK N.A.**

**CONSENT ORDER OF CIVIL MONEY PENALTY**

**MAY 13, 2004**

**#2004-44**

**UNITED STATES OF AMERICA  
DEPARTMENT OF THE TREASURY  
OFFICE OF THE COMPTROLLER OF THE CURRENCY**

<b>In the Matter of:</b>	)	
Riggs Bank N.A.,	)	
McLean, Virginia	)	AA-EC-04-55

**CONSENT ORDER OF CIVIL MONEY PENALTY**

WHEREAS, the Comptroller of the Currency of the United States of America (“Comptroller”) intends to initiate a civil money penalty proceeding against Riggs Bank N.A., McLean, Virginia (“Bank”) pursuant to 12 U.S.C. § 1818(i) (as amended) for violations of the law and regulations regarding compliance with the Bank Secrecy Act (“BSA”) and 12 C.F.R. §§ 21.11 and 21.21, and for violations of the Consent Order issued against the Bank dated July 16, 2003.

WHEREAS, in the interest of cooperation and to avoid the costs associated with future administrative and judicial proceedings with respect to the above matter, the Bank, without admitting or denying any wrongdoing or the findings of fact set forth in Article II below, desires to enter into this Consent Order of Civil Money Penalty (“Order”) issued pursuant to 12 U.S.C. § 1818(i).

NOW, THEREFORE, in consideration of the above premises, it is stipulated by and between the Comptroller, through his duly authorized representative, and the Bank that:

## Article I

### JURISDICTION

(1) The Bank is a national banking association, chartered and examined by the Comptroller, pursuant to the National Bank Act of 1864, as amended, 12 U.S.C. § 1 et seq. Accordingly, the Bank is an “insured depository institution” as that term is defined in 12 U.S.C. § 1813(c)(2).

(2) Pursuant to 12 U.S.C. § 1813(q), the Comptroller is the “appropriate Federal banking agency” to initiate and maintain this civil money penalty proceeding against the Bank pursuant to 12 U.S.C. § 1818(i).

(3) The Bank is a subsidiary of Riggs National Corporation, a publicly-traded bank holding company.

## Article II

### FINDINGS AND CONCLUSIONS

#### A. Background

(1) Pursuant to 12 C.F.R. § 21.21(c), all national banks are required to establish and maintain BSA compliance programs reasonably designed to ensure and monitor their compliance with 31 U.S.C. §§ 5301-5355 and 31 C.F.R. Part 103. At a minimum, a bank’s BSA compliance program must provide for a system of internal controls to ensure ongoing compliance; provide for independent testing for compliance to be conducted by bank personnel or by an outside party; designate an individual or individuals responsible for coordinating and monitoring day-to-day compliance; and provide training for appropriate personnel.

(2) Pursuant to 12 C.F.R. § 21.11, a national bank must file SARs when the bank detects a known or suspected violation of Federal law or a suspicious transaction related to money laundering activity or a violation of the BSA.

(3) The Comptroller and the Bank entered into a Consent Order dated July 16, 2003, designed to address BSA deficiencies identified at the Bank.

(4) The Comptroller and the Bank entered into a supplemental Consent Order dated May 13, 2004.

A. BSA Compliance Program Deficiencies

(5) The Bank violated 12 C.F.R. § 21.21 by failing to comply with the BSA compliance program requirements and by failing to correct deficiencies in the four required elements for a BSA compliance program.

- (a) Internal Controls: The Bank's internal controls were, and continue to be, seriously deficient. The Bank's system of internal controls did not effectively identify or address the BSA-related risks that existed in various divisions of the Bank or that related to customers, products, services, or accounts that should have been viewed as high risk. Moreover, the Bank's Anti-Money Laundering and Enhanced Due Diligence program and Customer Identification Program pertaining to areas deemed to be high-risk were not adequately implemented.

- (i) The Bank did not collect or maintain sufficient information about its foreign private banking customers. As a result, the Bank failed to identify approximately one-third of the accounts related to the country of Saudi Arabia and an unacceptably high number of accounts related to the country of Equatorial Guinea.
  - (ii) The Bank omitted disclosure of several Bank accounts in response to requests from the OCC and other governmental agencies.
- (b) Independent Testing: The Bank's system for independently testing its BSA compliance was inadequate. Bank audits did not review all of the necessary areas, did not uncover or disclose the severity or the extent of weaknesses in the Bank's BSA compliance, and contained flawed testing and sampling.
- (c) Designation of Individual(s) to Coordinate and Monitor Compliance: The Bank's management was ineffective in overseeing the Bank's day-to-day compliance with the BSA laws and its regulations, as evidenced by the numerous and substantial deficiencies in the program.
- (d) Training: The Bank's numerous BSA-related deficiencies demonstrate that the Bank's training program was ineffective, did



not comply with the Consent Order, and was insufficient to ensure identification of and monitoring for suspicious activities.

**B. SAR Program Deficiencies**

(6) The Bank did not detect or investigate suspicious activities and did not file SARs as required. In particular, the Bank failed to:

- (a) refer specific inquiries from law enforcement to the area that investigated suspicious activities to determine whether SAR filings were appropriate;
- (b) file accurate Currency Transaction Reports and SARs, in part, based upon inaccurate or incomplete information maintained about Bank customers;
- (c) file timely SARs for any of the transactions listed in paragraph (7) of this Article; and
- (d) investigate suspicious activities occurring in accounts related to the countries of Saudi Arabia and Equatorial Guinea.

(7) The Bank did not adequately monitor for suspicious cash, wire, or monetary instrument transactions. In particular, the Bank failed to identify or to monitor potentially suspicious activity pertaining to:

- (a) tens of millions of dollars in cash withdrawals from accounts related to the Saudi Arabian embassy;

- (b) dozens of sequentially-numbered international drafts that totaled millions of dollars, that were drawn from accounts related to officials of Saudi Arabia, and that were returned to the Bank;
- (c) dozens of sequentially-numbered cashier's checks that were drawn from accounts related to officials of Saudi Arabia made payable to the account holder;
- (d) millions of dollars deposited into a private investment company owned by an official of the country of Equatorial Guinea;
- (e) hundreds of thousands of dollars transferred from an account of the country of Equatorial Guinea to the personal account of a government official of the country; and
- (f) over a million dollars transferred from an account of the country of Equatorial Guinea to a private investment company owned by the Bank's relationship manager.

C. Risk Management Deficiencies

(8) The Bank did not identify deficiencies in its risk management procedures. These deficiencies included systemic deficiencies in Bank policies, internal controls, and staff oversight. In particular, the Bank failed to:

- (a) increase its risk management procedures or scrutinize accounts related to the country of Equatorial Guinea, until October 2003, despite information that should have raised concerns for the Bank;

- (b) properly supervise the Bank's relationship manager for the Equatorial Guinea account relationships; and
- (c) discover that a relationship manager had signature authority over two Equatorial Guinea accounts.

D. Conclusion

(9) The Comptroller has concluded that the Bank engaged in systemic violations of law, regulations, and a final order and failed to correct those violations. The Bank failed to comply fully with the requirements of the Consent Order against the Bank dated July 16, 2003. The Bank's BSA compliance program was deficient in all four elements: internal controls, independent testing, designation of individual(s) to coordinate and monitor compliance, and training appropriate personnel. In addition, the Bank failed to file accurate and timely Suspicious Activity Reports ("SARs").

Article III

ORDER OF CIVIL MONEY PENALTY

(1) The Bank is hereby ordered to pay a civil money penalty in the amount of twenty-five million dollars (\$25,000,000).

(2) This penalty assessment shall be concurrent with the twenty-five million dollars (\$25,000,000) penalty assessed against the Bank by the Financial Crimes Enforcement Network.

(3) The payments to the Comptroller and the Financial Crimes Enforcement Network referred to above shall be satisfied by one payment of twenty-five million dollars (\$25,000,000) to the United States Department of the Treasury.

(4) The Bank shall make payment in full upon issuance of this Order by check or wire transfer. If a check is the selected method of payment, it must be made payable to the United States Department of the Treasury and shall be delivered to: Comptroller of the Currency, P.O. Box 73150, Chicago, Illinois 60673-7150. The docket number of this case should be entered on the check. If a wire transfer is the selected method of payment, it must be made to Treasury NYC Bank account #2071-0001. A copy of the check or wire transfer shall be delivered to the Director, Enforcement and Compliance Division, Office of the Comptroller of the Currency, 250 E St., S.W., Washington, D.C. 20219.

(5) This Order shall be enforceable to the same extent and in the same manner as an effective and outstanding order that has been issued and has become final pursuant to 12 U.S.C. §§ 1818(h) and (i) (as amended).

#### Article IV

#### WAIVERS

- (1) By executing this Order, the Bank waives:
  - (a) the right to the issuance of a Notice of Civil Money Penalty Assessment under 12 U.S.C. § 1818(i);
  - (b) all rights to a hearing and a final agency decision pursuant to 12 U.S.C. § 1818(i) and 12 C.F.R. Part 19;

- (c) all rights to seek judicial review of this Order;
- (d) all rights in any way to contest the validity of this Order; and
- (e) any and all claims for fees, costs or expenses against the Comptroller, or any of his agents or employees, related in any way to this enforcement matter or this Order, whether arising under common law or under the terms of any statute, including, but not limited to, the Equal Access to Justice Act, 5 U.S.C. § 504 and 28 U.S.C. § 2412.

(2) The Bank's Board of Directors acknowledges that it has read and understands the premises and obligations of this Order and declares that no separate promise or inducement of any kind has been made by the Comptroller, his agents or employees to cause or induce the Bank to agree to consent to the issuance of this Order and/or to execute this Order.

(3) It is hereby agreed that the provisions of this Order constitute a settlement of the civil money penalty proceeding contemplated against the Bank by the Comptroller. The Comptroller agrees not to institute further civil money penalty proceedings against the Bank for the acts, omissions or violations alleged in Article II above, unless such acts, omissions or violations reoccur.

(4) It is further agreed that the provisions of this Order shall not be construed as an adjudication on the merits and, except as set forth above in paragraph (3), shall not inhibit, estop, bar, or otherwise prevent the Comptroller from taking any action affecting

the Bank if, at any time, he deems it appropriate to do so to fulfill the responsibilities placed upon him by the several laws of the United States of America.

(5) The Bank understands that nothing herein shall preclude any proceedings brought by the Comptroller to enforce the terms of this Order, and that nothing herein constitutes, nor shall the Bank contend that it constitutes, a waiver of any right, power, or authority of any other representatives of the United States or agencies thereof, including the Department of Justice, to bring other actions deemed appropriate.

IN TESTIMONY WHEREOF, the undersigned, authorized by the Comptroller as his representative, has hereunto set his hand on behalf of the Comptroller.

*/s/ Tim Long*

5-13-04

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Timothy W. Long  
Senior Deputy Comptroller

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Date

IN TESTIMONY WHEREOF, the undersigned, as the duly authorized and acting President and Chief Executive Officer of the Bank, has hereunto set his hands on behalf of the Bank.

Riggs Bank N.A.

Signed

5/13/04

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By: Lawrence I. Hebert  
Its: President and Chief Executive Officer

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Date

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**RECENT DEVELOPMENTS UNDER  
THE BANK SECRECY ACT  
AND THE  
USA PATRIOT ACT**

*Cynthia W. Young  
Wyatt, Tarrant & Combs, LLP  
Louisville, Kentucky*

*Rick G. Alsip  
Wyatt, Tarrant & Combs, LLP  
Louisville, Kentucky*

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**SECTION I**





**RECENT DEVELOPMENTS UNDER THE BANK SECRECY ACT  
AND THE USA PATRIOT ACT**

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**Recent Developments  
under the  
Bank Secrecy Act  
and the  
USA Patriot Act**

By Cynthia W. Young and Rick G. Alsip  
Wyatt, Tarrant & Combs, LLP

**Introduction**

Enacted in 1970, the Bank Secrecy Act (BSA) was intended to prevent banks and other insured depository institutions from being used to launder money by requiring such institutions to report certain types of currency transactions (including through currency transaction reports (CTRs) and suspicious activity reports (SARs)) and maintain certain records and information. Amended several times since its enactment, including most recently with the passage of the USA Patriot Act, the BSA has recently undergone a dramatic shift in focus following the terrorist attacks of September 11<sup>th</sup>, 2001. No longer viewed simply as a tool to combat money laundering arising from drug or other criminal activities, the focus of the BSA now includes even more important goal - combating and disrupting the financing of international terrorism.

This dramatic shift in focus and the obvious importance of this new goal, coupled with the Riggs Bank scandal that had members of Congress openly questioning whether banking regulators were committed to, or even capable of, enforcing the BSA, has dramatically changed the way banks and their regulators approach the obligations of banks under the BSA. While this article provides a brief overview of some of the more significant BSA developments for banks during the past two years, without question, it is this dramatic shift in focus that is the most significant development under the BSA. As Daniel P. Stipano, Acting Chief Counsel of the Office of the Comptroller of the Currency (OCC), said in a speech in February 2005 when addressing the changing focus of the BSA, “[I]t is clear that what was good enough in the past may not be good enough now. The stakes are much, much higher than ever before, and a ‘business as usual’ approach is not going to be sufficient to meet the challenges at hand.”<sup>1</sup>

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<sup>1</sup> Remarks of Daniel P. Stipano, Acting Chief Counsel, Office of the Comptroller of the Currency, Before the Florida International Bankers Association, Miami, Florida, February 10, 2005, available at <http://www.occ.gov/ftp/release/2005-13a.pdf>. Indeed, Mr. Stipano’s remarks clearly demonstrate the importance and heightened scrutiny regulators are now giving to BSA compliance.

## Customer Identification Programs

On May 9, 2003, the Financial Crimes Enforcement Network of the Department of Treasury (FinCEN), the OCC, the Board of Governors of the Federal Reserve (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision and the National Credit Union Administration, jointly adopted a final rule implementing Section 326 of the Patriot Act.<sup>2</sup> Section 326 of the Patriot Act called for the adoption of rules that set forth the minimum standards that banks and other depository institutions must meet regarding the verifying the identity of their customers when they open an account at the institution. The final rule required all depository institutions by October 1, 2003 to have adopted a board-approved, written customer identification program (CIP) as part of the institution's BSA, anti-money laundering program that is appropriate for the institution's size and types of businesses. Under the final rule, an institution's CIP must contain the following procedures:

- Risk-based procedures that enable the institution to form a reasonable belief that it knows the identity of the customer opening the account, including
  - procedures for obtaining specific identifying information about the customer prior to opening an account, including at a minimum the customer's name, date of birth, address and taxpayer identification number (or other appropriate identification number if the customer is not a U.S person);
  - procedures for verifying the identity of the customer with a reasonable period of time after opening the account, including when the institution will use documents, non-documentary methods or a combination thereof;
  - procedures to address situations when the institution cannot verify the customer's identity;
- Procedures for making and maintaining a record of all information obtained under the foregoing procedures (including certain documents relied on and methods followed), and all identifying information obtained must be maintained for five years after the account is closed and all other information must be maintained for five years after the record is made;
- Procedures to determine whether the customer appears on any list of known or suspected terrorist or terrorists organizations; and

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<sup>2</sup> The adopting release and final rule is available at <http://www.occ.gov/fr/fedregister/68fr25090.pdf>.

➤ Procedures to provide customers with adequate notice that the institution is requesting information to verify their identity.

A depository institution's CIP may also contain procedures for addressing its reliance on another financial institution for certain of its CIP procedures.

In January 2004, the federal banking regulators issued interpretive guidance in the form of a set of frequently asked questions with respect to the new CIP rule.<sup>3</sup> This FAQ provides guidance on issues such as the meaning of the terms "account" and "customer", identifying information required to be obtained and identity verification procedures. In July 2004, the federal banking regulators also issued examination procedures with respect to CIPs.<sup>4</sup> These examination procedures were developed jointly by the regulators to evaluate compliance by depository institutions with the new CIP rule as well as establish a consistent supervisory approach among those regulators with respect to CIP issues.

#### **OCC Enforcement Guidance for BSA Program Deficiencies**

In November 2004, the OCC issued enforcement guidance aimed at creating a consistent approach among OCC examiners for citing violations of and bringing enforcement actions with respect to violations by national banks of the BSA compliance program rule and the SAR filing requirements.<sup>5</sup> The guidance notes that the BSA and the OCC's implementing regulations requires national banks to maintain a written, board-approved program to ensure their compliance with the BSA (including the CIP program addressed above), which at a minimum must include:

- a system of internal controls to assure ongoing compliance with the BSA;
- a system of independent testing of such compliance to be conducted by bank personnel or by an outside party;
- an individual designated as responsible for coordinating and monitoring day-to-day compliance with the BSA; and
- appropriate training for bank personnel.

The enforcement guidance indicates that unlike other situations in which regulators have considerable discretion, the BSA mandates that the OCC issue a cease-and-desist order whenever

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<sup>3</sup> The FAQ guidance is available at <http://www.fdic.gov/news/news/financial/2004/fil0404a.html>.

<sup>4</sup> The CIP examination procedures are available at <http://www.federalreserve.gov/boarddocs/srletters/2004/sr0413a1.pdf>.

<sup>5</sup> The enforcement guidance is available at <http://www.occ.gov/ftp/bulletin/2004-50.doc>.

a national bank fails to establish and maintain an appropriate BSA compliance program or fails to correct any problem with its program previously cited by its regulators.<sup>6</sup> The guidance then lists situations in which a violation citation and accompanying C&D are appropriate, noting that the OCC may choose to address BSA compliance program deficiencies as safety and soundness concerns rather than BSA compliance program violations, depending on the severity of the violation, bank management's capability and cooperation and the OCC's confidence that the bank will fix the problem.

With respect to a national bank's obligation to file an SAR, the OCC notes that the decision to file an SAR is inherently subjective and indicates that a bank should not be cited for a violation of the SAR filing requirements unless the failure to file involved bad faith, a significant or egregious situation, or a pattern or practice or other systematic breakdown. The OCC indicated it will evaluate the severity of the violations, when they occurred, whether frequent or isolated and similar findings in prior exams in considering whether to cite a violation of the SAR filing requirements.

Reaction to this enforcement guidance has been mixed. Many in the banking industry believe that this guidance requires the OCC to impose stiffer enforcement actions on banks with BSA violations, an interpretation that would certainly be in line with the increased regulatory scrutiny being placed on BSA issues. In a speech given in February 2005, Daniel P. Stipano, Acting Chief Counsel of the OCC, indicated that the OCC intended this guidance to provide national banks with an understanding of the OCC's rules and expectations and he noted that the OCC was the only federal banking regulator to have issued such guidance.<sup>7</sup> Mr. Stipano also noted that the OCC now requires any proposed citation of the BSA compliance program requirements to be approved by the OCC's Washington Supervision Review Committee given the harsh enforcement actions that can result from violations of the BSA compliance program requirements as noted above. If such a citation is not approved, the examiner must resort to a more informal remedy to address the issue. Unfortunately for banks, the severity of the underlying criminal or terrorist activity that a bank allegedly failed to uncover due to its BSA compliance program deficiencies will no doubt impact how the OCC and other regulators'

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<sup>6</sup> A similar requirement is imposed on the other federal banking regulators with respect to the depository institutions that they supervise.

<sup>7</sup> See note 1.

perceive the “severity” of the bank’s deficiencies in considering an appropriate regulatory response.

### **SAR Filing Safe Harbor Reaffirmed**

In May 2004, the federal banking regulators issued an interagency advisory regarding a recent U.S. District Court case, *Whitney Nat’l Bank v. Karam*,<sup>8</sup> in which the subjects of a SAR filing by a national bank regarding suspicious lending activities filed a defamation suit against the bank for filing the SAR. While the BSA specifically prohibits disclosing a copy of an SAR to the party that is the subject of the SAR, the plaintiffs in this case attempted to get around this requirement by seeking to discover from the bank any information regarding conversations the bank may have had with law enforcement about the possible filing of an SAR.

According to the interagency advisory, the U.S. District Court concluded that the bank could not produce documents in discovery related to the existence or information contained in the SAR or communications regarding its filing or content, including communications with government authorities about the SAR or the possible legal violations that led to the filing of the SAR. In issuing the interagency advisory, the federal banking regulators noted that this conclusion was consistent with the approach taken in the majority of courts that the BSA provides banks and their employees an unlimited safe harbor from civil liability for filing an SAR.

### **Memorandum of Understanding among Regulators**

In October 2004, FinCEN and the federal banking regulators announced that they had entered into a memorandum of understanding (MOU) to set forth certain procedures for the exchange of information among the regulators and FinCEN regarding BSA examinations and compliance.<sup>9</sup> The stated purposes of the MOU are to

- assist FinCEN in fulfilling its role as the primary administrator of the BSA and the federal banking regulators in their roles as banking regulators;
  - increase compliance with the BSA in the filing of reports and keeping of records;
- and
- improve interagency cooperation in the areas of BSA examination and compliance.

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<sup>8</sup> The interagency guidance is available at <http://www.occ.treas.gov/ftp/bulletin/2004-24a.pdf>. The *Whitney* case can be found at 306 F.Supp. 678 (S.D. Tex. 2004).

<sup>9</sup> The MOU is available at <http://www.treas.gov/press/releases/reports/fincenbankingregulatorsmou.pdf>.



Of particular interest to bankers, in addition to a variety of periodical reports required to be given by the banking regulators to FinCEN and vice versa, the MOU specifically requires the federal banking regulators to promptly notify FinCEN of significant BSA violations or deficiencies at banks.<sup>10</sup> Such a deficiency is defined to include

- systemic or pervasive BSA compliance program deficiencies or reporting or recordkeeping violations;
- situations in which a bank fails to respond to regulatory warnings regarding such deficiencies or violations or continues a history of such deficiencies or violations, even if dissimilar to those cited in prior exams; or
- a non-technical, one-time violation that demonstrates willful or reckless disregard for the requirements of the BSA, or that creates a substantial risk of money laundering or the financing of terrorism within the bank.

#### **Other Regulatory Initiatives**

The following are some additional regulatory developments that have occurred under the BSA during the past two years:

- The federal banking regulators are currently working on joint BSA examination procedures which they hope to issue later in 2005.
- In March 2005, FinCEN and the federal banking regulators issued a joint statement on banking services provided to money service businesses (MSBs), including check cashiers and money transmitters.<sup>11</sup> While noting that they would issue additional guidance on their expectations under the BSA for banks who have MSB customers, FinCEN and the federal banking regulators felt it was necessary to issue this joint statement at this time to clarify that they do not expect banks to regulate the conduct of their MSB clients and that this misperception was leaving many legitimate MSBs without an ability to obtain banking services.<sup>12</sup>

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<sup>10</sup> This is an important point. FinCEN serves as the general administrator of the BSA and, as noted further below, plays an important role in some of the more high profile enforcement actions such as those involving Riggs Bank and AmSouth. In the Congressional hearings that followed the Riggs Bank scandal, Congressional members questioned why the federal banking regulators rarely referred instances of BSA violations to FinCEN. In the Riggs Bank situation, the OCC first noted BSA deficiencies and problems at Riggs in 1997 but did not alert FinCEN until 2003.

<sup>11</sup> The joint statement is available at <http://www.fincen.gov/bsamsbrevisedstatement.pdf>.

<sup>12</sup> But Compare this joint statement with the guidance that the OCC issued in June 2004 (available at <http://www.occ.gov/ftp/advisory/2004-7.txt>) which specifically indicated that national banks should perform "careful due diligence of the accounts of MSBs to control money laundering and reputational risks." Such due

➤ In June 2004, FinCEN and the federal banking regulators issued an interagency advisory to depository institutions on accepting accounts from foreign governments, embassies and political figures.<sup>13</sup> Clearly a reaction to the Riggs Bank scandal discussed further below, the guidance is brief and suggests that while the federal banking regulators will not, absent “extraordinary circumstances”, require or suggest that banks close or refuse to open a particular account or relationship, banks clearly should evaluate the risks associated with dealing with foreign governments, embassies and/or political figures and expect enhanced scrutiny from regulators if the regulators perceive those relationships as involving high degrees of risks.

➤ In June 2003, FinCEN adopted a revised SAR form.<sup>14</sup> Among the changes, two new boxes, one related to terrorist financing and the other to identity theft, were added to the prior SAR form.

### **Impact on Merger Applications**

One of the specific Patriot Act amendments to the BSA requires federal banking regulators to consider a depository institution’s record in BSA and anti-money laundering compliance in deciding applications for bank mergers, acquisitions and other combinations. Regulatory officials have indicated in speeches and testimony that those agencies have recently told some banking organizations applying to engage in a merger or other expansion transaction that such organizations should instead focus on their BSA compliance efforts. Clearly depository institutions interested in growing through acquisitions, and even those interested in being acquired, will need to be mindful of BSA compliance issues which ultimately could negatively impact their strategic aims.

### **Recent Regulatory Enforcement Actions**

Without question, Riggs Bank, N.A. is the most publicized enforcement action under the BSA in recent memory. Riggs Bank had been an institution in the Washington D.C. area for nearly two centuries. It was one of the preferred financial institutions for foreign embassies and diplomats and boasted of having been the bank of choice for at least 21 United States Presidents. In July 2003, the OCC entered into a cease and desist order with Riggs to correct numerous BSA

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diligence might include, according to the OCC, financial information about the MSBs, including primary lines of business and major customers, the MSBs anti-money laundering policies, information on the MSB’s owners, the MSB’s license if any, etc. Query whether that level of due diligence sounds more like the role of a regulator than a banking organization providing services to its customers.

<sup>13</sup> The interagency advisory is available at <http://www.fincen.gov/advis36.pdf>.

<sup>14</sup> See <http://www.occ.gov/ftp/bulletin/2003-27.txt>.

deficiencies and violations; however, many of deficiencies and violations were not corrected and in May 2004 the OCC and FinCEN assessed against Riggs, and Riggs consented to pay, a \$25 million civil money penalty for violations of the reporting and anti-money laundering program requirements of the BSA. The OCC and FinCEN described Riggs' violations of the BSA as "willful" (i.e., demonstrating a reckless disregard for the bank's legal obligations) and "systemic". Every aspect of the bank's anti-money laundering program was deemed seriously deficient, particularly in the bank's failure to identify a large numbers of accounts belonging to two foreign governments. From 2000 to 2003, the regulators alleged that Riggs Bank failed to file either timely or at all 33 SARs involving transactions of almost \$98 million because Riggs' procedures to spot and report suspicious activity (such as structuring cash transactions to avoid BSA reporting and recordkeeping requirements) either did not exist or were not implemented. Considerable criticism was leveled at Riggs with respect to accounts held by certain foreign governments or their affiliates, noting that numerous transactions exhibited "classic" indicators of suspicious activity that Riggs failed to report. Riggs was also found not to have followed the CTR filing requirements.<sup>15</sup> These deficiencies and violations allowed persons such as former Chilean dictator Augusto Pinochet and the president and other government officials of Equatorial Guinea to hide millions of dollars.

Shortly after this civil money penalty was imposed against Riggs Bank, its federal banking regulators had to explain in hearings before Congress how Riggs' BSA compliance problems, first identified in 1997 by the OCC, were allowed to reach this point. John Hawke, Comptroller of the Currency, essentially described the situation as "a failure of supervision" and lack of aggressiveness on the part of the OCC in addressing the compliance concerns at Riggs. During these hearings, many Congressional members openly questioned whether the federal banking regulators were committed to or even capable of ensuring that banks comply with the BSA.

In January 2005, Riggs Bank's BSA violations resulted in the bank pleading guilty to one criminal violation of the BSA and agreeing to pay an additional \$16 million fine and subject itself to a five year corporate probation. The bank also agreed to close its private and diplomatic banking operations. This guilty plea paved the way for PNC Financial Services Group to

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<sup>15</sup> For a more specific listing of some of the BSA deficiencies and violations that occurred at Riggs Bank, see the Assessment of Civil Money Penalty that Riggs consented to with FinCEN, which is available at <http://www.fincen.gov/riggsassessment3.pdf>.

conclude its acquisition of Riggs earlier this year. But it should be noted that this was not before PNC significantly reduced the price it was willing to offer to acquire Riggs given the damage that Riggs' BSA violations imposed on the Riggs' organization.

But Riggs Bank is not alone in paying a heavy price for failing to comply with the BSA. In October 2004, AmSouth Bank of Birmingham consented to being assessed a \$10 million civil money penalty by the Federal Reserve and FinCEN. Like the situation in Riggs, AmSouth's anti-money laundering program was deemed deficient, including materially deficient in three of the four minimum program requirements. AmSouth also failed to file SARs when it should have, including one situation where SARs were not filed notwithstanding the fact that bank employees had indicated to bank management that certain accounts were possibly being used to further a Ponzi scheme. Again, like the situation in Riggs Banks, the regulators described AmSouth's BSA violations as "willful" and "systemic".<sup>16</sup> In addition to the \$10 civil money penalty, AmSouth entered into a deferred prosecution agreement with the U.S. Attorney's Office in which AmSouth agreed to pay an additional \$40 million fine.

While Riggs and AmSouth represented large banks with several billion dollars in assets, smaller community banks are also being subjected to enforcement actions related to their compliance with the BSA, among other issues. Examples in 2004 included the Community State Bank, Poteau, Oklahoma (\$125 million in assets on December 31, 2004),<sup>17</sup> Traders Bank, Spencer, West Virginia (\$110 million in assets on December 31, 2004),<sup>18</sup> Merchants Bank of California, Carson, California (\$72 million in assets on December 31, 2004),<sup>19</sup> and Surety Bank, Fort Worth, Texas (\$54 million in assets on December 31, 2004).<sup>20</sup>

Not surprisingly, these enforcement actions have created considerable fear in the banking community over BSA compliance issues. The American Bankers Association (along with all of the state banking associations) sent a letter in January 2005 to the federal banking regulators, the Secretary of the Treasury and FinCEN expressing the concern on the part of the banking industry

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<sup>16</sup> For a more specific listing of some of the BSA deficiencies and violations that occurred at AmSouth, see the Assessment of Civil Money Penalty that Riggs consented to with FinCEN, which is available at <http://www.fincen.gov/amsouthassessmentcivilmoney.pdf>.

<sup>17</sup> See written agreement available at <http://www.federalreserve.gov/boarddocs/press/enforcement/2004/20041021/attachment.pdf>.

<sup>18</sup> See written agreement available at <http://www.federalreserve.gov/boarddocs/press/enforcement/2004/20040802/attachment.pdf>.

<sup>19</sup> See consent order available at <http://www.occ.treas.gov/FTP/EAs/ea2004-64.pdf>.

<sup>20</sup> See consent order available at <http://www.occ.treas.gov/FTP/EAs/ea2004-65.pdf>.

as to the lack of consistency in examinations and compliance guidance with respect to the BSA. Chief among the expressed concerns was the fear that regulators and examiners are moving towards an unrealistic “zero-tolerance” policy with respect to BSA compliance problems. This letter also notes that some banks are beginning to file SARs in situations where an SAR is probably not required rather than risk being second-guessed by their banking regulators, a practice that ultimately could significantly undermine the usefulness of the SARs reporting system.

### Conclusion

Clearly the events of September 11, 2001, the passage of the Patriot Act and the scandals involving banks such as Riggs Bank have brought the issue of BSA compliance back to the forefront of issues facing banking organizations and their regulators. All banking organizations would be well advised to reevaluate their BSA compliance programs and procedures in light of the applicable legal requirements, the problems illustrated in the recent enforcement actions involving banks such as Riggs Bank and AmSouth, and the particular risks the organization faces based on its products, services and customers. A strong commitment to BSA compliance starting with management and running through the entire banking organization coupled with an appropriate, risk-based BSA compliance program will go along way towards ensuring that a banking organization is not characterized as “willfully” violating the BSA or having “systemic” BSA deficiencies. As Daniel P. Stipano, Acting Chief Counsel of the OCC, pointed out in a speech in February 2005, whenever a bank “fails to have appropriate systems and controls to effectively manage its risks, whatever those risks are, then we have the profile of an institution that will almost certainly attract a high level of regulatory scrutiny, *especially where we perceive a lack of a sincere, thoroughgoing commitment to BSA compliance.*”<sup>21</sup>

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As a postscript, portions of the Patriot Act (including some of the more controversial aspects relating to enhanced surveillance procedures) are set to expire at the end of 2005. Congressional hearings are currently underway as to whether those portions of the Patriot Act should be extended or even expanded. The provisions of the Patriot Act that amended the BSA however only terminate if Congress adopts a joint resolution terminating those provisions.

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<sup>21</sup> See note 1 (emphasis added).



# Federal Register

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Friday,  
May 9, 2003

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## Part II

### **Department of the Treasury**

31 CFR Part 103

Office of the Comptroller of the  
Currency

12 CFR Part 21

Office of Thrift Supervision

12 CFR Part 563

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### **Federal Reserve System**

12 CFR Parts 208 and 211

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### **Federal Deposit Insurance Corporation**

12 CFR Part 326

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### **National Credit Union Administration**

12 CFR Part 748

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### **Commodity Futures Trading Commission**

17 CFR Parts 1 and 42

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### **Securities and Exchange Commission**

17 CFR Part 270 and 31 CFR Part 103

Transactions and Customer Identification  
Programs; Final Rules and Proposed Rule

**DEPARTMENT OF THE TREASURY****Office of the Comptroller of the Currency**

12 CFR Part 21

[Docket No. 03-08]

RIN 1557-AC06

**FEDERAL RESERVE SYSTEM**

12 CFR Parts 208 and 211

[Docket No. R-1127]

**FEDERAL DEPOSIT INSURANCE CORPORATION**

12 CFR Part 326

**DEPARTMENT OF THE TREASURY****Office of Thrift Supervision**

12 CFR Part 563

[Docket No. 2003-16]

**NATIONAL CREDIT UNION ADMINISTRATION**

12 CFR Part 748

RIN 3133

**DEPARTMENT OF THE TREASURY**

31 CFR Part 103

RIN 1506-AA31

**Customer Identification Programs for Banks, Savings Associations, Credit Unions and Certain Non-Federally Regulated Banks**

**AGENCIES:** The Financial Crimes Enforcement Network, Treasury; Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; Office of Thrift Supervision, Treasury; National Credit Union Administration.

**ACTION:** Joint final rule.

**SUMMARY:** The Department of the Treasury, through the Financial Crimes Enforcement Network (FinCEN), together with the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) (collectively, the Agencies), have jointly adopted a final rule to implement section 326 of the Uniting and Strengthening America by Providing Appropriate Tools

Required To Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001 (the Act). Section 326 requires the Secretary of the Treasury (Secretary) to jointly prescribe with each of the Agencies, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC), a regulation that, at a minimum, requires financial institutions to implement reasonable procedures to verify the identity of any person seeking to open an account, to the extent reasonable and practicable; maintain records of the information used to verify the person's identity; and determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to the financial institution by any government agency. This final regulation applies to banks, savings associations, credit unions, private banks, and trust companies.

**DATES:** *Effective Date:* This rule is effective June 9, 2003.

*Compliance Date:* Each bank must comply with this final rule by October 1, 2003.

**FOR FURTHER INFORMATION CONTACT:**

*OCC:* Office of the Chief Counsel at (202) 874-3295.

*Board:* Enforcement and Special Investigations Sections at (202) 452-5235, (202) 728-5829, or (202) 452-2961.

*FDIC:* Special Activities Section, Division of Supervision and Consumer Protection, and Legal Division at (202) 898-3671.

*OTS:* Compliance Policy Division at (202) 906-6012.

*NCUA:* Office of General Counsel at (703) 518-6540; or Office of Examination and Insurance at (703) 518-6360.

*Treasury:* Office of the Chief Counsel (FinCEN) at (703) 905-3590; Office of the General Counsel (Treasury) at (202) 622-1927; or the Office of the Assistant General Counsel for Banking & Finance (Treasury) at (202) 622-0480.

**SUPPLEMENTARY INFORMATION:****I. Background****A. Section 326 of the USA PATRIOT Act**

On October 26, 2001, President Bush signed into law the USA PATRIOT Act, Pub. L. 107-56. Title III of the Act, captioned "International Money Laundering Abatement and Anti-terrorist Financing Act of 2001," adds several new provisions to the Bank Secrecy Act (BSA), 31 U.S.C. 5311 *et seq.* These provisions are intended to facilitate the prevention, detection, and prosecution of international money laundering and the financing of terrorism.

Section 326 of the Act adds a new subsection (l) to 31 U.S.C. 5318 of the BSA that requires the Secretary to prescribe regulations "setting forth the minimum standards for financial institutions and their customers regarding the identity of the customer that shall apply in connection with the opening of an account at a financial institution."

Section 326 applies to all "financial institutions." This term is defined very broadly in the BSA to encompass a variety of entities, including commercial banks, agencies and branches of foreign banks in the United States, thrifts, credit unions, private banks, trust companies, investment companies, brokers and dealers in securities, futures commission merchants, insurance companies, travel agents, pawnbrokers, dealers in precious metals, check-cashers, casinos, and telegraph companies, among many others. See 31 U.S.C. 5312(a)(2) and (c)(1)(A).

For any financial institution engaged in financial activities described in section 4(k) of the Bank Holding Company Act of 1956 (section 4(k) institutions), the Secretary is required to prescribe the regulations issued under section 326 jointly with each of the Agencies, the SEC, and the CFTC (the Federal functional regulators).

Section 326 of the Act provides that the regulations must require, at a minimum, financial institutions to implement reasonable procedures for (1) verifying the identity of any person seeking to open an account, to the extent reasonable and practicable; (2) maintaining records of the information used to verify the person's identity, including name, address, and other identifying information; and (3) determining whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to the financial institution by any government agency. In prescribing these regulations, the Secretary is directed to take into consideration the various types of accounts maintained by various types of financial institutions, the various methods of opening accounts, and the various types of identifying information available.

**B. Overview of Comments Received**

On July 23, 2002, Treasury and the Agencies published a joint notice of proposed rulemaking in the *Federal Register* (67 FR 48290) applicable to (a) any financial institution defined as a "bank" in 31 CFR 103.11(c)<sup>1</sup> and

<sup>1</sup> This definition includes banks, savings associations, credit unions, Edge Act and Agreement corporations, and branches and agencies of foreign banks.

subject to regulation by one of the Agencies; and (b) any foreign branch of an insured bank. On the same date, Treasury separately published an identical, proposed rule for credit unions, private banks, and trust companies that do not have a Federal functional regulator (67 FR 48299).<sup>2</sup> Treasury and the Agencies proposed general standards that would require each bank to design and implement a customer identification program (CIP) tailored to the bank's size, location, and type of business. The proposed rule also included certain specific standards that would be mandated for all banks.<sup>3</sup>

Treasury and the Agencies collectively received approximately five hundred comments in response to these proposed rules (collectively referred to as the "proposal" or the "proposed rule" for "banks"), although some commenters sent copies of the same letter to Treasury and to each of the Agencies. The majority of comments received by Treasury and the Agencies were from banks, savings associations, credit unions, and their trade associations. Most of these commenters agreed with the largely risk-based approach set forth in the proposal that allowed each bank to develop a CIP based on its specific operations.

Some commenters, however, criticized the specific requirements in the proposed rule and suggested that Treasury and the Agencies issue a final rule containing an entirely risk-based approach without any minimum identification and verification requirements. According to some of these commenters, such a thoroughly risk-based approach would give banks appropriate discretion to focus their efforts and finite resources on specific, high-risk accounts most likely to be used by money-launderers and terrorists.

Other commenters, especially those representing credit card banks and credit card issuers, asserted that the proposed minimum identification and verification requirements should be eliminated because they did not take into account the unique nature of credit card operations. They warned that these requirements, if implemented, would

<sup>2</sup> In the preamble for this proposed rule, Treasury explained that a single final regulation would be issued for all financial institutions defined as "banks" under 31 CFR 103.11(c), with modifications to accommodate certain differences between Federally regulated and non-Federally regulated banks. See 67 FR 48299, 48300.

<sup>3</sup> At the same time, Treasury also published (1) together with the SEC, proposed rules for broker-dealers (67 FR 48306) and mutual funds (67 FR 48318); and (2) together with the CFTC, proposed rules for futures commission merchants and introducing brokers (67 FR 48328).

have a chilling effect on credit practices important to U.S. consumers and would impose significant compliance costs on their industry with little benefit to law enforcement.

By contrast, some smaller banks criticized the flexibility of the proposal and stated that a risk-based approach would leave too much room for interpretation by the Agencies. These commenters urged Treasury and the Agencies to issue a final rule establishing more specific requirements. For example, some commenters suggested that the rule prescribe risk assessment levels for each customer type and type of account, along with a specific description of acceptable forms of identification and methods of verification appropriate for each bank's size and location.

While commenters representing various segments of the industry differed on the approach that should be taken in the final rule, the vast majority concluded that Treasury and the Agencies had underestimated the compliance burden that would be imposed by certain elements of the proposal. Commenters were especially concerned about the proposed requirements that banks verify the identity of signatories on accounts, keep copies of documents used to verify a customer's identity, and retain identity verification records for five years after an account is closed.

Some commenters also suggested that banks be given greater flexibility when dealing with established customers and urged that banks be permitted to rely on identification and verification of customers performed by a third party, including an affiliate. Other commenters asked for additional guidance regarding the lists of known and suspected terrorists and terrorist organizations that must be checked, and regarding what will be deemed adequate notice to customers for purposes of complying with the final rule. Many commenters requested that the final rule contain a delayed implementation date that would provide banks with the time needed to design a customer identification program, obtain board approval, alter existing policies and procedures, forms and software, and train staff.

Several comments were received from companies engaged in the sale of technology or services that could be used to identify and verify customers, retain records, and check lists of known and suspected terrorists and terrorist organizations. Many of these companies recommended that the proposed rule be modified to make clear that use of specific products and services would be

permissible. Some of these commenters urged that the rule require banks to authenticate any documents obtained to verify the identity of the customer through the use of automated document authentication technology.

A small number of comments were received from individuals. Some of these individuals criticized the proposed requirement that banks obtain a social security number from persons opening an account as an infringement upon individual liberty and privacy. Some individuals were concerned that this requirement would expose them to an added risk of identity theft. Other individuals supported the proposal and concluded that its verification requirements might diminish instances of identity theft and fraud. A few commenters suggested that the government develop a separate national identification number or require that social security cards bear photographs and or other safeguards.

A variety of commenters applauded the efforts of Treasury and the Federal functional regulators to devise a uniform set of rules that apply to banks, broker-dealers, mutual funds, futures commission merchants, and introducing brokers.<sup>4</sup> They noted that, without uniformity, customers of financial institutions may seek to open accounts with institutions that customers perceive to have less robust customer identification requirements. These commenters also suggested revisions that would enhance the uniformity of the rules.

Treasury and the Agencies have modified the proposed rule in light of the comments received. A discussion of the comments, and the manner in which the proposed rule has been modified, follows in the section-by-section analysis.

In addition, as suggested by a number of commenters, Treasury and the Agencies expect to issue supplementary guidance following issuance of the final rule.

#### *C. Joint Issuance by Treasury and the Agencies*

The final rule implementing section 326 is being issued jointly by Treasury, through FinCEN, and by the Agencies. It applies to (1) a "bank," as defined in 31 CFR 103.11(c), that is subject to regulation by one of the Agencies, and (2) to any non-Federally insured credit union, private bank or trust company that does not have a Federal functional regulator (collectively referred to in the final rule as "a bank").

<sup>4</sup> See footnote 3, *supra*.



The substantive requirements of this joint final rule are being codified as part of Treasury's BSA regulations located in 31 CFR part 103. In addition, each of the Agencies is concurrently publishing a provision in its own regulations<sup>5</sup> to cross-reference this final rule in order to clarify the applicability of the final rule to the banks subject to its jurisdiction.

Regulations governing the applicability of section 326 to certain financial institutions that are regulated by the SEC and the CFTC are the subject of separate rulemakings. Treasury, the Agencies, the SEC, and the CFTC consulted extensively in the development of all joint rules implementing section 326 of the Act. All of the participating agencies intend the effect of the rules to be uniform throughout the financial services industry. Treasury intends to issue separate rules under section 326 for certain non-bank financial institutions that are not regulated by one of the Federal functional regulators.

The Secretary has determined that the records required to be kept by section 326 of the Act have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings, or in the conduct of intelligence or counterintelligence activities, to protect against international terrorism.

In addition, Treasury, under its own authority, is issuing conforming amendments to 31 CFR 103.34, which imposes requirements concerning the identification of bank customers.

#### D. Compliance Date

Nearly all commenters on the proposed rule requested that banks be given adequate time to develop and implement the requirements of any final rule implementing section 326 of the Act. These commenters stated that if the proposed rule were implemented, banks would be required, among other things, to revise existing account opening policies and procedures, obtain board approval, train staff, update forms, purchase new or updated software for customer verification and checking of government lists, and purchase new equipment for copying or scanning and storing records. Commenters requested a delayed effective or compliance date, but, given the variety of banks that would be covered by the final rule, there was no consensus regarding the amount of time that would be necessary to comply with the final rule. The transition periods suggested by commenters ranged from 60 days to two

<sup>5</sup> 12 CFR 21.21 (OCC); 12 CFR 208.63, 211.5, and 211.24 (FRB); 12 CFR 326.6 (FDIC); 12 CFR 563.177 (OTS); and 12 CFR 746.2 (NCUA).

years from the date a final rule is published.

The final rule modifies various aspects of the proposal and eliminates some of the requirements that commenters identified as being most burdensome. Nonetheless, Treasury and the Agencies recognize that some banks will need time to develop a CIP, obtain board approval, and implement the CIP, which will include various measures, such as training of staff, reprinting forms, and developing new software. Accordingly, although this final rule will be effective 30 days after publication, banks are provided with a transition period to implement the rule. Treasury and the Agencies have determined that each bank must fully implement its CIP by October 1, 2003.

## II. Section-by-Section Analysis of Final Rule Implementing Section 326

### Section 103.121(a) Definitions

**Section 103.121(a)(1) Account.** The proposed rule defined "account" as each formal banking or business relationship established to provide ongoing services, dealings, or other financial transactions and stated that a deposit account, transaction or asset account, and a credit account or other extension of credit would each constitute an "account."<sup>6</sup> The proposal also explained that the term "account" was limited to formal banking and business relationships established to provide "ongoing" services, dealings, or other financial transactions to make clear that this term is not intended to cover infrequent transactions such as the occasional purchase of a money order or a wire transfer.

Treasury and the Agencies received a large number of comments on this proposed definition. Some commenters agreed with the proposed definition though others thought the definition of "account" was either too broad or needed clarification. Some commenters suggested that the definition of "account" be narrowed to include only those relationships that are financial in nature. A number of commenters urged that the definition be limited to high-risk relationships that experts have identified as actually used by money launderers and terrorists. Some of these commenters suggested that particular types of accounts, especially those established as part of employee benefit plans, be excluded from the definition of "account."

Most commenters requested that the final rule provide additional examples

<sup>6</sup> The definition of "account" in the proposed rule was based on the statutory definition of "account" that is used in section 311 of the Act.

of the relationships that would constitute an "account." Many commenters requested that the rule clarify the meaning of "ongoing services." These commenters asked whether a person who repeatedly and regularly purchased a money order, requested a wire transfer, or cashed a check on a weekly basis, without any other relationship with a bank, would be considered to have an "account." Many other commenters asked that the exclusion for transfers of accounts between banks described in the preamble for the proposal—which commenters characterized as the "transfer exception"—be stated expressly in the regulation and expanded to cover all loans originated by a third party and purchased by a bank, such as mortgages purchased from non-bank lenders and vehicle loans purchased from car dealers.

The final rule contains a number of changes prompted by these comments. First, the reference to the term "business relationship" has been deleted from the definition of "account." This change is made to clarify that the regulation applies to the bank's provision of financial products and services, as opposed to general "business" dealings, such as those in connection with the bank's own operations or premises. Second, the definition now contains additional, but non-exclusive, examples of products and services, such as safety deposit box and other safekeeping services, cash management, and custodian and trust services, that constitute an "account."

The definition of "account" also has been changed to include a list of products and services that will not be deemed an "account." The preamble for the proposed rule had used the term "ongoing services" to define accounts covered by the final rule, and had referred to the exclusion of "occasional" transactions and "infrequent" purchases (which arguably would require a bank to monitor all transactions for repetitive contacts). By contrast, the final rule clarifies that "account" excludes products and services where a *formal banking relationship* is not established with a person, such as check cashing, wire transfer, or the sale of a check or money order.<sup>7</sup> Treasury and the

<sup>7</sup> This exclusion is consistent with legislative history indicating that by referencing the term "customers," Congress intended "that the regulations prescribed by Treasury take an approach similar to that of regulations promulgated under title V of the Gramm-Leach-Bliley Act of 1999, where the Federal functional regulators defined "customers" and "customer relationship" for purposes of the financial privacy rules." H.R. Rep. No. 107-250, pt. 1, at 62 (2001). The definitions of "customer" and "customer

Agencies note that part 103 already requires verification of identity in connection with many of these products and services. See, e.g., 31 CFR 103.29 (purchases of bank checks and drafts, cashier's checks, money orders, and traveler's checks for \$3000 or more); 31 CFR 103.33 (funds transfers of \$3000 or more).

In addition, the final rule codifies and clarifies the "transfer exception." Under the final rule, the definition of "account" excludes accounts that a bank acquires through an acquisition, merger, purchase of assets, or assumption of liabilities from any third party.<sup>8</sup> Treasury and the Agencies note that the Act provides that the regulations shall require reasonable procedures for "verifying the identity of any person seeking to open an account." Because these transfers are not initiated by customers, these accounts do not fall within the scope of section 326.<sup>9</sup>

Treasury and the Agencies generally agree with the view expressed by commenters who suggested that a bank's limited resources be focused on relationships that pose a higher risk of money laundering and terrorism. Accordingly, the Agencies have included an exception to the definition of "account" for accounts opened for the purpose of participating in an employee benefit plan established pursuant to the Employee Retirement Income Security Act of 1974. These accounts are less susceptible to use for the financing of terrorism and money laundering, because, among other reasons, they are funded through payroll deductions in connection with employment plans that must comply with Federal regulations which impose various requirements regarding the funding and withdrawal of funds from

relationship" in the financial privacy rules apply only to a consumer who has a "continuing relationship" with a bank, for example, in the form of a deposit or investment account, or a loan. See .3(h) and (i) of 12 CFR part 40 (OCC); 12 CFR part 216 (Board); 12 CFR part 332 (FDIC); 12 CFR part 573 (OTS); and 12 CFR part 716 (NCUA).

<sup>8</sup> In many cases, these third parties are themselves "financial institutions" for purposes of the BSA. Treasury anticipates that these third parties ultimately will be subject to their own customer identification rules implementing section 326 of the Act in the event that they are not presently covered by such a rule.

<sup>9</sup> Nevertheless, there may be situations involving the transfer of accounts where it would be appropriate for a bank, as part of the customer due diligence procedures required under existing regulations requiring banks to have compliance programs implementing the BSA (BSA compliance programs), to verify the identity of customers associated with accounts that it acquires from another financial institution. Treasury and the Agencies expect financial institutions to implement reasonable procedures to detect money laundering in any account, however acquired.

such accounts, including low contribution limits and strict distribution requirements.

*Section 103.121(a)(2) Bank.* The proposal jointly issued by Treasury and the Agencies applied to any financial institution defined as a "bank" in 31 CFR 103.11(c) and subject to regulation by one of the Agencies, including banks, savings associations, credit unions, Edge Act and Agreement corporations, and branches and agencies of foreign banks. The proposed definition also included "any foreign branch of an insured bank" to make clear that the procedures required by the rule would have to be implemented throughout the bank, no matter where its offices are located. The preamble for the proposal explained that the rule would apply to bank subsidiaries to the same extent as existing regulations requiring banks to have BSA compliance programs.<sup>10</sup> As described above, a second proposal issued simultaneously by Treasury applied to certain other financial institutions defined as a "bank" in 31 CFR 103.11(c), namely, those credit unions, private banks, and trust companies that do not have a Federal functional regulator.

Under the final rule, "bank" includes all financial institutions covered by both of the proposals described above, except that "bank" does not include any foreign branch of an insured U.S. bank. Several commenters explained that the proposal to cover foreign branches might conflict with local laws applicable to branches of insured banks operating outside of the United States and might place U.S. institutions at a competitive disadvantage. Consistent with the approach taken with respect to final regulations implementing other sections of the Act,<sup>11</sup> Treasury and the

<sup>10</sup> All insured depository institutions currently must have a BSA compliance program. See 12 CFR 21.21 (OCC); 12 CFR 206.63 (Board); 12 CFR 326.6 (FDIC); 12 CFR 563.177 (OTS); and 12 CFR 746.2 (NCUA). In addition, all financial institutions are required by section 352 of the Act, 31 U.S.C. 5318(h), to develop and implement an anti-money laundering program. Treasury issued a regulation implementing section 352 providing that a financial institution regulated by a Federal functional regulator is deemed to satisfy the requirements of section 5318(h)(1) if it implements and maintains an anti-money laundering program that complies with the regulation of its Federal functional regulator, i.e., the requirement to implement a BSA compliance program. See 31 CFR 103.120(b); 67 FR 2113 (April 29, 2002). However, Treasury temporarily deferred subjecting certain non-Federally regulated banks to the anti-money laundering program requirements in section 352. See 67 FR 67547 (November 6, 2002) (corrected 67 FR 68935 (November 14, 2002)).

<sup>11</sup> See, e.g., 67 FR 60562, 60565 (Sept. 26, 2002) (FinCEN's regulation titled "Anti-Money Laundering Requirements "Correspondent Accounts for Foreign Shell Banks: Recordkeeping and Termination of Correspondent Accounts for

Agencies have determined that foreign branches of insured U.S. banks are not covered by the final rule. Nevertheless, Treasury and the Agencies encourage each bank to implement an effective CIP, as required by this final rule, throughout its organization, including in its foreign branches, except to the extent that the requirements of the rule would conflict with local law.

As noted in the preamble for the proposal, the CIP must be a part of a bank's BSA compliance program. Therefore, it will apply throughout such a bank's U.S. operations (including subsidiaries) in the same way as the BSA compliance program requirement. However, all subsidiaries that are in compliance with a separately applicable, industry-specific rule implementing section 326 of the Act will be deemed to be in compliance with this final rule.

*Section 103.121(a)(3) Customer.* The proposal defined "customer" to mean any person<sup>12</sup> seeking to open a new account. In addition, the proposal defined a "customer" to include any signatory on an account. The preamble for the proposal explained that the term "customer" included a person that applied to open an account, but not someone seeking information about an account, such as rates charged or interest paid on an account, if the person did not apply to open an account. The preamble also stated that any person seeking to open an account at a bank, on or after the effective date of the final rule, would be a "customer," regardless of whether that person already had an account at the bank.

This proposed definition prompted a large number of comments. First, nearly all commenters recommended that the Agencies clarify in the text of the final rule that "customer" does not include a person who does not receive banking services, such as a person whose deposit or loan application is denied. Some of these commenters suggested that the rule for banks define "customer" to mean "a person who opens a new account," as did the proposed rules for broker-dealers, mutual funds, futures commission merchants and introducing brokers.

Foreign Banks" implementing sections 313 and 319(b) of the Act).

<sup>12</sup> The proposed rule defined "person" by reference to § 103.11(z). This definition includes individuals, corporations, partnerships, trusts, estates, joint stock companies, associations, syndicates, joint ventures, other unincorporated organizations or groups, certain Indian Tribes, and all entities cognizable as legal personalities. Treasury and the Agencies agree that it is not necessary to repeat this definition. Therefore, it is omitted from the final rule.

Treasury and the Agencies agree with the view expressed by some commenters that the statute should be construed to ensure that banks design procedures to determine the identity of only those persons who open accounts. Accordingly, the final rule defines a "customer" as "a person that opens a new account."<sup>13</sup> For example, in the case of a trust account, the "customer" would be the trust. For purposes of this rule, a bank will not be required to look through trust, escrow, or similar accounts to verify the identities of beneficiaries and instead will only be required to verify the identity of the named account holder.<sup>14</sup> In the case of brokered deposits, the "customer" will be the broker that opens the deposit account. A bank will not need to look through the deposit broker's account to determine the identity of each individual sub-account holder; it need only verify the identity of the named account holder.

Many commenters requested that the final rule clarify whether "customer" includes a minor child or an informal group with a common interest, such as a club account, where there is no legal entity. The final rule addresses these comments by providing that "customer" means "an individual who opens a new account for (1) an individual who lacks legal capacity, such as a minor; or (2) an entity that is not a legal person, such as a civic club."

A few banks stated that defining "customer" to include a signatory was consistent with their current practice of verifying the identity of the named account holder and any signatory on the account. However, most commenters strenuously objected to the inclusion of a signatory as a customer whose identity must be verified, and asserted that this proposed requirement would deviate significantly from their current business practices. These commenters stated that requiring banks to verify signatories on an account would be enormously burdensome to the financial institutions and signatories themselves—many of whom simply work as employees for firms with corporate accounts—and

<sup>13</sup> Therefore, each person named on a joint account is a "customer" under this final rule unless otherwise provided.

<sup>14</sup> However, based on a bank's risk assessment of a new account opened by a customer that is not an individual, a bank may need to take additional steps to verify the identity of the customer by seeking information about individuals with ownership or control over the account in order to identify the customer, as described in § 103.121(b)(2)(ii)(C), or may need to look through the account in connection with the customer due diligence procedures required under other provisions of its BSA compliance program.

would outweigh any benefit.<sup>15</sup> One commenter asserted that inclusion of signatories as customers went beyond the scope of section 326 of the Act. Although some commenters advocated that any requirement regarding a signatory should be omitted altogether, these commenters generally advocated a risk-based approach that would give banks the discretion to determine when a signatory's identity should be verified.

Credit card banks, in particular, were critical of the signatory requirement because the proposed provision, as drafted, encompassed all authorized users of credit cards. These banks characterized the signatory requirement as unnecessary in the case of credit card companies, which, they explained, already use sophisticated fraud filters to detect fraud and abnormal use. These banks also noted that a person need not be a signatory to use another person's credit card, especially when purchasing products by telephone or over the Internet. Therefore, the signatory requirement would not necessarily ensure that banks would be able to verify the identity of those using a credit card account.

After revisiting the issue of whether a signatory should be a "customer," Treasury and the Agencies have determined that requiring a bank to expend its limited resources on verifying the identity of all signatories on accounts could interfere with the bank's ability to focus on identifying customers and accounts that present a higher risk of not being properly identified. Accordingly, the proposed provision defining "customer" to include a signatory on an account is deleted. Instead, the final rule, at § 103.121(b)(2)(ii)(C), requires a bank's CIP to address situations when the bank

<sup>15</sup> Commenters contended that banks and individuals would confront numerous practical problems. Some commenters noted, for example, that the identification and verification of signatories could be burdensome for banks because business accounts might have many signatories and those signatories would change over time. Some commenters explained that collecting detailed information about an employee who is a signatory would raise privacy concerns for those employees who would be required to disclose personal information to their employer's financial institutions. Other commenters stated that a signatory rarely is present at the time of account opening and, consequently, a bank would encounter substantial obstacles when attempting to verify the signatory's identity using any of the most common methods described in the proposal, including by examining documents or by obtaining a credit report. (Under the Fair Credit Reporting Act (FCRA), a consumer reporting agency generally may furnish a consumer report in connection with transactions involving the consumer and no other. See 15 U.S.C. 1681b. Thus, for example, a bank would be prohibited from obtaining a credit report to verify the identity of an authorized user of a customer's credit card.)

will take additional steps to verify the identity of a customer that is not an individual by seeking information about individuals with authority or control over the account, including signatories, in order to verify the customer's identity.

In addition to defining who is a "customer," the final rule contains a list of entities that will not be deemed "customers." Many commenters questioned why a bank should be required to verify the identity of a government agency or instrumentality opening a new account, or of a publicly-traded company that is subject to SEC reporting requirements. Consistent with these and other comments urging that the final rule focus on requiring verification of the identity of customers that present a higher risk of not being properly identified, the final rule excludes from the definition of "customer" the following readily identifiable entities: a financial institution regulated by a Federal functional regulator; a bank regulated by a state bank regulator; and governmental agencies and instrumentalities, and companies that are publicly traded described in § 103.22(d)(2)(ii)-(iv).<sup>16</sup> Section 103.22(d)(2)(iv) exempts such companies only to the extent of their domestic operations. Accordingly, a bank's CIP will apply to any foreign offices, affiliates, or subsidiaries of such entities that open new accounts.

A great many commenters also objected to the requirement in § 103.121(b)(2)(ii) of the proposed rule that a bank verify the identity of an existing customer seeking to open a new account unless the bank previously verified the customer's identity in accordance with procedures consistent with the proposed rule and continues to have a reasonable belief that it knows the true identity of the customer. These commenters asserted that such a requirement would be burdensome for the bank and would upset existing customers. Some commenters recommended that the rule apply prospectively to new customers who previously had no account with the bank. Many commenters suggested that the final rule contain a risk-based approach where verification would not be required for an existing customer who opens a new account if the bank has a reasonable belief that it knows the identity of the customer, regardless of the procedures the bank followed to form this belief.

<sup>16</sup> Treasury previously determined that banks should be exempted from having to file reports of transactions in currency in connection with these entities. See 31 CFR 103.22(d)(1).

Treasury and the Agencies acknowledge that the proposed rule might have had unintended consequences for bank-customer relationships and that the risk-based approach suggested by commenters would avoid these consequences. Accordingly, the final rule excludes from the definition of "customer" a person that has an existing account with the bank, provided that the bank has a reasonable belief that it knows the true identity of the person.<sup>17</sup>

**Section 103.121(a)(4) Federal functional regulator.** The proposed rule defined "Federal functional regulator" by reference to § 103.120(a)(2), meaning each of the Agencies, the SEC, and the CFTC. There were no comments on this definition, and Treasury and the Agencies have adopted it as proposed.

**Section 103.121(a)(5) Financial institution.** The final rule includes a new definition for the term "financial institution" that cross-references the BSA, 31 U.S.C. 5312(a)(2) and (c)(1). This is a more expansive definition of "financial institution" than that in 31 CFR 103.11, and includes entities such as futures commission merchants and introducing brokers.

**Section 103.121(a)(6) Taxpayer identification number.** The proposed rule repeated the language from § 103.34(a)(4), which states that the provisions of section 6109 of the Internal Revenue Code and the regulations of the Internal Revenue Service thereunder determine what constitutes "a taxpayer identification number." There were no comments on this approach, and Treasury and the Agencies have adopted it substantially as proposed, with minor technical modifications.

**Section 103.121(a)(7) and (8) U.S. Person and non-U.S. person.** The proposed rule provided that "U.S. person" is an individual who is a U.S. citizen, or an entity established or organized under the laws of a State or the United States. A "non-U.S. person" was defined as a person who did not satisfy either of these criteria.

As described in greater detail below, a bank is generally required to obtain a U.S. taxpayer identification number from a customer who opens a new account. However, if the customer is a non-U.S. person and does not have such a number, the bank may obtain an

identification number from some other form of government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.

Several commenters suggested that it would be less confusing to bankers if "U.S. person" meant both a U.S. citizen and a resident alien, consistent with the definition of this term used in the Internal Revenue Code (IRS definition).<sup>18</sup> A few commenters criticized the proposed definition because it would require banks to establish whether a customer is or is not a U.S. citizen.

Treasury and the Agencies believe that the proposed definition of "U.S. person" is a better standard for purposes of this final rule than the IRS definition. Adoption of the IRS definition of "U.S. person" would require bank staff to distinguish among various tax and immigration categories in connection with any type of account that is opened. Under the proposed definition, a bank will not necessarily need to establish whether a potential customer is a U.S. citizen. The bank will have to ask each customer for a U.S. taxpayer identification number (social security number, employer identification number, or individual taxpayer identification number). If a customer cannot provide one, the bank may then accept alternative forms of identification. For these reasons, the definition is adopted as proposed.

**Section 103.121(b) Customer Identification Program: Minimum Requirements**

**Section 103.121(b)(1) General Rule.** The proposed rule required each bank to implement a CIP that is appropriate given the bank's size, location, and type of business. The proposed rule required a bank's CIP to contain the statutorily prescribed procedures, described these procedures, and detailed certain minimum elements that each of the procedures must contain. In addition, the proposed rule required that the CIP be written and that it be approved by the bank's board of directors or a committee of the board.

The proposed rule also stated that the CIP must be incorporated into the bank's BSA<sup>19</sup> compliance program and should not be a separate program. A bank's BSA compliance program must be written, approved by the board, and noted in the bank's minutes. It must include (1) internal policies, procedures, and controls to ensure ongoing compliance; (2) designation of

a compliance officer; (3) an ongoing employee training program; and (4) an independent audit function to test programs. The preamble for the proposal explained that the CIP should be incorporated into each of these four elements of a bank's BSA program.

Most commenters agreed with the proposal's approach of allowing banks to develop risk-based programs tailored to their specific operation, though some of these commenters recommended that Treasury and the Agencies adopt an entirely risk-based approach without any minimum requirements while others recommended a more prescriptive approach. Many commenters suggested that Treasury and the Agencies clarify the extent to which a bank could rely on a third party, especially an affiliate, to perform some or all aspects of its CIP.

Other commenters focused on the requirement that a bank's board of directors approve the CIP. These commenters urged Treasury and the Agencies to adopt a regulation that states that the role of a bank's board of directors need only be to approve broad policy rather than the specific methods or actual procedures that will be a part of a bank's CIP. One commenter recommended that the governing body of a financial institution be permitted to delegate its responsibility to approve the CIP.

The final rule attempts to strike an appropriate balance between flexibility and detailed guidance by allowing a bank broad latitude to design and implement a CIP that is tailored to its particular business practices while providing a framework of minimum standards for identifying each customer, as the Act mandates. Following the description of the procedures and minimum requirements for each element of a bank's CIP (identity verification, recordkeeping, comparison with government lists, and customer notice), the final rule contains a new section describing the extent to which a bank may rely on a third party to perform these elements, described in detail below.

The final rule removes the requirement that the bank's board of directors or a committee of the board must approve the bank's CIP because this requirement is redundant. A bank's BSA compliance program must already be approved by the board. Treasury and the Agencies regard the addition of a CIP to the bank's BSA compliance program to be a material change in the BSA compliance program that will require board approval. The board of director's responsibility to oversee bank compliance with section 326 of the Act

<sup>17</sup> As a foreign branch of an insured U.S. bank is no longer a "bank" for purposes of this rule, a customer of a bank's foreign branch will no longer be "a person who has an existing account with the bank." Therefore, the bank must verify the identity of a customer of its foreign branch in accordance with its CIP if such a customer opens a new account in the U.S.

<sup>18</sup> 28 U.S.C. 7701(a)(30)(A).

<sup>19</sup> See footnote 10, supra.

is a part of a board's conventional supervisory BSA compliance responsibilities that cannot be delegated to bank management. Therefore, a bank's board of directors must be responsible for approving a CIP described in detail sufficient for the board to determine that (1) the bank's CIP contains the minimum requirements of this final rule; and (2) the bank's identity verification procedures are designed to enable the bank to form a reasonable belief that it knows the true identity of the customer. Nevertheless, responsibility for the development, implementation, and day-to-day administration of the CIP may be delegated to bank management.

The final rule will apply to some non-Federally regulated banks that are not yet subject to an anti-money laundering compliance program requirement.<sup>20</sup> Therefore, the final rule only requires that the CIP be a part of a bank's anti-money laundering program once a bank becomes subject to an anti-money laundering compliance program requirement.<sup>21</sup>

**Section 103.121(b)(2) Identity Verification Procedures.** The proposed rule provided that each bank must have a CIP that includes procedures for verifying the identity of each customer, to the extent reasonable and practicable, based on the bank's assessment of certain risks. The proposed rule stated that these procedures must enable the bank to form a reasonable belief that it knows the true identity of the customer.

Some commenters recommended that the identity verification requirement be waived for new customers that are well known to a senior officer of the bank. Some of these commenters endorsed such a waiver provided that a bank employee could provide "an affidavit of identity" on behalf of the customer.

One commenter criticized the standard requiring a bank to have identity verification procedures "that enable the bank to form a reasonable belief that it knows the true identity of the customer" as too subjective. This commenter suggested that a better standard would be lack of affirmative notice of deficiency in the identity process. Another commenter suggested that the rule make clear that a bank is only required to verify a customer's identity, to the extent reasonable and practical, in order to establish that it has a reasonable basis for knowing the true identity of its customer.

<sup>20</sup> See footnote 10, *supra*.

<sup>21</sup> The final rule therefore provides that until such time as credit unions, private banks, and trust companies without a Federal functional regulator are subject to such a program, their CIPs must be approved by their boards of directors.

The final rule provides that a bank's CIP must include risk-based procedures for verifying the identity of each customer<sup>22</sup> to the extent reasonable and practicable. The final rule also states that the procedures must enable the bank to form a reasonable belief that it knows the true identity of the customer. As section 326 of the Act states, a bank's affirmative obligation to verify the identity of its customer applies to "any person" rather than only to a person whose identity is suspect, as suggested by one commenter. Furthermore, Treasury and the Agencies have determined that the statutory obligation to "verify the identity of any person" requires the bank to implement and follow procedures that allow the bank to have a reasonable belief that it knows the true identity of the customer.

Given the flexibility built into the final rule, Treasury and the Agencies believe that it is not appropriate to provide special treatment for new customers known to bank personnel. In addition, permitting reliance on bank personnel to attest to the identity of a customer may be subject to manipulation. Accordingly, the final rule does not establish different rules for customers who are known to bank personnel.

The final rule requires the identity verification procedures to be based upon relevant risks, including those presented by the types of accounts maintained by the bank, the various methods of opening accounts provided by the bank, and the types of identifying information available. In addition to these risk factors, which are specifically identified in section 326, the final rule states that the procedures should take into account the bank's size, location, and type of business or customer base, additional factors mentioned in the Act's legislative history.<sup>23</sup>

**Section 103.121(b)(2)(i) Customer Information Required.** The proposed rule required that a bank's CIP must contain procedures that specify the identifying information the bank must obtain from a customer. It stated that, at a minimum, a bank must obtain from each customer the following information prior to opening an account: (1) Name; (2) address (a residential and mailing address for individuals, and principal place of business and mailing address for a person other than an individual); (3)

date of birth for individuals; and (4) an identification number.

Treasury and the Agencies received a variety of comments criticizing the requirement that a bank obtain certain minimum identifying information prior to opening an account. Some commenters, including a trade association representing large financial institutions, recommended that a bank be permitted to open an account for a customer who lacks some of the minimum identifying information, provided that the bank has formed a reasonable belief that it knows the true identity of the customer. Credit card banks explained that the minimum information requirement would create problems for retailers that offer credit cards at the point of sale. These commenters stated that retailers were not likely to have the means to record identifying information other than what is currently collected. They suggested that when there are systems in place to identify customers and detect suspicious transactions, the rule should require only the collection of information that the credit card bank or card issuer deems necessary and appropriate to identify the customer.

Other commenters stated that the rule should not require a bank to obtain the minimum identifying information prior to account opening in every instance. Some of these commenters suggested that a bank be permitted to obtain the required information within a reasonable time after the account is opened. Some commenters suggested that the rule permit banks to obtain identifying information from a party other than the customer. This would arise, for example, when a bank offers a credit card based on information obtained from a credit reporting agency. Other commenters suggested that a bank also be required to obtain information about a customer's occupation, profession or business, as this information is needed by a bank that intends to file a report of transactions in currency or a suspicious activities report on the customer.

Consistent with the proposal, the final rule provides that a bank's CIP must contain procedures that specify the identifying information that the bank must obtain from each customer prior to opening an account. In addition, the rule specifies the four basic categories of information that a bank must obtain from the customer prior to opening an account. Treasury and the Agencies believe that requiring banks to gather these standard forms of information prior to opening an account is not overly burdensome because such identifying information is routinely

<sup>22</sup> Other elements of the bank's CIP, such as procedures for recordkeeping or checking of government lists, are requirements that may not vary depending on risk factors.

<sup>23</sup> H.R. Rep. No. 107-250, pt. 1, at 62 and 63 (2001).

gathered by most banks in the account opening process and is required by other sections of 31 CFR part 103. Of course, based upon an assessment of the risks described above, a bank may require a customer to provide additional information to establish the customer's identity.

Treasury and the Agencies acknowledge that imposing this requirement on banks that offer credit card accounts is likely to alter the manner in which they do business by requiring them to gather additional information beyond that which they currently obtain directly from a customer who opens an account at the point of sale or by telephone. Treasury and the Agencies are mindful of the legislative history of section 326, which indicates that Congress expected the regulations implementing this section to be appropriately tailored for accounts opened in situations where the account holder is not physically present at the financial institution and that the regulations should not impose requirements that are burdensome, prohibitively expensive, or impractical.<sup>24</sup>

Therefore, Treasury and the Agencies have included an exception in the final rule for credit card accounts only, which would allow a bank broader latitude to obtain some information from the customer opening a credit card account, and the remaining information from a third party source, such as a credit reporting agency, prior to extending credit to a customer. Treasury and the Agencies recognize that these practices have produced an efficient and effective means of extending credit with little risk that the lender does not know the identity of the borrower.

Treasury and the Agencies also received comments on the advisability of requiring banks to collect the specific identifying information (name, date of birth, address, and identification number), as would have been required under the proposed rule. With respect to obtaining the customer's name, one commenter recommended that based on Texas law and banks' experience, a bank should be required to obtain the name under which the customer is doing business and the customer's legal name. The final rule continues to require that the bank obtain the customer's name, meaning a legal name that can be verified. As noted above, this is a minimum requirement, and a bank may also need to obtain the name under which a person does business in order to establish a reasonable belief it knows the true identity of the customer.

<sup>24</sup>H.R. Rep. No. 107-250, pt. 1, at 63 (2001).

One trade association suggested that banks be permitted to make a risk-based determination before requiring a customer to provide date of birth because many customers would prefer not to share this information. One commenter stated that date of birth is not an important identifying characteristic and should be deleted. Another commenter stated that credit card issuers do not request this information because it can raise fair lending issues. Finally, a few commenters noted that standardized mortgage applications require age rather than date of birth and would have to be altered.

The final rule provides that a bank must obtain the date of birth for a customer who is an individual. Treasury and the Agencies believe that date of birth is an important identifying characteristic and can be used to provide a bank or law enforcement with an additional means to distinguish between customers with identical names. However, the required collection and retention of information about a customer's date of birth does not relieve the bank from its obligations to comply with anti-discrimination laws or regulations, such as the prohibition in the Equal Credit Opportunity Act against discrimination in any aspect of a credit transaction on the basis of age or other prohibited classification. Banks collecting date of birth from individual customers should be able to take reasonable measures to convert this information into age for purposes of the forms used in the secondary mortgage market given the delayed compliance date for the final rule.

Many commenters criticized the requirement that a bank obtain both the customer's physical and mailing address, if different. Most commenters urged Treasury and the Agencies to eliminate the requirement that the customer provide a physical address. Some of these commenters stated that this requirement could interfere with the ability of certain segments of the population to obtain a bank account, such as members of the military, persons who reside in mobile homes with no fixed address, and truck drivers who do not have a physical address. Banks that offer credit card accounts and card issuers stated that the address requirement would be extremely burdensome because they would have to change the manner in which they do business, and in some cases, credit card banks currently do not have the capacity to collect both addresses. Some of these commenters stated that new credit card customers are reluctant to give more than one address and, therefore, it

would be difficult to obtain this information from customers. A trade association representing credit card banks asserted that customers may have a legitimate reason for handling correspondence through post office boxes and should not have to provide a physical address. This commenter asserted that requiring the customer to provide a physical address will discourage the provision of financial services to the unbanked and will prevent a victim of identity theft from using an alternative to an unsecured home mailbox. Another commenter noted that the physical address of a customer's principal place of business may not be relevant if the bank is working with a customer's local office. This commenter recommended that the rule simply permit the bank to obtain the customer's street address. Credit card banks and issuers urged Treasury and the Agencies to make the requirement that a bank obtain the customer's physical address optional.

Section 326 of the Act requires Treasury and the Agencies to prescribe regulations that require financial institutions to implement "reasonable procedures." Accordingly, under the final rule, a bank will not be required to obtain more than a single address for a customer. Nonetheless, Treasury and the Agencies believe that the identification, verification, and recordkeeping provisions of the Act, taken together, should provide appropriate resources for law enforcement agencies to investigate money laundering and terrorist financing. The final rule therefore provides that a bank generally must obtain a residential or business street address for a customer who is an individual because Treasury and the Agencies have determined that law enforcement agencies should be able to contact an individual customer at a physical location, rather than solely through a mailing address. Treasury and the Agencies recognize that this provision may be impracticable for members of the military who cannot readily provide a physical address, and other individuals who do not have a physical address but who reliably can be contacted. Accordingly, the final rule provides an exception under these circumstances that allows a bank to obtain an Army Post Office or Fleet Post Office box number, or the residential or business street address of next of kin or of another contact individual. For a customer other than an individual, such as a corporation, partnership, or trust, the bank may obtain the address of the principal place of business, local office,



or other physical location of the customer. Of course, a bank is free to obtain additional addresses from the customer, such as the customer's mailing address, to meet its own or its customer's business needs.

The proposal required that banks obtain an identification number from customers. For U.S. persons, a bank would have been required to obtain a U.S. taxpayer identification number. For non-U.S. persons, a bank would have been required to obtain a number from various alternative forms of government-issued identification.

One commenter stated that this requirement would not be burdensome. Commenters representing certain consumer advocacy groups commended Treasury and the Agencies for providing banks with the discretion to accept alternative forms of identifying information from non-U.S. citizens. These commenters stated that this position would assist low-income immigrants in gaining financial stability. By contrast, some commenters stated that the final rule should not permit a bank to open an account for a customer using only a foreign identification number when the customer provides a U.S. address. Other commenters asked for guidance on whether a bank is permitted to accept a number from the identification document issued by a foreign government. A few commenters urged the government to require a national identification document for all individuals.

Other commenters, primarily credit card banks, stated that the requirement that a bank obtain a U.S. taxpayer identification number from U.S. persons would create considerable hardship. They stated that new credit card customers are reluctant to give out their social security numbers, especially over the telephone. They urged that banks be given the discretion to collect identifying information, other than social security numbers, when appropriate in light of consumer privacy and security concerns. In the alternative, they recommended that banks be permitted to obtain a U.S. taxpayer identification number for U.S. persons from a trusted third party source, such as a credit reporting agency.

Some commenters questioned what number to use for accounts opened in the name of a bowling league or class reunion, or to accept donations for a special cause. Other commenters questioned what number could be obtained from foreign businesses and enterprises that have no taxpayer

identification number or other government-issued documentation.

The final rule provides that a bank must obtain an "identification number" from every customer. As discussed above, under the definition of "customer," the final rule permits a bank to obtain the identification number of the individual who opens an account in the name of an individual who lacks legal capacity, such as a minor, or a civic group, such as a bowling league.

After reviewing the comments, Treasury and the Agencies have determined that requiring a bank to obtain a customer's identification number, such as a social security number, from the customer himself or herself, in every case, including over the telephone, would be unreasonable and impracticable because it would be contrary to banks' current practices and could alienate many potential customers. Accordingly, Treasury and the Agencies have adopted an exception for credit card accounts that will permit a bank offering such accounts to acquire information about the customer, including an identification number, from a trusted third party source prior to extending credit to the customer, rather than having to obtain this information directly from the customer prior to opening an account.

The final rule also provides that for a non-U.S. person, a bank must obtain one or more of the following: A taxpayer identification number (social security number, individual taxpayer identification number, or employer identification number); passport number and country of issuance; alien identification card number; or number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard. This standard provides a bank with some flexibility to choose among a variety of identification numbers that it may accept from a non-U.S. person.<sup>25</sup> However, the identifying information the bank accepts must permit the bank to establish a reasonable belief that it knows the true identity of the customer.

Treasury and the Agencies emphasize that the final rule neither endorses nor prohibits bank acceptance of information from particular types of identification documents issued by foreign governments. A bank must decide for itself, based upon appropriate

risk factors, including those discussed above (the types of accounts maintained by the bank, the various methods of opening accounts provided by the bank, the other types of identifying information available, and the bank's size, location, and customer base), whether the information presented by a customer is reliable.

Treasury and the Agencies recognize that a foreign business or enterprise may not have a taxpayer identification number or any other number from a government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard. Therefore, the final rule notes that when opening an account for such a customer, the bank must request alternative government-issued documentation certifying the existence of the business or enterprise.

The proposal also contained a limited exception to the requirement that a bank obtain a taxpayer identification number from a customer opening a new account. The exception permitted a bank to open an account for a person other than an individual (such as a corporation, partnership, or trust) that has applied for, but has not received, an employer identification number (EIN), provided that the bank obtains a copy of the application before it opens the account and obtains the EIN within a reasonable period of time after the account is established. The preamble to the proposed rule explained that this exception was included for a new business that might need access to banking services, particularly a bank account or an extension of credit, before it has received an EIN from the Internal Revenue Service.

Some commenters questioned this limited exception for certain businesses. A few commenters suggested expanding the exception to include individuals who have applied for, but have not yet received a taxpayer identification number. Another commenter stated that the exception provided no added benefit and would add to a bank's recordkeeping and monitoring burden.

Treasury and the Agencies have determined that a bank should be afforded more flexibility in situations where a person, including an individual, has applied for, but has not yet received, a taxpayer identification number. Therefore, the final rule states that instead of obtaining a taxpayer identification number from a customer prior to opening an account, the CIP may include procedures for opening an account for a customer (including an individual) that has applied for, but has not received, a taxpayer identification

<sup>25</sup> The rule provides this flexibility because there is no uniform identification number that non-U.S. persons would be able to provide to a bank. See Treasury Department, "A Report to Congress in Accordance with Section 326(b) of the USA PATRIOT Act," October 21, 2002.

number.<sup>26</sup> To lessen the recordkeeping burden for a bank that elects to use this exception, the final rule also provides that the bank's CIP need only include procedures requiring the bank to confirm that the application was filed before the customer opens the account and to obtain the taxpayer identification number within a reasonable period of time after the account is opened. Thus, a bank will be able to exercise its discretion<sup>27</sup> to determine how to confirm that a customer has filed an application for a taxpayer identification number rather than having to keep a copy of the application on file.

**Section 103.121(b)(2)(ii) Customer Verification.** The proposed rule provided that the CIP must contain risk-based procedures for verifying the information that the bank obtains in accordance with § 103.121(b)(2)(i), within a reasonable period of time after the account is opened.<sup>28</sup> The proposed rule also described when a bank is required to verify the identity of existing customers.

Several commenters asked Treasury and the Agencies to underscore that these verification procedures may be risk-based by noting that a bank may verify less than all of the identifying information provided by the customer. Many commenters noted that there is currently no reliable, efficient, or effective means of verifying a customer's social security number. Some of these commenters asked the government to establish a method that would permit banks to establish the authenticity and accuracy of a customer's name and taxpayer identification number.

Treasury and the Agencies recognize that there currently is no method that would permit a bank to verify, for example, a taxpayer identification, passport or alien identification number through an official source. Accordingly, the final rule provides that a bank's CIP must contain procedures for verifying the identity of the customer, "using the

information obtained in accordance with paragraph (b)(2)(i)," namely, the identifying information obtained by the bank. Thus, a bank need not establish the accuracy of every element of identifying information obtained but must do so for enough information to form a reasonable belief it knows the true identity of the customer.

Some commenters stated that they appreciated the flexibility of the proposal permitting an institution to determine how soon identity must be verified. Other commenters asked Treasury and the Agencies to clarify what is a "reasonable period of time." As stated in the preamble for the proposal, Treasury and the Agencies believe that the amount of time it will take an institution to verify a customer's identity may depend upon various factors, such as the type of account opened, whether the customer is physically present when the account is opened, and the type of identifying information available. For the same reasons, the final rule provides banks with the flexibility necessary to accommodate a wide range of situations by stating that the bank must verify the identifying information within a reasonable time after the account is opened.<sup>29</sup>

As discussed above in the definition section, many commenters criticized the proposed approach regarding verification of existing customers that open new accounts. The final rule addresses these concerns by modifying the definition of "customer" to exclude a person who has an existing account with the bank if the bank has a reasonable belief that it knows the true identity of the person.

Many commenters urged that the final rule continue to allow, but not mandate, documentary verification. A few commenters requested that the final rule provide additional guidance on verification. Some commenters asked that the final rule clarify that a bank may choose to use only documentary methods and may refuse to open an account using other methods.

The final rule addresses these comments by stating that a bank's CIP's verification procedures must describe when the bank will use documents, non-documentary methods, or a combination of both methods to verify a customer's identity.

<sup>29</sup> It is possible that a bank would, however, violate other laws by permitting a customer to transact business prior to verifying the customer's identity. See, e.g., 31 CFR part 500 (regulations of Treasury's Office of Foreign Asset Control (OFAC) prohibiting transactions involving designated foreign countries or their nationals).

**Section 103.121(b)(2)(ii)(A)**

**Verification Through Documents.** The proposed rule provided that the CIP must contain procedures describing when the bank will verify identity through documents and setting forth the documents that the bank will use for this purpose. It then gave examples of documents that could be used to verify the identity of individuals and other persons such as corporations, partnerships, and trusts.

Most commenters noted that banks do not have the means to authenticate or validate documents provided by their customers and urged Treasury and the Agencies to clarify that document authentication is not a CIP requirement. Treasury and the Agencies wish to confirm that once a bank has obtained and verified the identity of the customer through a document such as a driver's license or passport, the bank will not be required to take steps to determine whether the document has been validly issued. A bank generally may rely on government-issued identification as verification of a customer's identity; however, if a document shows obvious indications of fraud, the bank must consider that factor in determining whether it can form a reasonable belief that it knows the customer's true identity.

Some commenters also asked that Treasury and the Agencies provide more examples and discuss appropriate types of documentary identification in the final rule or in separate guidance that banks may easily access. Commenters asked whether a utility bill, or library card addressed to the same physical address and name of the person seeking the account, or a foreign identification card, such as a foreign voter registration card or driver's license, would be acceptable. Some commenters questioned whether copies of documents would suffice.

Given the recent increases in identity theft and the availability of fraudulent documents, Treasury and the Agencies agree with a commenter who suggested that the value of documentary verification is enhanced by redundancy. The rule gives examples of types of documents that are considered reliable. However, a bank is encouraged to obtain more than one type of documentary verification to ensure that it has a reasonable belief that it knows the customer's true identity. Moreover, banks are encouraged to use a variety of methods to verify the identity of a customer, especially when the bank does not have the ability to examine original documents.

The final rule attempts to strike the appropriate balance between the

<sup>26</sup> This position is analogous to that in regulations issued by the Internal Revenue Service (IRS) concerning "awaiting-TIN [taxpayer identification number] certificates." The IRS permits a taxpayer to furnish an "awaiting-TIN certificate" in lieu of a taxpayer identification number to exempt the taxpayer from the withholding of taxes owed on reportable payments (i.e., interest and dividends) on certain accounts. See 26 CFR 31.3406(g)-3.

<sup>27</sup> For example, the bank may wish to examine a copy of the application filed.

<sup>28</sup> The preamble for the proposed rule noted that, although an account may be opened, it is common practice among banks to place limits on the account, such as by restricting the number of transactions or the dollar value of transactions, until a customer's identity is verified. Therefore, the proposed regulation provided the bank with the flexibility to use a risk-based approach to determine how soon identity must be verified.



benefits of requiring additional documentary verification and the burdens that may arise from such a requirement by providing that a bank's CIP must state the documents that a bank will use. This will require each bank to conduct its own risk-based analysis of the types of documents it believes will enable it to know the true identity of its customers.

The final rule continues to provide an illustrative list of identification documents. For an individual, these may include an unexpired government-issued identification evidencing nationality or residence and bearing a photograph or similar safeguard, such as a driver's license or passport. For a person other than an individual, these may include documents showing the existence of the entity, such as certified articles of incorporation, a government-issued business license, a partnership agreement, or a trust instrument.

Some commenters questioned whether the examples of identification documents given for persons other than individuals would be reliable. One commenter questioned whether trust documents alone would be sufficient verification of identity. Another commenter suggested allowing banks to rely on a certification by the trustee, or an appropriate legal opinion, rather than the trust instrument to verify the existence of a trust. Someone else suggested that banks should be allowed to rely on documentation consisting of evidence that a business is either publicly traded or is authorized to do business in a state or the United States.

The examples provided in the final rule were intended only to illustrate the documents a bank might use to verify the identity of a customer that is a corporation, partnership, or trust. A bank may use other documents, provided that they allow the bank to establish that it has a reasonable belief that it knows the true identity of its customer. Accordingly, the final rule makes no significant changes to the examples.

**Section 103.121(b)(2)(ii)(B) Non-Documentary Verification.** Recognizing that some accounts are opened by telephone, by mail, and over the Internet, the proposed rule provided that a bank's CIP also must contain procedures describing what non-documentary methods the bank will use to verify identity and when the bank will use these methods (whether in addition to, or instead of, relying on documents). The preamble for the proposed rule also noted that even if the customer presents identification documents, it may be appropriate to use non-documentary methods as well.

The proposed rule gave examples of non-documentary verification methods that a bank may use, including contacting a customer after the account is opened; obtaining a financial statement; comparing the identifying information provided by the customer against fraud and bad check databases to determine whether any of the information is associated with known incidents of fraudulent behavior (negative verification); comparing the identifying information with information available from a trusted third party source, such as a credit report from a consumer reporting agency (positive verification); and checking references with other financial institutions. The preamble for the proposed rule stated that a bank also may wish to analyze whether there is logical consistency between the identifying information provided, such as the customer's name, street address, ZIP code, telephone number, date of birth, and social security number (logical verification).

The proposal required that the procedures address situations where an individual, such as an elderly person, legitimately is unable to present an unexpired government-issued identification document that bears a photograph or similar safeguard; the bank is not familiar with the documents presented; the account is opened without obtaining documents; the account is not opened in a face-to-face transaction, for example over the phone, by mail, or through the Internet; and the type of account increases the risk that the bank will not be able to verify the true identity of the customer through documents.

Several commenters asked for additional guidance regarding when non-documentary verification methods should be used in addition to documentary verification methods and the circumstances in which only one or all of the non-documentary verification methods listed are necessary. Commenters also asked for guidance on audit methodology, and an explanation of the due diligence required for verification of accounts opened by telephone, mail, and through the Internet. A few commenters suggested that reference to verification, where a bank compares information provided by the customer with information from trusted third party sources, be expressly mentioned in the final rule.

As the large number of comments on this section illustrates, a rule that attempted to address every scenario and combination of risk-factors that a bank might confront would be extremely complex and invariably would fail to

address many situations. Rather than adopt a lengthy and potentially unwieldy rule that still would not address every situation, Treasury and the Agencies have concluded that it would be more effective to adopt general principles that are fleshed out through examples. Therefore, the final rule states that for a bank relying on non-documentary verification methods, the CIP must contain procedures that describe the non-documentary methods the bank will use.

The final rule generally retains the illustrative list of non-documentary methods contained in the proposal. Treasury and the Agencies have clarified that one method is "independently verifying the customer's identity through the comparison of information provided by the customer with information obtained from a consumer reporting agency, public database, or other source," rather than verifying "documentary information" through such sources.

The final rule also retains the variety of situations that the procedures must address that were identified in the proposal, with the following two changes. First, because "transaction" is a defined term in 31 CFR part 103, instead of using the term "face-to-face transaction," the final rule states that the procedures must address the situation where a customer opens an account without appearing in person at the bank. Second, the final clause of this provision provides that the CIP must include procedures to address situations where the bank is otherwise presented with circumstances that increase the risk that the bank will be unable to verify the true identity of a customer through documents. This clause acknowledges that there may be circumstances beyond those specifically described in this provision when a bank should use non-documentary verification procedures.

As stated in the preamble for the proposed rule, because identification documents may be obtained illegally and may be fraudulent, and in light of the recent increase in identity theft, Treasury and the Agencies encourage banks to use non-documentary methods even when the customer has provided identification documents.

**Section 103.121(b)(2)(ii)(C) Additional Verification for Certain Customers.** As described above, the proposed rule required the identification and verification of each signatory for an account. Most commenters objected to this requirement as overly burdensome, and, upon consideration of the points raised by the commenters, Treasury and the Agencies agree that it is appropriate

to delete it. For the reasons discussed below, however, the rule does require that a bank's CIP address the circumstances in which it will obtain information about such individuals in order to verify the customer's identity. Treasury and the Agencies believe that while the majority of customers may be verified adequately through the documentary or non-documentary verification methods described in paragraphs (b)(2)(ii)(A) and (B), there may be instances where this is not possible. The risk that the bank will not know the customer's true identity may be heightened for certain types of accounts, such as an account opened in the name of a corporation, partnership, or trust that is created or conducts substantial business in a jurisdiction that has been designated by the United States as a primary money laundering concern or has been designated as non-cooperative by an international body.

Obtaining sufficient information to verify a customer's identity can reduce the risk that a bank will be used as a conduit for money laundering and terrorist financing. Treasury and the Agencies believe that a bank must identify customers that pose a heightened risk of not being properly identified, and a bank's CIP must prescribe additional measures that may be used to obtain information about the identity of the individuals associated with the entity in whose name such an account is opened when standard documentary and non-documentary methods prove to be insufficient.

For these reasons, the requirement to verify the identity of signatories has been replaced by a new provision in the final rule that requires that a bank's CIP address situations where, based on the bank's risk assessment of a new account opened by a customer that is not an individual, the bank also will obtain information about individuals with authority or control over such account, including signatories, in order to verify the customer's identity. This additional verification method will only apply when the bank cannot adequately verify the customer's identity using the documentary and non-documentary verification methods described in (b)(2)(ii)(A) and (B). Moreover, a bank need not undertake any additional verification if it chooses not to open an account when it cannot verify the customer's identity using standard documentary and non-documentary verification methods.

**Section 103.121(b)(2)(iii) Lack of Verification.** The proposed rule stated that a bank's CIP must include procedures for responding to circumstances in which the bank cannot

form a reasonable belief that it knows the true identity of a customer. The preamble for the proposed rule listed what these procedures should include. In addition, the proposal stated that a bank should only maintain an account for a customer when it can form a reasonable belief that it knows the customer's true identity.<sup>30</sup>

The final rule retains the general requirement that a bank's CIP include procedures for responding to circumstances in which the bank cannot form a reasonable belief that it knows the true identity of the customer. However, the rule text itself now states that the procedures should describe the following: when a bank should not open an account for a potential customer; the terms under which a customer may use an account while the bank attempts to verify the customer's identity; when the bank should close an account after attempts to verify a customer's identity have failed; and when the bank should file a Suspicious Activity Report in accordance with applicable law and regulation.

One commenter stated that requiring a bank to close an account if it cannot verify a customer's identity would conflict with state laws and would subject the bank to legal liability. The commenter urged that if this provision is retained, the final rule also should shield banks from state regulatory and borrower liability in these circumstances. Other commenters asked that Treasury and the Agencies clarify that further investigation that results in failure to open an account will not trigger adverse action requirements under the FCRA, 15 U.S.C. 1681 *et seq.* or the Equal Credit Opportunity Act (ECOA), 15 U.S.C. 1691 *et seq.*

The final rule does not specifically require a bank to close the account of a customer whose identity the bank cannot verify, but instead leaves this determination to the discretion of the bank. Treasury and the Agencies have determined that there is no statutory basis to create a safe harbor that would shield banks from state regulatory or borrower liability if a bank should choose to close a customer's account. Any such closure should be consistent with the bank's existing procedures for closing accounts in accordance with its risk management practices. Treasury and the Agencies also note that a bank must comply with other applicable laws and regulations, such as the adverse

<sup>30</sup> The preamble also explained that there are some exceptions to this basic rule. For example, a bank may maintain an account at the direction of a law enforcement or intelligence agency, even though the bank does not know the true identity of the customer.

action provisions under ECOA and the FCRA, when determining not to open an account because it cannot establish a reasonable belief that it knows the true identity of the customer.<sup>31</sup>

#### **Section 103.121(b)(3) Recordkeeping**

**Section 103.121(b)(3)(i) Required Records.** The proposed rule set forth recordkeeping procedures that must be included in a bank's CIP. Under the proposal, a bank would have been required to maintain a record of the identifying information provided by the customer. Where a bank relies upon a document to verify identity, the proposal would have required the bank to maintain a copy of the document that the bank relied on that clearly evidences the type of document and any identifying information it may contain. The bank also would have been required to record the methods and result of any additional measures undertaken to verify the identity of the customer. Last, the bank would have been required to record the resolution of any discrepancy in the identifying information obtained.

This section of the proposed rule prompted the most comment. Though one commenter felt that the recordkeeping requirements in the proposed rule were weak, almost all other commenters identified the proposed documentation and record retention requirements as overly burdensome. Commenters urged Treasury and the Agencies to permit a bank to record the information from the documents obtained rather than requiring banks to maintain copies of these documents for the life of the account. Commenters generally argued that it would be difficult and very burdensome to store and retrieve copies of documents used to verify the identity of the customer. In addition, some commenters noted that many kinds of identification documents, particularly some new driver's licenses, have security features that prevent them from being copied legibly. Other commenters stated that copies of documents would be difficult to safeguard and could facilitate identity theft.

Commenters stated that requiring banks to keep copies of documents would substantially deviate from current banking practice and would violate certain states' laws. Banks offering credit card accounts through retailers, who require the customer to

<sup>31</sup> See 12 CFR 202.9(b) (Federal Reserve Regulation B that prescribes the form of ECOA notice and statement of specific reasons); 15 U.S.C. 1681m (FCRA provision that provides for duties of users taking adverse actions on the basis of information contained in consumer reports from other third parties or affiliates).

provide identifying documents at the point of sale, strenuously opposed this requirement if it were interpreted to cover documents presented to the merchant. These commenters stated that copy machines are not usually available at the point of sale, and that the rule as proposed would require merchants to purchase large numbers of additional copy machines. The commenters also anticipated that consumers would be greatly inconvenienced by this requirement and might have to endure lengthy waits during any busy shopping season. These commenters questioned whether the risks of money-laundering and the financing of terrorism through retail store credit cards, which generally have relatively low credit limits, restrictions on pre-payment, and other features to detect fraud, warrant the imposition of these additional costs.

Other commenters stated that requiring banks to keep copies of documents that have pictures, such as driver's licenses, could expose the bank to allegations of unlawful discrimination, even if the retention of this information were not prohibited under ECOA. Some banks objected to this requirement on the grounds that it directly conflicted with the position that the Agencies have traditionally taken on this issue, including the criticism of banks that have retained such information in their files when extending credit.

Other commenters asked that a bank be permitted to record the processes and procedures generally used for verification rather than being required to keep records of the methods used and the resolution for each and every account, especially where the bank uses standardized procedures for all customers and could demonstrate that these procedures were applied. Some commenters suggested that the final rule permit banks to use a risk-based approach for recordkeeping.

In light of the comments received, Treasury and the Agencies have reconsidered and modified the recordkeeping requirements of the proposed rule. The final rule provides that a bank's CIP must include procedures for making and maintaining a record of all information obtained under the procedures implementing the requirement that a bank develop and implement a CIP. However, the final rule affords banks significantly more flexibility than did the recordkeeping provisions contained in the proposal. Under the final rule, a bank's records are to include "a description," rather than a copy, of any document upon which the bank relied in order to verify the identity of the customer, noting the

type of document, any identification number contained in the document, the place of issuance, and, if any, the date of issuance and expiration date. The final rule also clarifies that the record must include "a description" of the methods and results of any measures undertaken to verify the identity of the customer, and of the resolution of any "substantive" discrepancy discovered when verifying the identifying information obtained, rather than any documents generated in connection with these measures.

As Treasury and the Agencies indicated in the preamble for the proposal, nothing in the rule modifies, limits, or supersedes section 101 of the Electronic Signatures in Global and National Commerce Act, Pub. L. 106-229, 114 Stat. 464 (15 U.S.C. 7001) (E-Sign Act). Thus, a bank may use electronic records to satisfy the requirements of this final rule, as long as the records are accurate and remain accessible in accordance with 31 CFR 103.38(d).

#### *Section 103.121(b)(3)(ii) Retention of Records*

The proposal required a bank to retain all of the records specified in the recordkeeping provision for five years after the date the account is closed.

This requirement prompted strenuous objections. Assuming that copies of the documents used to verify the identity of the customer would have to be retained, commenters asserted that retaining records until five years after the account is closed would be very burdensome. Some commenters noted that imaging is not a routine practice for community banks and could be costly. Banks offering credit card accounts stated that the record retention requirement would require a change in forms, processes, and systems, while also increasing storage costs. As credit cards do not have a specific term, commenters noted that banks would be required to keep these records forever, unless they are culled manually. Some commenters suggested that the retention period be shortened, with suggestions ranging from one to three years after the account is closed, while other commenters suggested that the period be shortened to five years from when the account is opened. Many commenters stated that two years from when the information is obtained would be consistent with other regulatory requirements, such as the record retention requirements for an application for an extension of credit subject to ECOA (12 CFR 202.12(b)).

By eliminating the requirement that a bank retain copies of the documents used to verify the identity of the

customer, Treasury and the Agencies believe that the final rule largely addresses the main concern of these commenters. However, Treasury and the Agencies also have determined that, while the identifying information provided by the customer should be retained, there is little value in requiring banks to retain the remaining records for five years after an account is closed because this information is likely to have become stale. Therefore, the final rule now prescribes a bifurcated record retention schedule that is consistent with the general five-year retention requirement in 31 CFR 103.38. First, the bank must retain the information referenced in paragraph (b)(3)(i)(A) (that is, information obtained about a customer), for five years after the date the account is closed or, in the case of credit card accounts, five years after the account is closed or becomes dormant. Second, the bank need only retain the records that it must make and maintain under the remaining parts of the recordkeeping provision, paragraphs (b)(3)(i)(B), (C), and (D) (that is, information that verifies a customer's identity) for five years after the record is made.

#### *Section 103.121(b)(4) Comparison with Government Lists.*

The proposed rule required a bank to have procedures for determining whether the customer appears on any list of known or suspected terrorists or terrorist organizations provided to the bank by any Federal government agency. In addition, the proposal stated that the procedures must ensure that the bank follows all Federal directives issued in connection with such lists.

Most commenters were concerned about how a bank would be able to determine what lists should be checked for purposes of this provision and how these lists would be made available. Some commenters asked that the final rule confirm that a bank will not have an affirmative duty to seek out all lists compiled by the Federal government and would only be required to check lists provided to it by the Federal government. Some commenters noted that lists published by OFAC are published but are not provided to financial institutions.<sup>32</sup> Many commenters urged that all lists within the meaning of section 326 of the Act,

<sup>32</sup> Nevertheless, the legislative history for this provision indicates that the lists Congress intended financial institutions to consult "are those already supplied to financial institutions by the Office of Foreign Asset Control (OFAC), and occasionally by law enforcement and regulatory authorities, as in the days immediately following the September 11, 2001, attacks on the World Trade Center and the Pentagon." H.R. Rep. No. 107-250, pt. 1, at 63 (2001).

be centralized, issued by a single designated government agency, and provided to financial institutions in a commonly used electronic format. Some of these commenters suggested that instead of providing multiple lists, the government set up a single Web site that would permit a bank to search for a name alphabetically, similar to the OFAC list. Other commenters asked Treasury and the Agencies to clarify what action a bank should take when a customer appears on a list.

Commenters also asked for guidance regarding the timing of when the comparison must be performed and asked whether the lists could be checked after an account is opened. Some commenters stated that there is no practical way for a financial institution to check lists prior to opening an account.

The final rule states that a bank's CIP must include procedures for determining whether the customer appears on any list of known or suspected terrorists or terrorist organizations issued by any Federal government agency and designated as such by Treasury in consultation with the Federal functional regulators. Because Treasury and the Federal functional regulators have not yet designated any such lists, the final rule cannot be more specific with respect to the lists banks must check in order to comply with this provision. However, banks will not have an affirmative duty under this regulation to seek out all lists of known or suspected terrorists or terrorist organizations compiled by the Federal government. Instead, banks will receive notification by way of separate guidance regarding the lists that must be consulted for purposes of this provision.

Treasury and the Agencies have modified this provision to give guidance as to when a bank must consult a list of known or suspected terrorists or terrorist organizations. The final rule states that the CIP's procedures must require the bank to make a determination regarding whether a customer appears on a list "within a reasonable period of time" after the account is opened, or earlier if required by another Federal law or regulation or by a Federal directive issued in connection with the applicable list.

The final rule provides that a bank's CIP must contain procedures requiring the bank to follow all Federal directives issued in connection with such lists. Again, because there are no lists that have been designated under this provision as yet, the final rule cannot provide more guidance in this area.

*Section 103.121(b)(5) Customer Notice.* The proposed rule would have

required a bank's CIP to include procedures for providing bank customers with adequate notice that the bank is requesting information to verify their identity. The preamble for the proposal stated that a bank could satisfy that notice requirement by generally notifying its customers about the procedures the bank must comply with to verify their identities. It stated that the bank could post a notice in its lobby or on its Internet website, or provide customers with any other form of written or oral notice.

Treasury and the Agencies received a large number of comments on this provision. Some commenters did not agree that section 326 of the Act requires notice to bank customers. Some of these commenters suggested that a bank's request for identifying information should be considered adequate notice. Other commenters did not question this requirement and stated that they appreciated the flexibility of this provision. However, a great many commenters asked for additional guidance on the content and timing of the notice and specifically requested that the final rule provide model language so that all institutions represent the requirements of section 326 in the same manner and the adequacy of notice is not left to the interpretation of individual examiners.

Section 326 provides that the regulations issued "shall, at a minimum, require financial institutions to implement, and customers (after being given adequate notice) to comply with reasonable procedures" that satisfy the statute. Based upon this statutory requirement, the final rule requires a bank's CIP to include procedures for providing bank customers with adequate notice that the bank is requesting information to verify their identities. However, the final rule provides additional guidance regarding what constitutes adequate notice and the timing of the notice requirement.

The final rule states that notice is adequate if the bank generally describes the identification requirements of the final rule and provides notice in a manner reasonably designed to ensure that a customer views the notice, or is otherwise given notice, before opening an account. The final rule also states that depending upon the manner in which an account is opened, a bank may post a notice in the lobby or on its website, include the notice on its account applications, or use any other form of oral or written notice. In addition, the final rule includes sample language that, if appropriate, will be deemed adequate notice to a bank's

customers when provided in accordance with the requirements of this final rule.

*Section 103.121(b)(6) Reliance on Another Financial Institution.* Many commenters urged that the final rule permit a bank to rely on a third party to perform elements of the bank's CIP. For example, some commenters asked that the final rule clarify that a bank may use a third party service provider to perform tasks and keep records. Other commenters recommended that the rule should permit a third party to verify the identity of the bank's customer in indirect lending arrangements, for example, where a car dealer acting as agent of the bank extends a loan to a customer or where a mortgage broker acts on a bank's behalf. Some commenters urged that the final rule be modified to more broadly permit financial institutions to share customer identification and verification duties with other financial institutions so as to avoid each institution having to undertake duplicative customer identification efforts. Some of these commenters suggested that a bank be permitted to allocate its responsibility to verify the customer's identity by contract with another financial institution as permitted in the proposed rule for broker-dealers.

Other commenters requested that the final rule permit the CIP obligations to be performed initially by only one financial institution if a customer has different accounts with different affiliates. These commenters noted that it is common for a customer to maintain several different accounts with a financial institution and its affiliates. The same customer, for example, may have a credit card account with one affiliate, a home mortgage with another affiliate, and a brokerage account with a broker-dealer affiliate. The commenters urged that a bank be permitted to rely on customer identification and verification performed by an affiliate because it would be superfluous and unnecessarily burdensome to subject the same customer to substantially similar customer identification and verification procedures on multiple occasions. Furthermore, those commenters urged Treasury and the Agencies to allow a bank to rely on an affiliate in order to reduce the substantial costs of maintaining duplicative records regarding identity verification under the recordkeeping provisions of the rule.

Treasury and the Agencies recognize that there may be circumstances where a bank should be able to rely on the performance by another financial institution of some or all of the elements of the bank's CIP. Therefore, the final rule provides that a bank's CIP may

include procedures specifying when the bank will rely on the performance by another financial institution (including an affiliate) of any procedures of the bank's CIP and thereby satisfy the bank's obligations under the rule. Reliance is permitted if a customer of the bank is opening, or has opened, an account or has established a similar banking or business relationship with the other financial institution to provide or engage in services, dealings, or other financial transactions.

In order for a bank to rely on the other financial institution, such reliance must be reasonable under the circumstances, and the other financial institution must be subject to a rule implementing the anti-money laundering compliance program requirements of 31 U.S.C. 5318(h) and be regulated by a Federal functional regulator. The other financial institution also must enter into a contract requiring it to certify annually to the bank that it has implemented its anti-money laundering program and that it will perform (or its agent will perform) the specified requirements of the bank's CIP. The contract and certification will provide a standard means for a bank to demonstrate the extent to which it is relying on another institution to perform its CIP, and that the institution has in fact agreed to perform those functions. If it is not clear from these documents, a bank must be able to otherwise demonstrate when it is relying on another institution to perform its CIP with respect to a particular customer.

The bank will not be held responsible for the failure of the other financial institution to adequately fulfill the bank's CIP responsibilities, provided the bank can establish that its reliance was reasonable and that it has obtained the requisite contracts and certifications. Treasury and the Agencies emphasize that the bank and the other financial institution upon which it relies must satisfy all of these conditions set forth in the rule. If they do not, then the bank remains solely responsible for applying its own CIP to each customer in accordance with this regulation.

All of the Federal functional regulators are adopting comparable provisions in their respective regulations to permit such reliance. Furthermore, the Federal functional regulators expect to share information and to cooperate with each other to determine whether the institutions subject to their jurisdiction are in compliance with the conditions of the reliance provision of this final rule.

The final rule issued here does not affect a bank's authority to contract for services to be performed by a third party

either on or off the bank's premises. Thus, for example, a bank may contract with a third party service provider to keep its records even when the bank does not act under the reliance provision set forth in the regulation. However, Treasury and the Agencies note that the performance of these services for Federally regulated banks<sup>33</sup> will be subject to regulation and examination by the Agencies under other applicable laws and regulations. See, e.g., 12 U.S.C. 1867.

The final rule also does not alter a bank's authority to use an agent to perform services on its behalf. Therefore, a bank is permitted to arrange for a car dealer or mortgage broker, acting as its agent in connection with a loan, to verify the identity of its customer. However, as with any other responsibility performed by an agent, and in contrast to the reliance provision in the rule, the bank ultimately is responsible for that agent's compliance with the requirements of this final rule.

**Section 103.121(c) Exemptions.** The proposed rule provided that the appropriate Federal functional regulator, with the concurrence of Treasury, may by order or regulation exempt any bank or type of account from the requirements of this section. The proposal stated that, in issuing such exemptions, the Federal functional regulator and Treasury shall consider whether the exemption is consistent with the purposes of the BSA, consistent with safe and sound banking, and in the public interest. The proposal stated that the Federal functional regulator and Treasury also may consider other necessary and appropriate factors.

There were a number of comments suggesting that various types of accounts be exempted from the final rule. For example, several commenters suggested that accounts of Federal, state, and local governmental entities, public companies, and correspondent banks be exempted from the final rule. One commenter suggested that student loan programs be exempted from the rule because current safeguards are sufficient to verify the identity of student loan borrowers. Another commenter suggested that small trust companies and limited purpose banks that provide trust services be exempted from the rule, because such entities are more local in operation, would be burdened

<sup>33</sup> Because it lacks the specific statutory authority to regulate and examine service providers, NCUA, as a matter of safety and soundness, will require credit unions to document that their service providers fully comply with this regulation and with the credit union's customer identification program.

by the rule, and have fewer employees to ensure compliance. Yet another commenter suggested that the NCUA exempt credit unions from the CIP requirements.

Any suggested exemptions that Treasury and the Agencies have determined to be appropriate are incorporated into the definitions of "account" and "customer" for the reasons described above. The exemption provision of the final rule is essentially adopted as proposed with respect to banks that have a Federal functional regulator. Because the final rule will also apply to certain banks that do not have a Federal functional regulator, a new provision has been added to make clear that Treasury alone will make all determinations regarding exemptions for these institutions.

**Section 103.121(d) Other Information Requirements Unaffected.** The proposal provided that nothing in § 103.121 shall be construed to relieve a bank of its obligations to obtain, verify, or maintain information in connection with an account or transaction that is required by another provision in part 103. For example, if an account is opened with a deposit of more than \$10,000 in cash, the bank opening the account must comply with the customer identification requirements in § 103.121, as well as with the provisions of § 103.22, which require that certain information concerning the transaction be reported by filing a Currency Transaction Report (CTR). There were no comments on this provision. Therefore, Treasury and the Agencies have adopted this provision generally as proposed, except that it has been clarified to provide that nothing in § 103.121 should be construed to relieve a bank of any of its obligations, including its obligations to obtain, verify, or maintain information in connection with an account or transaction that is required by another provision in part 103.

### III. Conforming Amendments to 31 CFR 103.34

Section 103.34(a) sets forth customer identification requirements when certain types of deposit accounts are opened. Together with the proposed rule implementing section 326, Treasury, on its own authority, proposed deleting 31 CFR 103.34(a) for the following reasons.

First, the preamble for the proposal explained that Treasury regards the requirements of §§ 103.34(a)(1) and (2) as inconsistent with the intent and purpose of section 326 of the Act and incompatible with proposed section 103.121. Generally §§ 103.34(a)(1) and (2) require a bank, within 30 days after



certain deposit accounts are opened, to secure and maintain a record of the taxpayer identification number of the customer involved. If the bank is unable to obtain the taxpayer identification number within 30 days (or a longer time if the person has applied for a taxpayer identification number), it need take no further action under § 103.34 concerning the account if it maintains a list of the names, addresses, and account numbers of the persons for which it was unable to secure taxpayer identification numbers, and provides that information to Treasury upon request. In the case of a non-resident alien, the bank is required to record the person's passport number or a description of some other government document used to determine identification. These requirements conflicted with those in proposed § 103.121 which required a bank to obtain the name, address, date of birth and an identification number from any person seeking to open a new account.

Second, § 103.34(a)(3) currently provides that a bank need not obtain a taxpayer identification number with respect to specified categories of persons<sup>34</sup> opening certain deposit accounts. Proposed § 103.121 did not exempt any persons from the CIP requirements. Treasury requested comment on whether any of the exemptions in § 103.34(a)(3) should apply in light of the intent and purpose of section 326 of the Act and the requirements of proposed § 103.121.

Third, § 103.34(a)(4) also provides that IRS rules shall determine whose number shall be obtained in the case of multiple account holders. In the preamble that accompanied its proposal, Treasury stated that this provision is

<sup>34</sup>The exemption applies to (i) agencies and instrumentalities of Federal, State, local, or foreign governments; (ii) judges, public officials, or clerks of courts of record as custodians of funds in controversy or under the control of the court; (iii) aliens who are ambassadors; ministers; career diplomatic or consular officers; naval, military, or other attaches of foreign embassies and legations; and members of their immediate families; (iv) aliens who are accredited representatives of certain international organizations, and their immediate families; (v) aliens temporarily residing in the United States for a period not to exceed 180 days; (vi) aliens not engaged in a trade or business in the United States who are attending a recognized college or university, or any training program supervised or conducted by an agency of the Federal Government; (vii) unincorporated subordinate units of a tax exempt central organization that are covered by a group exemption letter; (viii) a person under 18 years of age, with respect to an account opened as part of a school thrift savings program, provided the annual interest is less than \$10; (ix) a person opening a Christmas club, vacation club, or similar installment savings program, provided the annual interest is less than \$10; and (x) non-resident aliens who are not engaged in a trade or business in the United States.

inconsistent with section 326 of the Act, which requires that banks verify the identity of "any" person seeking to open an account.

In addition, Treasury proposed deleting § 103.34(b)(1) which requires a bank to keep "any notations, if such are normally made, of specific identifying information verifying the identity of the signer [who has signature authority over an account] (such as a driver's license number or credit card number)." Treasury stated that the quoted language in § 103.34(b)(1) is inconsistent with the proposed requirements of § 103.121. For this reason, Treasury, under its own authority, proposed to delete the quoted language.

Few comments were received regarding the proposed deletion of these provisions. Some commenters agreed that § 103.34(a) should be deleted if proposed § 103.121 were adopted. One commenter suggested that § 103.34(a) should be revised to achieve the objectives of the section 326 of the Act. One commenter representing a military bank requested continuance of the exemption for agencies and instrumentalities of the Federal government that will permit exemption of commissaries, exchanges and various military organizations. Another commenter requested maintenance of the exemption for government entities, court funds, unincorporated units of tax-exempt organizations, and school thrift programs.

Treasury has determined that given the more comprehensive requirements of the final version of § 103.121, there is no longer a need for § 103.34 (a). A number of the exemptions formerly in § 103.34(a) have now been added to § 103.121. Other exemptions conflict with the language and intent of section 326 of the Act and thus were not adopted in the final rule. While § 103.34(a) will no longer be needed once the final rule is fully effective, withdrawing the provision before October 1, 2003, would create a gap period during which banks would not be subject to a rule under the BSA requiring a customer to be identified when opening an account. Because Treasury and the Agencies do not believe such a gap period would be appropriate, the final rule—rather than withdrawing § 103.34(a)—amends the section to cut off its applicability on October 1, 2003, when § 103.121 becomes fully effective.<sup>35</sup>

<sup>35</sup> Appropriate conforming amendments are made to §§ 103.34(b)(11) and (12) to add a cross-reference to the Internal Revenue Code regarding the rules for determining what constitutes a taxpayer identification number.

By contrast, Treasury no longer believes that it is necessary to delete the quoted language in § 103.34(b), which requires a bank to keep "any notations, if such are normally made, of specific identifying information verifying the identity of [a person with signature authority over an account] (such as a driver's license number or credit card number)." The definition of "customer" in the final version of § 103.121 no longer includes a signatory on an account. Therefore, § 103.121 and § 103.34(b)(1) are not inconsistent and the records required to be kept in accordance with § 103.34(b)(1) will still have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings, or in the conduct of intelligence or counterintelligence activities, and to protect against international terrorism. Therefore, the proposal to delete the quoted language in § 103.34(b)(1) is not adopted as proposed.

#### IV. Technical Amendment to 31 CFR 103.11(j)

Section 103.11(j), which defines the term "deposit account," contains an obsolete reference to the definition of "transaction account," which is defined in § 103.11(hh). Under its own authority, Treasury proposed to correct this reference. There were no comments on this proposed technical correction. Therefore, it is adopted as proposed.

#### V. Regulatory Analysis

##### A. Regulatory Flexibility Act

Under the Regulatory Flexibility Act (RFA), an agency must either prepare a Final Regulatory Flexibility Analysis (FRFA) for a final rule or certify that the final rule will not have a significant economic impact on a substantial number of small entities.<sup>36</sup> See 5 U.S.C. 604 and 605(b).

Treasury and the Agencies have reviewed the impact of this final rule on small banks. Treasury and the Agencies certify that the final rule will not have a significant economic impact on a substantial number of small entities.

First, Treasury and the Agencies believe that banks already have implemented prudential business practices and anti-money laundering

<sup>36</sup> The RFA defines the term "small entity" in 5 U.S.C. 601 by reference to the definitions published by the Small Business Administration (SBA). The SBA has defined a "small entity" for banking purposes as a bank or savings institution with less than \$150 million in assets. See 13 CFR 121.201. The NCUA defines "small credit union" as those under \$1 million in assets. Interpretive Ruling and Policy Statement No. 87-2, Developing and Reviewing Government Regulations (52 FR 35231, September 18, 1987).

programs that include most of the procedures that a CIP must contain under this final rule. Banks generally undertake extensive measures to verify the identity of their customers as a matter of good business practice. In addition, Federally regulated banks already must have anti-money laundering programs that include procedures for identification, verification, and documentation of customer information.<sup>37</sup>

Second, although the final rule contains several requirements that will be new to banks we anticipate that the costs of implementing these requirements will not be economically significant. For example, the recordkeeping requirements in the final rule may impose some costs on banks to the extent that the information that must be maintained is not already collected and retained.<sup>38</sup> Treasury and the Agencies believe that the compliance burden is minimized for banks, including small banks, because the final rule vests a bank with the discretion to design and implement appropriate recordkeeping procedures, including allowing banks to maintain electronic records in lieu of (or in combination with) paper records.

The section of the final rule that requires banks to check lists of known and suspected terrorists and terrorist organizations and to follow Federal agency directives in connection with the lists is also a new requirement that will impose nominal burden, once Treasury and the Agencies publish lists that banks must consult. However, no such lists have been issued to date. Moreover, banks already must have procedures to satisfy other similar requirements. For instance, banks already have to ensure that they do not engage in transactions involving designated foreign countries, foreign nationals, and other entities prohibited under OFAC rules. See 31 CFR part 500. We also understand that many banks, including small banks, use electronic search tools to check lists<sup>39</sup> and already use identity verification software, both as part of their customer due diligence obligations under existing

BSA compliance program requirements and to detect fraud.

The notice provisions of the rule also are new. However, they are very flexible and, as written, should impose only minimal costs. The final rule permits a bank to satisfy the notice requirement by choosing from a variety of low-cost measures, such as posting a sign in the lobby or on its website, by adding it to an account statement, or using any other form of written or oral notice. In addition, the amount of time that a bank will need to develop its notices will be minimal as the final rule now contains a sample notice.

Treasury and the Agencies believe that the flexibility incorporated into the final rule will permit each bank to tailor its CIP to fit its own size and needs. In this regard, Treasury and the Agencies believe that expenditures associated with establishing and implementing a CIP will be commensurate with the size of a bank. If a bank is small, the burden to comply with the proposed rule should be *de minimis*.

Most commenters on the proposed rule stated that Treasury and the Agencies had underestimated the burden imposed by the proposed rule. They highlighted aspects of the proposal that they maintained would have imposed excessive burdens and would have required banks to alter their current practices. Most comments focused on the proposed provisions requiring banks to verify the identity of signatories on accounts, to keep copies of documents used to verify a customer's identity, and to retain identity verification records for five years after an account is closed.

In drafting the final rule, Treasury and the Agencies have either eliminated or minimized the most significant burdens identified by commenters. In response to commenters, for example, the final rule eliminates signatories from the definition of "customer," no longer requires a bank to keep copies of documents used to verify a customer's identity, and reduces the universe of records that must be kept for five years after an account is closed. Treasury and the Agencies have taken other steps that significantly reduce the scope of the rule and burdens of the rule. Many of these burden-reducing actions are described in the Paperwork Reduction Act discussion below.<sup>40</sup> As a result of

these changes, the final rule is far more flexible and less burdensome than the proposed rule while still fulfilling the statutory mandates enumerated in section 326 of the Act.

Finally, Treasury and the Agencies did consider whether it would be appropriate to exempt small banks from the requirements of the rule. We do not believe that an exemption for small banks is appropriate, given the flexibility built into the rule to account for, among other things, the differing sizes and resources of banks, as well as the importance of the statutory goals and mandate of section 326. Money laundering can occur in small banks as well as large banks.

#### B. Paperwork Reduction Act

Certain provisions of the final rule contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*). An agency may not conduct or sponsor, and a respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. Treasury submitted the final rule to the OMB for review in accordance with 44 U.S.C. 3507(d). The OMB has approved the collection of information requirements in today's rule under control number 1506-0026.

that a bank must obtain a physical and a mailing address from a customer opening an account. Under the final rule, the bank is only required to obtain a physical address.

- A new provision that permits a bank to rely on another financial institution to perform its CIP under certain conditions. This provision allows financial institutions that share a customer to share customer identification and verification obligations and to reduce the cost of maintaining duplicative records required by the recordkeeping provisions of the final rule.

- A revised provision that extends to customers who are individuals the exception that permits a bank to open an account for a customer that has applied for, but has not received, a taxpayer identification number.

- A new exemption for credit card accounts from the requirement that a bank obtain identifying information from the customer prior to opening an account. In connection with credit card accounts, a bank is permitted to obtain identifying information from a third party source prior to extending credit.

- A clarification stating that the government will provide lists of known or suspected terrorists and terrorist organizations to banks. Banks will not be required to seek out this information. In addition, the rule now states that the bank may determine whether a customer appears on the list within a reasonable time after the account is opened, unless it is required to do so earlier by another Federal law, regulation, or directive.

- A transition period that permits banks a period of several months to comply with the final rule.

<sup>37</sup> See footnote 10.

<sup>38</sup> See, e.g., identification and verification of customers in connection with each share or deposit account opened (31 CFR 103.34).

<sup>39</sup> We believe that most banks will use technology rather than manual methods to check lists. OFAC lists are generally incorporated into bank software and, in response to bank inquiries, Treasury and the Agencies have made clear that banks are permitted to share the lists they receive pursuant to section 314 of the Act with their service providers. We expect that any lists provided under section 326 of the Act will also be provided under the same conditions.

<sup>40</sup> In addition to the burden-reducing measures discussed in the Paperwork Reduction Act discussion, other changes include:

- A clarification that a bank must verify the customer's identity using the identifying information obtained. The proposed rule would have required the bank to verify all identifying information. The elimination of the requirement

#### Collection of Information Under the Proposed Rule

The proposed rule applied only to a financial institution that is a "bank" as defined in 31 CFR 103.11(c),<sup>41</sup> and any foreign branch of an insured bank. The proposed rule required each bank to establish a written CIP that must include recordkeeping procedures (proposed § 103.121(b)(3)) and procedures for providing customers with notice that the bank is requesting information to verify their identity (proposed § 103.121(b)(5)).

The proposed rule required a bank to maintain a record of (1) the identifying information provided by the customer, the type of identification document(s) reviewed, if any, the identification number of the document(s), and a copy of the identification document(s); (2) the means and results of any additional measures undertaken to verify the identity of the customer; and (3) the resolution of any discrepancy in the identifying information obtained. It also required these records to be maintained at the bank for five years after the date the account is closed (proposed § 103.121(b)(3)).

The proposed rule also required a bank to give its customers "adequate notice" of the identity verification procedures (proposed § 103.121(b)(5)). The proposed rule stated that a bank could satisfy the notice requirement by posting a sign in the lobby or providing customers with any other form of written or oral notice.

#### Collection of Information Under the Final Rule

The final rule, like the proposed rule, requires banks to implement reasonable procedures to (1) maintain records of the information used to verify a customer's identity, and (2) provide notice of these procedures to customers. These recordkeeping and disclosure requirements are required under section 326 of the Act. However, the final rule greatly reduces the paperwork burden attributable to these requirements, as described below.

The final rule also contains a new recordkeeping provision permitting a bank to rely on another financial institution to perform some or all its CIP, under certain circumstances. Among other things, the other financial institution must provide the bank with a contract requiring it to certify annually to the bank that it has implemented its anti-money laundering program, and that it will perform (or its agent will

<sup>41</sup> This definition includes banks, thrifts, and credit unions.

perform) the specified requirements of the bank's CIP.

#### Response to Comments Received

We received approximately 500 comments on the proposed rule. Most of the commenters specifically mentioned the recordkeeping burden associated with the proposed rule. Some commenters also asked Treasury and the Agencies to clarify the meaning of "adequate notice" and requested that a sample notice be provided in the final rule.

Only a few commenters provided burden estimates of additional burden hours that would result from the proposed rule. However, these burden estimates did not necessarily focus on the recordkeeping and disclosure requirements in the proposal and ranged from 200 extra hours per year to 9,000 additional hours. Treasury and the Agencies believe that the final rule substantially addresses the concerns of the commenters. Specific concerns about paperwork burden have been addressed as follows:

First, the recordkeeping and disclosure burden are minimized in the final rule because Treasury and the Agencies reduced the entire scope of the final rule, by:

- Narrowing and clarifying the scope of "account." The final rule specifically excludes accounts that (1) a bank acquires through an acquisition, merger, purchase of assets, or assumption of liabilities from a third party, and (2) accounts opened for the purpose of participating in an employee benefit plan established pursuant to the Employee Retirement Income Security Act of 1974. It also specifically excludes wire transfers, check cashing, and the sale of travelers checks, and any other product or service that does not lead to a "formal banking relationship" from the scope of the rule;

- Narrowing the definition of "bank" covered by the rule to exclude a bank's foreign branches; and

- Limiting and clarifying who is a "customer" for purposes of the final rule. The final rule now defines "customer" as "a person that opens a new account" making clear that a person who does not receive banking services, such as a person whose deposit or loan application is denied, is not a customer. The definition of customer also excludes signatories from the definition of "customer." Moreover, the final rule excludes from the definition of "customer" the following readily-identifiable entities: A financial institution regulated by a Federal functional regulator; a bank regulated by a state bank regulator; and governmental

agencies and instrumentalities and companies that are publicly traded (*i.e.*, entities described in § 103.22(d)(2)(ii)-(iv)). The final rule also excludes existing customers of the bank, provided that the bank has a reasonable belief that it knows the true identity of the person.<sup>42</sup>

Second, recordkeeping burden was further reduced by:

- Eliminating the requirement that a bank keep copies of any document that it relied upon in order to verify the identity of the customer and substituting a requirement that a bank's records need only include "a description" of any document that it relied upon in order to verify the identity of the customer. The final rule also clarifies that the records need only include "a description" of the methods and results of any measure undertaken to verify the identity of the customer, and of the resolution of any substantive discrepancy discovered when verifying the identifying information obtained, rather than any documents generated in connection with these measures; and

- Reducing the length of time that records must be kept. The final rule requires that identifying information be kept for five years after the date the account is closed (or for credit card accounts, five years after the account is closed or becomes dormant). All other records may be kept for five years after the account is opened.

Third, disclosure burden was reduced by providing sample language that, if appropriate and properly provided, will be deemed adequate notice to a bank's customer. Disclosure burden also was reduced by clarifying the term "adequate notice."

Treasury and the Agencies believe that little additional burden is imposed as a result of the recordkeeping requirements outlined in section 103.121(b)(3), because the type of recordkeeping required by the final rule is a usual and customary business practice. In addition, banks already must keep similar records to comply with existing regulations in 31 CFR part 103 (*see, e.g.*, 31 CFR 103.34, requiring certain records for each deposit or share account opened).

Treasury and the Agencies believe that nominal burden is associated with the disclosure requirement outlined in § 103.121(b)(5). This section contains a sample notice that if appropriate and

<sup>42</sup> The proposed rule stated that the identity of an existing customer would not need to be verified if the bank (1) had previously verified the customer's identity in accordance with procedures consistent with the proposed rule, and (2) continues to have a reasonable belief that it knows the true identity of the customer.



provided in accordance with the final rule, will be deemed adequate notice. In addition, it continues to permit banks to choose among a variety of low-cost methods of providing adequate notice and to select the least burdensome method, given the circumstances under which customers seek to open new accounts.

Treasury and the Agencies also believe that nominal burden is associated with the new recordkeeping requirement in § 103.121(b)(6). This section permits a bank to rely on another financial institution to perform some or all its CIP under certain conditions, including the condition that the financial institution enter into a contract with the bank providing that it will certify annually to the bank that it (1) has implemented its anti-money laundering program and (2) will perform (or its agent will perform) the specified requirements of the bank's CIP. Not all banks will choose to rely on a third party. For those that do, the minimal burden of retaining the certification described above should allow them to reduce net burden under the rule by such reliance.

#### Burden Estimates

Treasury and the Agencies have reconsidered the burden estimates published in the proposed rule, given the comments stating that the burdens associated with the paperwork collections were underestimated. Having done so, and considering the reduction in burden taken in this final rule, Treasury and the Agencies have adjusted their estimates of the paperwork burden of this rule. The burden estimates that follow are estimates of the incremental burden imposed upon banks by this final rule, recognizing that some of the requirements in this rule are a usual and customary practice in the banking industry, or duplicate other regulatory requirements.

The potential respondents are national banks and Federal branches and agencies (OCC financial institutions); state member banks and branches and agencies of foreign banks (Board financial institutions); insured state nonmember banks (FDIC financial institutions); savings associations (OTS financial institutions); Federally insured credit unions (NCUA financial institutions); and certain non-Federally regulated credit unions, private banks, and trust companies (FinCEN institutions).

*Estimated number of respondents:*  
OCC: 2207.  
Board: 1240.  
FDIC: 5,500.

OTS: 962.

NCUA: 9,688.

FinCEN: 2,460.

*Estimated average annual recordkeeping burden per respondent:* 10 hours.

*Estimated average annual disclosure burden per respondent:* 1 hour.

*Estimated total annual recordkeeping and disclosure burden:* 242,627 hours.

Treasury and the Agencies invite comment on the accuracy of the burden estimates and invite suggestions on how to further reduce these burdens. Comments should be sent (preferably by fax (202-395-6974)) to Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Office of Management and Budget, Paperwork Reduction Project (1506-0026), Washington, DC 20503 (or by the Internet to [jlackeyj@omb.eop.gov](mailto:jlackeyj@omb.eop.gov)), with a copy to FinCEN by mail or the Internet at the addresses previously specified.

#### Executive Order 12866

Treasury, the OCC, and OTS have determined that the final rule is not a "significant regulatory action" under Executive Order 12866 for the following reasons.

The rule follows closely the requirements of section 326 of the Act. Moreover, Treasury, the OCC, and OTS believe that national banks and savings associations already have procedures in place that fulfill most of the requirements of the final rule because the procedures are a matter of good business practice. In addition, national banks and savings associations already are required to have BSA compliance programs that address many of the requirements detailed in this final rule.

At the proposed rule stage, Treasury, the OCC, and OTS invited national banks, the thrift industry, and the public to provide any cost estimates and related data that they think would be useful in evaluating the overall costs of the rule. Most of the cost estimates provided by commenters related to the requirements in the proposed rule that banks verify the identity of signatories on accounts, keep copies of documents used to verify a customer's identity, and retain identity verification records for five years after an account is closed. As described in the preamble, the final rule eliminates signatories from the definition of "customer," and no longer requires a bank to keep copies of documents used to verify a customer's identity. The final rule also reduces the universe of records that must be kept for five years after an account is closed. Treasury, the OCC and the OTS have taken other steps that significantly reduce the scope of the rule and the

burden of the rule. These burden-reducing measures are described in the Paperwork Reduction Act discussion and Regulatory Flexibility Act discussion, above.<sup>43</sup>

#### List of Subjects

##### 12 CFR Part 21

Crime, Currency, National banks, Reporting and recordkeeping requirements, Security measures.

##### 12 CFR Part 208

Accounting, Agriculture, Banks, banking, Confidential business information, Crime, Currency, Investments, Mortgages, Reporting and recordkeeping requirements, Securities.

##### 12 CFR Part 211

Exports, Foreign banking, Holding companies, Investments, Reporting and recordkeeping requirements.

##### 12 CFR Part 326

Banks, banking, Currency, Insured nonmember banks, Reporting and recordkeeping requirements, Security measures.

##### 12 CFR Part 563

Accounting, Advertising, Crime, Currency, Investments, Reporting and Recordkeeping requirements, Savings associations, Securities, Surety bonds.

##### 12 CFR Part 748

Credit unions, Crime, and Security measures.

##### 31 CFR Part 103

Administrative practice and procedure, Authority delegations (Government agencies), Banks, banking, Brokers, Currency, Foreign banking, Foreign currencies, Gambling, Investigations, Law enforcement, Penalties, Reporting and recordkeeping requirements, Securities.

#### Department of the Treasury

##### 31 CFR Chapter I

#### Authority and Issuance

■ For the reasons set forth in the preamble, part 103 of title 31 of the Code of Federal Regulations is amended as follows:

<sup>43</sup> For these same reasons, and consistent with section 201 of the Unfunded Mandates Reform Act of 1995 (Pub. L. 104-4), Treasury, the OTS and the OCC have also determined that this final rule will not result in expenditures by State, local, and tribal governments in the aggregate, or by the private sector of \$100 million or more in any one year, and therefore the rule is not subject to the requirements of section 202 of that Act.

**PART 103—FINANCIAL RECORDKEEPING AND REPORTING OF CURRENCY AND FOREIGN TRANSACTIONS**

■ 1. The authority citation for part 103 is revised to read as follows:

**Authority:** 12 U.S.C. 1829b and 1951–1959; 31 U.S.C. 5311–5314 and 5316–5332; title III, secs. 312, 313, 314, 319, 326, 352, Pub L. 107–56, 115 Stat. 307.

**§ 103.11 [Amended]**

■ 2. Section 103.11(j) is amended by removing “paragraph (q)” and adding “paragraph (hh)” in its place.

**§ 103.34 [Amended]**

■ 3. Section 103.34 is amended as follows:

■ a. By amending the first sentence of paragraph (a)(1) to add the words “and before October 1, 2003” after the words “May 31, 1978” and after the words “June 30, 1972”;

■ b. By amending paragraph (b)(11) to add the words “as determined under section 6109 of the Internal Revenue Code of 1986” after the words “taxpayer identification number;” and

■ c. By amending paragraph (b)(12) to add the words “as determined under section 6109 of the Internal Revenue Code of 1986” after the words “taxpayer identification number.”

■ 2. Subpart I of part 103 is amended by adding new § 103.121 to read as follows:

**§ 103.121 Customer Identification Programs for banks, savings associations, credit unions, and certain non-Federally regulated banks.**

(a) *Definitions.* For purposes of this section:

(1)(i) *Account* means a formal banking relationship established to provide or engage in services, dealings, or other financial transactions including a deposit account, a transaction or asset account, a credit account, or other extension of credit. *Account* also includes a relationship established to provide a safety deposit box or other safekeeping services, or cash management, custodian, and trust services.

(ii) *Account* does not include:

(A) A product or service where a formal banking relationship is not established with a person, such as check-cashing, wire transfer, or sale of a check or money order;

(B) An account that the bank acquires through an acquisition, merger, purchase of assets, or assumption of liabilities; or

(C) An account opened for the purpose of participating in an employee benefit plan established under the

Employee Retirement Income Security Act of 1974.

(2) *Bank* means:

(i) A bank, as that term is defined in § 103.11(c), that is subject to regulation by a Federal functional regulator; and

(ii) A credit union, private bank, and trust company, as set forth in § 103.11(c), that does not have a Federal functional regulator.

(3)(i) *Customer* means:

(A) A person that opens a new account; and

(B) An individual who opens a new account for:

(1) An individual who lacks legal capacity, such as a minor; or

(2) An entity that is not a legal person, such as a civic club.

(ii) *Customer* does not include:

(A) A financial institution regulated by a Federal functional regulator or a bank regulated by a state bank regulator;

(B) A person described in § 103.22(d)(2)(ii) through (iv); or

(C) A person that has an existing account with the bank, provided that the bank has a reasonable belief that it knows the true identity of the person.

(4) *Federal functional regulator* is defined at § 103.120(a)(2).

(5) *Financial institution* is defined at 31 U.S.C. 5312(a)(2) and (c)(1).

(6) *Taxpayer identification number* is defined by section 6109 of the Internal Revenue Code of 1986 (26 U.S.C. 6109) and the Internal Revenue Service regulations implementing that section (e.g., social security number or employer identification number).

(7) *U.S. person* means:

(i) A United States citizen; or

(ii) A person other than an individual (such as a corporation, partnership, or trust), that is established or organized under the laws of a State or the United States.

(8) *Non-U.S. person* means a person that is not a U.S. person.

(b) *Customer Identification Program: minimum requirements.*

(1) *In general.* A bank must implement a written Customer Identification Program (CIP) appropriate for its size and type of business that, at a minimum, includes each of the requirements of paragraphs (b)(1) through (5) of this section. If a bank is required to have an anti-money laundering compliance program under the regulations implementing 31 U.S.C. 5318(h), 12 U.S.C. 1818(s), or 12 U.S.C. 1786(q)(1), then the CIP must be a part of the anti-money laundering compliance program. Until such time as credit unions, private banks, and trust companies without a Federal functional regulator are subject to such a program, their CIPs must be approved by their boards of directors.

(2) *Identity verification procedures.*

The CIP must include risk-based procedures for verifying the identity of each customer to the extent reasonable and practicable. The procedures must enable the bank to form a reasonable belief that it knows the true identity of each customer. These procedures must be based on the bank's assessment of the relevant risks, including those presented by the various types of accounts maintained by the bank, the various methods of opening accounts provided by the bank, the various types of identifying information available, and the bank's size, location, and customer base. At a minimum, these procedures must contain the elements described in this paragraph (b)(2).

(i) *Customer information required.* (A)

*In general.* The CIP must contain procedures for opening an account that specify the identifying information that will be obtained from each customer. Except as permitted by paragraphs (b)(2)(i)(B) and (C) of this section, the bank must obtain, at a minimum, the following information from the customer prior to opening an account:

(1) Name;

(2) Date of birth, for an individual;

(3) Address, which shall be:

(i) For an individual, a residential or business street address;

(ii) For an individual who does not have a residential or business street address, an Army Post Office (APO) or Fleet Post Office (FPO) box number, or the residential or business street address of next of kin or of another contact individual; or

(iii) For a person other than an individual (such as a corporation, partnership, or trust), a principal place of business, local office, or other physical location; and

(4) Identification number, which shall be:

(i) For a U.S. person, a taxpayer identification number; or

(ii) For a non-U.S. person, one or more of the following: a taxpayer identification number; passport number and country of issuance; alien identification card number; or number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.

**Note to paragraph (b)(2)(i)(A)(4)(ii):** When opening an account for a foreign business or enterprise that does not have an identification number, the bank must request alternative government-issued documentation certifying the existence of the business or enterprise.

(B) *Exception for persons applying for a taxpayer identification number.*

Instead of obtaining a taxpayer identification number from a customer prior to opening the account, the CIP may include procedures for opening an account for a customer that has applied for, but has not received, a taxpayer identification number. In this case, the CIP must include procedures to confirm that the application was filed before the customer opens the account and to obtain the taxpayer identification number within a reasonable period of time after the account is opened.

(C) *Credit card accounts.* In connection with a customer who opens a credit card account, a bank may obtain the identifying information about a customer required under paragraph (b)(2)(i)(A) by acquiring it from a third-party source prior to extending credit to the customer.

(ii) *Customer verification.* The CIP must contain procedures for verifying the identity of the customer, using information obtained in accordance with paragraph (b)(2)(i) of this section, within a reasonable time after the account is opened. The procedures must describe when the bank will use documents, non-documentary methods, or a combination of both methods as described in this paragraph (b)(2)(ii).

(A) *Verification through documents.* For a bank relying on documents, the CIP must contain procedures that set forth the documents that the bank will use. These documents may include:

(1) For an individual, unexpired government-issued identification evidencing nationality or residence and bearing a photograph or similar safeguard, such as a driver's license or passport; and

(2) For a person other than an individual (such as a corporation, partnership, or trust), documents showing the existence of the entity, such as certified articles of incorporation, a government-issued business license, a partnership agreement, or trust instrument.

(B) *Verification through non-documentary methods.* For a bank relying on non-documentary methods, the CIP must contain procedures that describe the non-documentary methods the bank will use.

(1) These methods may include contacting a customer; independently verifying the customer's identity through the comparison of information provided by the customer with information obtained from a consumer reporting agency, public database, or other source; checking references with other financial institutions; and obtaining a financial statement.

(2) The bank's non-documentary procedures must address situations

where an individual is unable to present an unexpired government-issued identification document that bears a photograph or similar safeguard; the bank is not familiar with the documents presented; the account is opened without obtaining documents; the customer opens the account without appearing in person at the bank; and where the bank is otherwise presented with circumstances that increase the risk that the bank will be unable to verify the true identity of a customer through documents.

(C) *Additional verification for certain customers.* The CIP must address situations where, based on the bank's risk assessment of a new account opened by a customer that is not an individual, the bank will obtain information about individuals with authority or control over such account, including signatories, in order to verify the customer's identity. This verification method applies only when the bank cannot verify the customer's true identity using the verification methods described in paragraphs (b)(2)(ii)(A) and (B) of this section.

(iii) *Lack of verification.* The CIP must include procedures for responding to circumstances in which the bank cannot form a reasonable belief that it knows the true identity of a customer. These procedures should describe:

(A) When the bank should not open an account;

(B) The terms under which a customer may use an account while the bank attempts to verify the customer's identity;

(C) When the bank should close an account, after attempts to verify a customer's identity have failed; and

(D) When the bank should file a Suspicious Activity Report in accordance with applicable law and regulation.

(3) *Recordkeeping.* The CIP must include procedures for making and maintaining a record of all information obtained under the procedures implementing paragraph (b) of this section.

(i) *Required records.* At a minimum, the record must include:

(A) All identifying information about a customer obtained under paragraph (b)(2)(i) of this section;

(B) A description of any document that was relied on under paragraph (b)(2)(ii)(A) of this section noting the type of document, any identification number contained in the document, the place of issuance and, if any, the date of issuance and expiration date;

(C) A description of the methods and the results of any measures undertaken to verify the identity of the customer

under paragraph (b)(2)(ii)(B) or (C) of this section; and

(D) A description of the resolution of any substantive discrepancy discovered when verifying the identifying information obtained.

(ii) *Retention of records.* The bank must retain the information in paragraph (b)(3)(i)(A) of this section for five years after the date the account is closed or, in the case of credit card accounts, five years after the account is closed or becomes dormant. The bank must retain the information in paragraphs (b)(3)(i)(B), (C), and (D) of this section for five years after the record is made.

(4) *Comparison with government lists.* The CIP must include procedures for determining whether the customer appears on any list of known or suspected terrorists or terrorist organizations issued by any Federal government agency and designated as such by Treasury in consultation with the Federal functional regulators. The procedures must require the bank to make such a determination within a reasonable period of time after the account is opened, or earlier, if required by another Federal law or regulation or Federal directive issued in connection with the applicable list. The procedures must also require the bank to follow all Federal directives issued in connection with such lists.

(5)(i) *Customer notice.* The CIP must include procedures for providing bank customers with adequate notice that the bank is requesting information to verify their identities.

(ii) *Adequate notice.* Notice is adequate if the bank generally describes the identification requirements of this section and provides the notice in a manner reasonably designed to ensure that a customer is able to view the notice, or is otherwise given notice, before opening an account. For example, depending upon the manner in which the account is opened, a bank may post a notice in the lobby or on its website, include the notice on its account applications, or use any other form of written or oral notice.

(iii) *Sample notice.* If appropriate, a bank may use the following sample language to provide notice to its customers:

**IMPORTANT INFORMATION ABOUT PROCEDURES FOR OPENING A NEW ACCOUNT**

To help the government fight the funding of terrorism and money laundering activities, Federal law requires all financial institutions to obtain, verify, and record information that identifies each person who opens an account.

What this means for you: When you open an account, we will ask for your name,

address, date of birth, and other information that will allow us to identify you. We may also ask to see your driver's license or other identifying documents.

(6) *Reliance on another financial institution.* The CIP may include procedures specifying when a bank will rely on the performance by another financial institution (including an affiliate) of any procedures of the bank's CIP, with respect to any customer of the bank that is opening, or has opened, an account or has established a similar formal banking or business relationship with the other financial institution to provide or engage in services, dealings, or other financial transactions, provided that:

(i) Such reliance is reasonable under the circumstances;

(ii) The other financial institution is subject to a rule implementing 31 U.S.C. 5318(h) and is regulated by a Federal functional regulator; and

(iii) The other financial institution enters into a contract requiring it to certify annually to the bank that it has implemented its anti-money laundering program, and that it will perform (or its agent will perform) the specified requirements of the bank's CIP.

(c) *Exemptions.* The appropriate Federal functional regulator, with the concurrence of the Secretary, may, by order or regulation, exempt any bank or type of account from the requirements of this section. The Federal functional regulator and the Secretary shall consider whether the exemption is consistent with the purposes of the Bank Secrecy Act and with safe and sound banking, and may consider other appropriate factors. The Secretary will make these determinations for any bank or type of account that is not subject to the authority of a Federal functional regulator.

(d) *Other requirements unaffected.* Nothing in this section relieves a bank of its obligation to comply with any other provision in this part, including provisions concerning information that must be obtained, verified, or maintained in connection with any account or transaction.

Dated: April 28, 2003.

**James F. Sloan,**  
Director, Financial Crimes Enforcement Network.

Dated: April 17, 2003.

In concurrence:  
**John D. Hawke, Jr.,**  
Comptroller of the Currency.

In concurrence:

By order of the Board of Governors of the Federal Reserve System, April 21, 2003.

**Jennifer J. Johnson,**  
Secretary of the Board.

In concurrence:

By order of the Board of Directors of the Federal Deposit Insurance Corporation this 16th day of April, 2003.

**Valerie J. Best,**  
Assistant Executive Secretary.

In concurrence:

Dated: April 9, 2003.

**James E. Gilleran,**  
Director, Office of Thrift Supervision.

In concurrence:

Dated: April 7, 2003.

**Becky Baker,**  
Secretary of the Board, National Credit Union Administration.

**Office of the Comptroller of the Currency**

12 CFR Chapter I

**Authority and Issuance**

■ For the reasons set out in the preamble, the OCC amends chapter I of title 12 of the Code of Federal Regulations as set forth below:

**PART 21—MINIMUM SECURITY DEVICES AND PROCEDURES, REPORTS OF SUSPICIOUS ACTIVITIES, AND BANK SECRECY ACT COMPLIANCE PROGRAM**

**Subpart C—Procedures for Monitoring Bank Secrecy Act Compliance**

■ 1. The authority citation for part 21, subpart C, continues to read as follows:

Authority: 12 U.S.C. 93a, 1818, 1881–1884 and 3401–3422; 31 U.S.C. 5318.

■ 2. In § 21.21:

- A. Revise the section heading; and
- B. Revise § 21.21(b) to read as follows:

**§ 21.21 Procedures for monitoring Bank Secrecy Act (BSA) compliance.**

\* \* \* \* \*

(b) *Establishment of a BSA compliance program.* (1) *Program requirement.* Each bank shall develop and provide for the continued administration of a program reasonably designed to assure and monitor compliance with the recordkeeping and reporting requirements set forth in subchapter II of chapter 53 of title 31, United States Code and the implementing regulations issued by the Department of the Treasury at 31 CFR part 103. The compliance program must be written, approved by the bank's board of directors, and reflected in the minutes of the bank.

(2) *Customer identification program.* Each bank is subject to the requirements

of 31 U.S.C. 5318(l) and the implementing regulation jointly promulgated by the OCC and the Department of the Treasury at 31 CFR 103.121, which require a customer identification program to be implemented as part of the BSA compliance program required under this section.

\* \* \* \* \*

Dated: April 17, 2003.

**John D. Hawke, Jr.,**  
Comptroller of the Currency.

**Federal Reserve System**

12 CFR Chapter II

**Authority and Issuance**

■ For the reasons set out in the preamble, the Board of Governors of the Federal Reserve System amends 12 CFR Chapter II as follows:

**PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)**

■ 1. The authority citation for part 208 continues to read as follows:

Authority: 12 U.S.C. 24, 24a, 36, 92a, 93a, 248(a), 248(c), 321–338a, 371d, 461, 481–486, 601, 611, 1814, 1816, 1818, 1820(d)(9), 1823(j), 1828(o), 1831, 1831o, 1831p–1, 1831r–1, 1831w, 1831x, 1835a, 1843(l), 1882, 2901–2907, 3105, 3310, 3331–3351, and 3906–3909; 15 U.S.C. 78b, 78l(b), 78l(g), 78l(i), 78o–4(c)(5), 78q, 78q–1, and 78w; 31 U.S.C. 5318; 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128.

■ 2. Revise § 208.63(b) to read as follows:

**§ 208.63 Procedures for monitoring Bank Secrecy Act compliance.**

\* \* \* \* \*

(b) *Establishment of BSA compliance program.* (1) *Program requirement.* Each bank shall develop and provide for the continued administration of a program reasonably designed to ensure and monitor compliance with the recordkeeping and reporting requirements set forth in subchapter II of chapter 53 of title 31, United States Code, the Bank Secrecy Act, and the implementing regulations promulgated thereunder by the Department of the Treasury at 31 CFR part 103. The compliance program shall be reduced to writing, approved by the board of directors, and noted in the minutes.

(2) *Customer identification program.* Each bank is subject to the requirements of 31 U.S.C. 5318(l) and the implementing regulation jointly promulgated by the Board and the Department of the Treasury at 31 CFR 103.121, which require a customer identification program to be

implemented as part of the BSA compliance program required under this section.

**PART 211—INTERNATIONAL BANKING OPERATIONS (REGULATION K)**

■ 1. The authority citation for part 211 is revised to read as follows:

Authority: 12 U.S.C. 221 *et seq.*, 1818, 1835a, 1841 *et seq.*, 3101 *et seq.*, and 3901 *et seq.*; 15 U.S.C. 6801 and 6805; 31 U.S.C. 5318.

■ 2. In § 211.5, add new paragraph (m) to read as follows:

**§ 211.5 Edge and agreement corporations.**

(m) *Procedures for monitoring Bank Secrecy Act compliance.*

(1) [Reserved]

(2) *Customer identification program.*

Each Edge or agreement corporation is subject to the requirements of 31 U.S.C. 5318(l) and the implementing regulation jointly promulgated by the Board and the Department of the Treasury at 31 CFR 103.121, which require a customer identification program.

■ 3. In § 211.24, add new paragraph (j) to read as follows:

**§ 211.24 Approval of offices of foreign banks; procedures for applications; standards for approval; representative office activities and standards for approval; preservation of existing authority.**

(j) *Procedures for monitoring Bank Secrecy Act compliance.*

(1) [Reserved]

(2) *Customer identification program.*

Except for a federal branch or a federal agency or a state branch that is insured by the FDIC, a branch, agency, or representative office of a foreign bank operating in the United States is subject to the requirements of 31 U.S.C. 5318(l) and the implementing regulation jointly promulgated by the Board and the Department of the Treasury at 31 CFR 103.121, which require a customer identification program.

By order of the Board of Governors of the Federal Reserve System, April 21, 2003.

Jennifer J. Johnson,  
Secretary of the Board.

Federal Deposit Insurance Corporation  
12 CFR Chapter III

**Authority and Issuance**

■ For the reasons set out in the preamble, the FDIC amends title 12, chapter III of the Code of Federal Regulations, as set forth below:

**PART 326—Minimum Security Devices and Procedures and Bank Secrecy Act Compliance**

■ 1. The authority citation for part 326 is revised to read as follows:

Authority: 12 U.S.C. 1813, 1815, 1817, 1818, 1819 (Tenth), 1881–1883; 31 U.S.C. 5311–5314 and 5316–5332.2.

■ 2. Revise § 326.8(b) to read as follows:

**§ 326.8 Bank Secrecy Act compliance.**

(b) *Compliance procedures.* (1) *Program requirement.* Each bank shall develop and provide for the continued administration of a program reasonably designed to assure and monitor compliance with recordkeeping and reporting requirements set forth in subchapter II of chapter 53 of title 31, United States Code and the implementing regulations issued by the Department of the Treasury at 31 CFR part 103. The compliance program shall be written, approved by the bank's board of directors, and noted in the minutes.

(2) *Customer identification program.* Each bank is subject to the requirements of 31 U.S.C. 5318(l) and the implementing regulation jointly promulgated by the FDIC and the Department of the Treasury at 31 CFR 103.121, which require a customer identification program to be implemented as part of the Bank Secrecy Act compliance program required under this section.

By order of the Board of Directors of the Federal Deposit Insurance Corporation this 16th day of April, 2003.

Valerie J. Best,  
Assistant Executive Secretary.

Office of Thrift Supervision

12 CFR Chapter V

**Authority and Issuance**

■ For the reasons set out in the preamble, OTS amends title 12, chapter V of the Code of Federal Regulations, as set forth below:

**PART 563—SAVINGS ASSOCIATIONS—OPERATIONS**

■ 1. The authority citation for part 563 is revised to read as follows:

Authority: 12 U.S.C. 375b, 1462, 1462a, 1463, 1464, 1467a, 1468, 1817, 1820, 1828, 1831a, 3806; 31 U.S.C. 5318; 42 U.S.C. 4106.

■ 2. In § 563.177:

- A. Revise the section heading; and
- B. Revise paragraph (b) to read as follows:

**§ 563.177 Procedures for monitoring Bank Secrecy Act (BSA) compliance.**

(b) *Establishment of a BSA compliance program.* (1) *Program requirement.* Each savings association shall develop and provide for the continued administration of a program reasonably designed to assure and monitor compliance with the recordkeeping and reporting requirements set forth in subchapter II of chapter 53 of title 31, United States Code and the implementing regulations issued by the Department of the Treasury at 31 CFR part 103. The compliance program must be written, approved by the savings association's board of directors, and reflected in the minutes of the savings association.

(2) *Customer identification program.* Each savings association is subject to the requirements of 31 U.S.C. 5318(l) and the implementing regulation jointly promulgated by the OTS and the Department of the Treasury at 31 CFR 103.121, which require a customer identification program to be implemented as part of the BSA compliance program required under this section.

Dated: April 9, 2003.

James E. Gilleran,  
Director, Office of Thrift Supervision.

National Credit Union Administration  
12 CFR Chapter VII

**Authority and Issuance**

■ For the reasons set out in the preamble, NCUA amends title 12, chapter VII of the Code of Federal Regulations, as set forth below:

**PART 748—SECURITY PROGRAM, REPORT OF CRIME AND CATASTROPHIC ACT AND BANK SECRECY ACT COMPLIANCE**

■ 1. The authority citation for part 748 is revised to read as follows:

Authority: 12 U.S.C. 1786(a), 1786(q); 15 U.S.C. 6801 and 6805(b); 31 U.S.C. 5311 and 5318.

■ 2. In § 748.2:

- A. Revise the section heading; and
- B. Revise paragraph (b) to read as follows:

**§ 748.2 Procedures for monitoring Bank Secrecy Act (BSA) compliance.**

(b) *Establishment of a BSA compliance program.* (1) *Program requirement.* Each federally-insured credit union shall develop and provide for the continued administration of a

program reasonably designed to assure and monitor compliance with the recordkeeping and recording requirements set forth in subchapter II of chapter 53 of title 31, United States Code and the implementing regulations issued by the Department of the Treasury at 31 CFR part 103. The compliance program must be written, approved by the credit union's board of directors, and reflected in the minutes of the credit union.

(2) *Customer identification program.* Each federally-insured credit union is subject to the requirements of 31 U.S.C. 5318(l) and the implementing regulation jointly promulgated by the NCUA and the Department of the Treasury at 31 CFR 103.121, which require a customer identification program to be implemented as part of the BSA compliance program required under this section.

\* \* \* \* \*

Dated: April 7, 2003.

**Becky Baker,**  
*Secretary of the Board, National Credit Union  
Administration.*

[FR Doc. 03-11019 Filed 5-8-03; 8:45 am]

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7537-01-P; 4810-33-P; 6714-01-P



**UNITED STATES OF AMERICA  
DEPARTMENT OF THE TREASURY  
FINANCIAL CRIMES ENFORCEMENT NETWORK**

**IN THE MATTER OF  
RIGGS BANK, N.A.**

**No. 2004-01**

**ASSESSMENT OF CIVIL MONEY PENALTY**

**I. INTRODUCTION**

The Secretary of the United States Department of the Treasury has delegated to the Director of the Financial Crimes Enforcement Network ("FinCEN") the authority to determine whether a financial institution has violated the Bank Secrecy Act, 31 USC §§5311 et seq. and 31 CFR Part 103 thereunder ("BSA"), and what, if any, sanction is appropriate.

In order to resolve this matter, and only for that purpose, Riggs Bank N.A. ("Riggs") has entered into a CONSENT TO THE ASSESSMENT OF CIVIL MONEY PENALTY ("CONSENT") dated May 13, 2004, without admitting or denying FinCEN's determinations described in Sections III and IV below, except as to jurisdiction in Section II below, which is admitted.

The CONSENT is incorporated into this ASSESSMENT OF CIVIL MONEY PENALTY ("ASSESSMENT") by this reference.

**II. JURISDICTION**

Riggs is the principal subsidiary of Riggs National Corporation, a publicly traded bank holding company based in Washington, D.C. As of December 31, 2003, Riggs had assets of approximately \$6 billion, deposits of \$4.29 billion, and stockholders' equity of \$427.2 million. Riggs is a "financial institution" and a "bank" within the meaning of 31 USC §5312(a)(2) and 31 CFR §103.11. The Office of the Comptroller of the Currency (the "OCC") is Riggs' primary federal supervisory agency and examines Riggs for BSA compliance.

**III. FINDINGS**

**A. Summary of Violations**

FinCEN has determined that Riggs willfully violated the suspicious activity and currency transaction reporting requirements of the BSA and its implementing regulations, and that Riggs has willfully violated the anti-money laundering program ("AML program") requirement of the BSA and its implementing regulations. The violations



Riggs engaged in were systemic – Riggs was deficient in designing a program tailored to the risks of its business that would ensure appropriate reporting, implementing the procedures it did have, and responding to classic “red flags” of suspicious conduct. Riggs failed to correct the violations and implement an adequate BSA program in a timely manner. Consequently, on July 16, 2003, the OCC entered into a comprehensive Consent Order with Riggs to correct the deficiencies and referred the BSA violations to FinCEN for a determination of whether a civil penalty was warranted. Since then, however, additional violations occurred and the OCC is concurrently issuing a supplemental Consent Order requiring additional corrective actions.

**B. Violations of the Anti-Money Laundering Program Requirements**

FinCEN has determined that Riggs has been in violation of the AML program requirements of the BSA. As of April 24, 2002, the BSA has required banks to establish an AML program to guard against money laundering. A bank regulated by a Federal functional regulator is deemed to have satisfied the requirements of 31 USC §5318(h)(1) if it implements and maintains an AML program that complies with the regulation of its Federal functional regulator governing such programs. 31 CFR §103.120. Since January 27, 1987, the OCC has required each bank under its supervision to establish and maintain a BSA compliance program that, at a minimum: (a) provides for a system of internal controls to ensure ongoing compliance; (b) provides for independent testing for compliance conducted by bank personnel or an outside party; (c) designates an individual or individuals responsible for coordinating and monitoring day-to-day compliance; and (d) provides training for appropriate personnel. 12 CFR §21.21(c).

Riggs’ program contained serious deficiencies and was not in compliance with the BSA regulations. In January 2003, Riggs’ program was deficient in all four elements required by the AML program regulation. Some of the internal control and audit deficiencies continued after the OCC’s Consent Order was issued. These deficiencies are described in detail below.

**1. Internal Controls**

Riggs’ system of internal controls was inadequate to ensure ongoing compliance with the BSA across all business lines. Riggs’ internal controls were not designed to take into account the exposure posed by the customers, products, services, and accounts from high-risk international geographic locations that are commonly viewed as high-risk for money laundering. Indeed, Riggs’ internal controls proved insufficient to detect and monitor risk, or to alert the bank to the need to take preventive or corrective action when the risk materialized.

Riggs did not implement an effective system to identify and assess the BSA/AML risk present throughout the institution. The risk matrices used in some of Riggs’ divisions all contained similar criteria, rather than being tailored to the particular lines of business on a risk-graded basis, which weakened their effectiveness. As a result, management was unable to define and analyze concentrations of risk in the accounts, customers, locations, and products of Riggs.

Riggs' customer due diligence program was weak and was not implemented in an effective or consistent manner. Certain areas of Riggs failed to acquire or to use the bank's account opening and customer activity information collection procedures. Further, customer due diligence information required by Riggs' policies and procedures was frequently missing. As a result, Riggs failed to identify a large number of accounts associated with the governments of two foreign countries. Moreover, Riggs' enhanced due diligence policies and procedures governing high-risk areas were weak or, in some cases, nonexistent. High-risk areas include high-risk transactions such as transactions payable upon proper identification ("PUPID"), high-risk customers such as check cashers and money remitters, and accounts involving high-risk international geographic locations including international private banking, embassy banking, politically exposed persons, and non-resident aliens. On two occasions, although Riggs' management said that the institution had discontinued PUPID transactions, Riggs allowed the transactions to continue.

Riggs also failed to implement adequate internal controls to ensure the identification of suspicious transactions and the timely filing of complete suspicious activity reports ("SARs") on reportable transactions. Riggs did not effectively use procedures and automated technology already in place to identify and review suspicious cash, monetary instruments, or wire activity. Riggs did not have procedures or internal controls to ensure that subpoenas and other government requests regarding accountholders were referred to the division responsible for investigating potential suspicious activity.

Finally, internal controls were lacking in Riggs' management of its largest banking relationship, which involved the accounts of a foreign government, its politically exposed persons, and the companies owned by such persons (described section III.C.3. below). There was insufficient staff and procedures to monitor the accounts and a lack of oversight over the account relationship manager and his staff. These problems continued even after numerous warning signs indicated that Riggs needed to take corrective action.

## 2. Independent Testing

Riggs did not implement an adequate system for independent testing of BSA compliance. The independent testing for compliance with the BSA was neither timely nor effective for the level of risk within Riggs. The internal audit could not verify that management's corrective action for identified deficiencies were effective or timely. In addition, the scope of the audit failed to include an evaluation of the areas of money laundering vulnerabilities, BSA compliance, or the suspicious activity reporting process.

3. Designation of Individual(s) to Coordinate and Monitor Compliance

Riggs also lacked effective monitoring for compliance by the BSA officer. Day-to-day oversight and monitoring of high-risk transactions, high-risk customers, and high-risk geographies were minimal. Strategies and alternative measures to ensure ongoing BSA/AML monitoring for suspicious transactions were not adequately developed and applied. In addition, the person(s) responsible for BSA compliance at Riggs failed to adequately monitor, identify, investigate, analyze, and report suspicious activity.

4. Training Appropriate Personnel

Training on monitoring and detecting suspicious activity was particularly weak at Riggs. For example, bank officer visits to customer business locations did not include assessments of BSA/AML risk factors. In addition, branch personnel most familiar with accounts held by money services businesses ("MSBs") were unaware of the factors that typically are associated with suspicious activity and the new BSA registration requirements for MSBs.

In summary, Riggs failed to develop and maintain an effective BSA compliance program in violation of 12 CFR § 21.21(c) and, thus, failed to establish and implement an adequate AML program in violation of § 5318(h)(1) of the BSA and its implementing regulation, 31 CFR § 103.120. Riggs' faulty AML program resulted in its violation of the suspicious activity and currency transactions reporting requirements of the BSA, as discussed below.

C. Violations of the SAR Requirements

FinCEN has determined that from 2000 through 2003, Riggs violated the SAR requirements of the BSA set forth in 31 USC §5318(g) and 31 CFR §103.18 by failing to file or by delinquently filing approximately 33 SARs. These 33 SARs represent at least \$98 million in suspicious transactions.<sup>1</sup>

1. SAR Requirements

A bank must report any transaction involving or aggregating to at least \$5,000 that it "knows, suspects, or has reason to suspect" (i) involves funds derived from illegal activities or is conducted to disguise funds derived from illegal activities, (ii) is designed to evade the reporting or recordkeeping requirements of the BSA (e.g., structuring transactions to avoid currency transaction reporting) or (iii) "has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the bank knows of no reasonable explanation for the transaction

<sup>1</sup> These SARs report transactions and categories of transactions described below. Generally, Riggs' SAR program suffered from a lack of timeliness. FinCEN's review of SARs filed by Riggs from February 2000 through April 2004 disclosed an additional 61 SARs that were filed more than 60 days after the suspicious activity occurred.

after examining the available facts, including the background and possible purpose of the transaction.” 31 USC §5318(g) and 31 CFR §103.18.

The SAR regulation requires a bank to file SARs “to the extent and in the manner required by this section” by “completing” a SAR Form. 31 CFR §103.18(a). A bank must file a SAR no later than 30 calendar days after the date of initial detection of facts that may constitute a basis for filing a SAR. 31 CFR §103.18(b)(3) and Instructions to SAR Form, TD F 90-22.47. If no suspect is identified on the date of the detection of the incident requiring the filing, a bank may delay filing a SAR for an additional 30 calendar days to identify a suspect. In no case is reporting to be delayed more than 60 calendar days after the date of initial detection of a reportable transaction. When filing a SAR, a bank must provide a detailed description of why the transaction was unusual, irregular, or suspicious in the narrative section of the form. Part V, SAR Form, TD F 90-22.47. The form requires “a chronological and complete account” of the transaction. The form emphasizes that the narrative description “is critical” and that the care with which it is written “may determine whether or not the described conduct and its possible criminal nature are clearly understood” by law enforcement.

To comply with the SAR rule, a bank must be able to determine whether transactions are in fact reportable. Therefore, a bank is required to have in place systems to identify the kinds of transactions and accounts that may be a high risk for money laundering or that exhibit indicia of suspicious activity, considering the type of products and services it offers and the nature of its customers. Otherwise, a bank cannot assure that it is in fact reporting suspicious transactions as required by the BSA.<sup>2</sup> In this case, the record shows that Riggs had information about its customers and their transactions that caused it to “know, suspect, or have reason to suspect” that many transactions were reportable suspicious transactions. However, Riggs failed to report these transactions, delinquently reported them, and/or filed incomplete reports because Riggs’ procedures to identify, analyze, and report suspicious activity were either non-existent or not implemented. As a result, Riggs violated the SAR requirements of 31 USC §5318(g) and 31 CFR §103.18.

## 2. Basic Deficiencies in SAR Procedures and Filings

As noted above, subpoenas and other matters were not appropriately referred for investigation. As a result, Riggs failed to identify for review accounts in which suspicious activity might be occurring. The SARs that were eventually filed by Riggs reported activity that occurred two to three years before the date of filing.

Structuring, which is the breaking up of transactions for the purpose of evading the BSA reporting and recordkeeping requirements, is often indicative of underlying illegal activity. It is also unlawful under the BSA. See 31 USC §5324. Structuring is one of the most basic situations that an effective SAR program should be designed to detect and report.<sup>3</sup> Riggs failed to discover that several customers had been structuring

<sup>2</sup> See Matter of Korea Exchange Bank, No. 2003-04 (June 24, 2003).

<sup>3</sup> See Matter of Western Union, No. 2003-2 (March 6, 2003).

transactions. These instances included the regular structuring of cash deposits into the bank, as well as the structuring of money order purchases. Riggs belatedly filed SARs on these transactions. However, most of these SARs were deficient because the narrative descriptions of the transactions were sparse and conclusory. Rather than providing specific information on the type, timing, and amount of activity observed in each account, Riggs simply stated that there was an appearance of structuring. Riggs also failed to report the total dollar amount allegedly structured in each account. Such deficiencies make it difficult for law enforcement to evaluate whether the activity described in the SAR is worth pursuing.<sup>4</sup>

### 3. Embassy Banking/International Private Banking Relationships

Extensive and frequent suspicious cash, monetary instrument, and wire activity at Riggs occurred within the accounts held by the government of a foreign country, politically exposed persons of that country, and the companies owned by such persons, where very little monitoring of activity was performed by the bank. Within this relationship, there were a number of transactions that exhibited classic indicators of suspicious activity, or at a minimum lacked any reasonable business or economic purpose, but were never identified and reported. These transactions included:

- aggregate cash withdrawals from the accounts of the government, politically exposed persons, and government employees that totaled tens of million of dollars over a 2-year period, the majority of which were conducted through PUPID transactions;
- dozens of sequentially numbered international drafts drawn from a politically exposed person's account on 3 dates over a 2-month period, totaling millions of dollars, and made payable to the account holder, which were returned to Riggs for crediting back to the account; and
- dozens of sequentially numbered cashier's checks purchased from the same above-listed account on 3 different dates over a period of six months, totaling tens of millions of dollars, and made payable to the account holder, half of which were returned to Riggs for deposit back into the account.

Riggs also failed to identify, monitor, and report suspicious activity related to the accounts of another foreign government, its politically exposed persons, and the companies owned by such persons. This was among Riggs' largest depository relationships; however, the relationship manager for these accounts had little or no supervision. Riggs failed to monitor the activity in these accounts, despite various indicators in early 2003 that should have alerted it to the high-risk nature of the relationship, including publication of a newspaper article alleging official corruption and Riggs' receipt of a subpoena requiring documents regarding the relationship.<sup>5</sup> Meanwhile, Riggs failed to implement controls or monitor the ongoing activity.

<sup>4</sup> See Matter of Great Eastern Bank of Florida, No. 2002-02 (Sept. 4, 2002).

<sup>5</sup> Guidance on applying scrutiny to situations of this type has been available for some time. See Guidance on Enhanced Scrutiny for Transactions that May Involve the Proceeds of Foreign Corruption (January

As a result of these deficiencies, Riggs could not properly identify, evaluate, and report suspicious activity occurring in the relationship, including activity by its employee, the relationship manager. Riggs failed to discover that the relationship manager had signatory authority over two accounts within the relationship, received funds from a government account within the relationship, and failed to file SARs on a timely basis. Examples of the relationship manager's suspicious transactions with respect to this relationship include:

- alteration of a check from the account of a politically exposed person who is the relative of a government official; and
- over \$1 million in wire transfers from accounts owned by the government into the account of a private investment corporation owned by the relationship manager at another U.S. bank.

Riggs also failed to identify, evaluate, and report on suspicious activity occurring in the accounts owned by the government involving transactions by and for the benefit of politically exposed persons, including:

- cash deposits into the account of a private investment corporation owned by a politically exposed person who is a government official, totaling millions of dollars, over a 2-year period; and
- wire transfers, totaling hundreds of thousands of dollars, from a government account to the personal account of another government official who had signature authority over the government account.

#### D. Violations of the CTR Requirements

FinCEN has determined that Riggs violated the BSA currency transaction reporting requirements set forth at 31 CFR §103.27(d) by failing to provide accurate information or omitting information on numerous currency transaction reports ("CTRs"). Under the BSA, banks are required to file CTRs for transactions in currency greater than \$10,000 in a single day. 31 USC §5313 and 31 CFR §103.22. Banks are required to file CTRs in the form prescribed by the Secretary of the Treasury and provide all the information called for by the form. 31 CFR §103.27(d).

The CTRs filed by Riggs on two markets did not contain the accurate legal names of those businesses. Over a one-year period, Riggs filed 90 CTRs representing \$6 million for one market and 52 CTRs representing \$1.3 million for the other market. The businesses had been long-standing customers of Riggs before Riggs began filing CTRs with their accurate legal names.

Riggs' failure to collect, document, and verify customer and account information resulted in its failure to provide accurate information on 6 CTRs filed on a company

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2001), which was jointly issued by the Departments of the Treasury and State, the OCC, the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision.

owned by a politically exposed person who is a foreign government official. In the CTRs, Riggs reported the company's line of business as the export of timber, although the entity was actually a private investment company holding the personal investments of a politically exposed person who is a foreign government official. Together, the 6 CTRs revealed \$11.5 million in cash deposited over 2 years.

E. Willful Nature of BSA Violations

FinCEN has determined that Riggs' violations of the BSA and its implementing regulations were willful. The conduct of a bank may be characterized as willful if it demonstrates a reckless disregard for its obligations under law or regulation. As an OCC-supervised bank, Riggs was aware of the AML program, SAR, and CTR requirements of the BSA and its implementing regulations. Riggs' failure to establish and implement a BSA/AML program adequate to meet its suspicious activity and currency transaction reporting requirements constitute systemic violations demonstrating a reckless disregard of its obligations under the BSA.

Riggs' willfulness is further demonstrated by its failure to correct identified deficiencies. The OCC deemed Riggs' BSA compliance systemically deficient in 2003 and thus entered into a Consent Order with Riggs on July 16, 2003. However, Riggs is not in full compliance with the OCC's July 2003 Consent Order. Riggs' failure to establish and implement an adequate BSA compliance program, followed by its failure to correct deficiencies identified by its primary Federal regulator, is a pattern of conduct indicative of willfulness.

IV. CIVIL MONEY PENALTY

FinCEN has determined that by failing (1) to establish and implement an adequate AML program, (2) to file timely, accurate, and complete SARs, and (3) to file accurate and complete CTRs as described in Section III, above, Riggs willfully violated the AML program, SAR, and CTR provisions of the BSA and a civil money penalty is due pursuant to 31 USC §5321 and 31 CFR §103.57(f). In light of the seriousness of the violations, their continuing and ongoing nature, the potential harm they pose to the public, and taking into account the financial resources of Riggs, FinCEN has determined that the appropriate penalty amount in this matter is \$25 million.

V. CONSENT TO ASSESSMENT

In order to resolve this matter, and only for that purpose, Riggs, without admitting or denying either the facts or determinations described in Sections III and IV above, except as to jurisdiction in Section II, which is admitted, consents to the assessment of a civil money penalty against it in the sum of \$25 million. This penalty assessment shall be concurrent with the \$25 million penalty assessed against Riggs by the OCC. The penalty assessment of FinCEN and the OCC referenced above shall be satisfied by one payment of \$25 million to the Department of the Treasury.

Riggs agrees to pay the amount of \$25 million upon the assessment of the civil money penalty. Such payment shall be:

- a. made by certified check, bank cashier's check, or bank money order or by wire;
- b. made payable to the United States Department of the Treasury;
- c. any check or money order or copy of the wire transfer must be hand-delivered or sent by overnight mail to Nicholas A. Procaccini, Assistant Director and Chief Financial Officer, FinCEN, 2070 Chain Bridge Road, Suite 200, Vienna, Virginia 22182; and
- d. submitted under a cover letter, which references the caption and file number in this matter.

Riggs recognizes and states that it entered into the CONSENT freely and voluntarily and that no offers, promises, or inducements of any nature whatsoever were made by FinCEN or any employee, agent, or representative of FinCEN to induce Riggs to enter into the CONSENT, except for those specified in the CONSENT.

Riggs understands and agrees that the CONSENT embodies the entire agreement between Riggs and FinCEN relating to this enforcement matter only, as described in Section III above. Riggs further understands and agrees that there are no express or implied promises, representations, or agreements between Riggs and FinCEN other than those expressly set forth or referred to in the CONSENT and that nothing in the CONSENT or this ASSESSMENT is binding on any other agency of government, whether federal, state, or local.





**UNITED STATES OF AMERICA  
DEPARTMENT OF THE TREASURY  
FINANCIAL CRIMES ENFORCEMENT NETWORK**

**IN THE MATTER OF  
AMSOUTH BANK**

**No. 2004-2**

**ASSESSMENT OF CIVIL MONEY PENALTY**

**I. INTRODUCTION**

The Secretary of the United States Department of the Treasury has delegated to the Director of the Financial Crimes Enforcement Network ("FinCEN") the authority to determine whether a financial institution has violated the Bank Secrecy Act and its implementing regulations, 31 USC §§5311 *et seq.* and 31 CFR Part 103 thereunder, and what, if any, sanction is appropriate.

In order to resolve this matter, and only for that purpose, AmSouth Bank ("AmSouth") has entered into a CONSENT TO THE ASSESSMENT OF CIVIL MONEY PENALTY ("CONSENT") dated October 12, 2004, without admitting or denying FinCEN's determinations described in Sections III and IV below, except as to jurisdiction in Section II below, which is admitted.

The CONSENT is incorporated into this ASSESSMENT OF CIVIL MONEY PENALTY ("ASSESSMENT") by this reference.

**II. JURISDICTION**

AmSouth is a subsidiary of AmSouth Bancorporation, a publicly traded company. Both entities are based in Birmingham, Alabama. As of December 31, 2003, AmSouth Bancorporation had assets of approximately \$45.6 billion, deposits of \$30.4 billion, and stockholders' equity of \$3.2 billion. AmSouth is a "financial institution" and a "bank" within the meaning of 31 USC §5312(a)(2) and 31 CFR §103.11. The Board of Governors of the Federal Reserve System (the "Federal Reserve") is AmSouth's primary federal supervisory agency and examines AmSouth for Bank Secrecy Act compliance.

**III. FINCEN'S DETERMINATIONS**

**A. Summary of Violations**

FinCEN has determined that AmSouth willfully violated the anti-money laundering program and suspicious activity reporting requirements of the Bank Secrecy

Act and its implementing regulations. AmSouth failed to develop an anti-money laundering program tailored to the risks of its business and reasonably designed, as required by law, to prevent the Bank from being used to launder money and finance terrorist activities and to ensure compliance with the Bank Secrecy Act. AmSouth's program lacked adequate board and management oversight, lacked fully implemented policies and procedures across the Bank to provide for appropriate due diligence and capture of suspicious activity information, lacked adequate training to ensure compliance, and had a materially deficient internal audit process that failed to detect these inadequacies. The result was a fragmented program in which areas of the Bank had information on suspicious activity that was never communicated to those responsible for Bank Secrecy Act compliance. These systemic deficiencies in AmSouth's anti-money laundering program resulted in AmSouth's failure to timely file suspicious activity reports in circumstances where the Bank was aware of suspicious activity by its customers. FinCEN has concluded that these failures warrant a civil penalty, to be assessed concurrently with the civil penalty by the Federal Reserve. Concurrently with this CONSENT, the Federal Reserve is entering into a comprehensive Cease and Desist Order and Order of Assessment of a Civil Money Penalty with AmSouth requiring, in addition to payment of a civil penalty, corrective action to bring AmSouth into compliance with its Bank Secrecy Act obligations.

**B. Violations of the Anti-Money Laundering Program Requirements**

FinCEN has determined that, since April 24, 2002, AmSouth has been in violation of the anti-money laundering program requirements of the Bank Secrecy Act. Every bank was required to establish an anti-money laundering program by April 24, 2002, that guards against money laundering and terrorist financing and ensures compliance with the Bank Secrecy Act and its implementing regulations. 31 USC §5318(h)(1) and 31 CFR §103.120. A bank regulated by a federal functional regulator is deemed to have satisfied these requirements if it develops and maintains an anti-money laundering program that complies with the regulation of its federal functional regulator governing such programs. 31 CFR §103.120. The Federal Reserve requires each bank under its supervision to establish and maintain a Bank Secrecy Act compliance program that, at a minimum: (a) provides for a system of internal controls to ensure ongoing compliance; (b) designates an individual or individuals responsible for coordinating and monitoring day-to-day compliance; (c) provides training for appropriate personnel; and (d) provides for independent testing for compliance conducted by bank personnel or an outside party. 12 CFR §208.63.

During its June 2004 examination of the Bank, the Federal Reserve Bank of Atlanta identified deficiencies in AmSouth's anti-money laundering program. FinCEN has determined that AmSouth's program was materially deficient in three of the four required elements. Specifically, AmSouth's anti-money laundering program had deficient internal controls that lacked sufficient policies and procedures to guide and direct the activities of its employees, ineffectively used the automated systems in place to monitor for suspicious activity across the enterprise, and lacked adequate board and management

oversight. AmSouth's employee training was insufficient, with both management and staff lacking a clear understanding of their obligations and how to accomplish them. Finally, the independent audit function was inadequate. These deficiencies are described in further detail below.

### 1. Internal Controls

AmSouth failed to develop and implement adequate internal policies, procedures, and controls to ensure compliance with the Bank Secrecy Act and its implementing regulations. AmSouth did not meet its legal obligations to assess the Bank's risks or vulnerabilities to money laundering and terrorist financing and to tailor its policies, procedures, and controls accordingly. With the exception of its private banking line of business, AmSouth failed to conduct a risk assessment of its customer base to identify categories of high-risk customers, products, and geographic locations. The Bank lacked procedures to identify and monitor customers with cash-intensive activity to determine if the activity was suspicious. This due diligence failure resulted in the Bank's inability to tailor its due diligence procedures as appropriate to the varying degrees of risk posed by its customers, including the creation of enhanced due diligence procedures where warranted. It also prevented AmSouth from developing a method for monitoring the transactions of high-risk customers to determine if the actual activity was commensurate with expected activity and/or lacked any apparent business or legal purpose.

The Bank's anti-money laundering program lacked adequate internal controls and procedures to integrate information generated by a number of the Bank's units and departments that was necessary to enable the performance of appropriate due diligence, including compliance with Section 314(a) of the Patriot Act. Specifically, systems used at the Bank's branches for recording monetary instruments sold to non-accountholders were not fully integrated with the Bank's system for responding to requests sent by FinCEN under Section 314(a) of the Patriot Act. Despite the fact that such records must be maintained for Bank Secrecy Act compliance, the Bank could not determine whether the scope of its Section 314(a) searches was adequate for monetary instrument transactions.<sup>1</sup> Information maintained, and reports generated in various departments not directly involved in Bank Secrecy Act compliance, but which nevertheless inform the Bank of suspicious activity occurring within it (e.g., in litigation reports, fraud and loss prevention monitoring), were not regularly provided to Bank Secrecy Act compliance or Corporate Security personnel for appropriate action. For example, the Legal Department had no system in place to alert Bank Secrecy Act compliance personnel to subpoenas and information requests it received from law enforcement. In certain other cases, it did not provide information to the Bank Secrecy Act compliance or Corporate Security personnel about suspicious activity obtained through litigation activity and reports generated from it, which was used only to monitor and manage litigated cases. Many of the departments within AmSouth lacked adequate procedures and guidance regarding the delivery of information to appropriate personnel for suspicious activity determinations.

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<sup>1</sup> This issue will be resolved and addressed in the course of the remedial actions by the Bank.

AmSouth failed to develop and implement policies, procedures, and internal controls adequate to ensure the referral, investigation, and reporting of suspicious transactions. In fact, AmSouth's policies and procedures lacked meaningful information on what constitutes a reportable event or the procedures to be followed in investigating and reporting suspicious transactions. Written procedures establishing criteria for, and directing employee decisions on, when to administratively close a referral or conduct an investigation and when to file a SAR were inadequate.

Finally, reporting to management for the purposes of monitoring and oversight of compliance activities was materially deficient. AmSouth lacked written procedures for the preparation of reports to senior management and the security director. Further, the reporting that did exist focused heavily on loss detection and prevention, to the detriment of Bank Secrecy Act compliance. Without adequate reporting, board and senior management committees responsible for overseeing some or all of the suspicious activity identification and reporting process could not be effective.

## 2. Training Appropriate Personnel

AmSouth management and staff lacked sufficient understanding of their Bank Secrecy Act compliance obligations in large part because of an inadequate training program. Before February 2004, AmSouth did not provide bank-wide training for detecting and reporting fraud and other forms of suspicious activity for employees. Suspicious activity reports were not filed because the business units were never instructed on what activity warrants reporting. Many employees did not understand their obligations. In fact, some personnel operated under the misapprehension that suspicious activity reports were not required to be filed unless there was a loss to the Bank, leading to failures in reporting that are discussed *infra*. Employees lacked sufficient knowledge and experience to detect and report suspicious activity.

## 3. Independent Testing for Compliance

AmSouth's independent testing for compliance with the Bank Secrecy Act and its implementing regulations was materially inadequate. AmSouth conducted its first ever enterprise-wide internal audit of Bank Secrecy Act compliance in 2003. However, the scope of AmSouth's review of suspicious activity identification, investigation, and filing procedures in the 2003 internal audit was inadequate and limited to a "reasonableness and completeness" check of suspicious activity reports that were actually filed. As a result, the audit did not review detection and monitoring reports, sample and test potentially suspicious accounts, or render an opinion, general or otherwise, on the overall adequacy of AmSouth's anti-money laundering program with respect to detecting, monitoring and reporting suspicious activity. The internal audit did not evaluate monitoring parameters to determine if they were appropriate or effective. The auditors did not confirm whether all accounts reflected on the monitoring reports received by compliance personnel were actually analyzed and resulted in either suspicious activity report filings or adequate notations of the reasons that the activity did not merit a suspicious activity report. No

accounts were independently sampled or tested for identification of suspicious activity. The audit thus was incapable of determining the adequacy of the procedures for monitoring, detecting, and reporting suspicious activity. Management's review of, and quality assurance over, the audit work performed, the findings documented, and the conclusions rendered were inadequate.

In summary, AmSouth failed to develop and maintain a Bank Secrecy Act compliance program appropriate for the size and complexity of its business in violation of 12 CFR §208.63 and, thus, failed to establish and implement an adequate anti-money laundering program in violation of §5318(h)(1) of the Bank Secrecy Act and its implementing regulation, 31 CFR §103.120. AmSouth's inadequate anti-money laundering program resulted in violations of the suspicious activity reporting requirements of the Bank Secrecy Act, as discussed below.

### C. Violations of the Suspicious Activity Reporting Requirements

FinCEN has determined that AmSouth violated the suspicious activity reporting requirements of the Bank Secrecy Act and its implementing regulations set forth in 31 USC §5318(g) and 31 CFR §103.18. Because of AmSouth's inability to identify or monitor high-risk customers or transactions effectively, the Federal Reserve's June 2004 examination could not identify all transactions meriting the filing of a suspicious activity report. The Cease and Desist Order that AmSouth is entering into with the Federal Reserve simultaneously with this CONSENT will require AmSouth to continue its implementation of procedures to identify such circumstances and make the appropriate filings. However, FinCEN has identified examples of significant instances of suspicious activity known to the Bank, on which suspicious activity reports should have been, but were not filed, which are discussed below.

#### 1. Suspicious Activity Reporting Requirements

A bank must report any transaction involving or aggregating to at least \$5,000 that it "knows, suspects, or has reason to suspect" (i) involves funds derived from illegal activities or is conducted to disguise funds derived from illegal activities, (ii) is designed to evade the reporting or recordkeeping requirements of the Bank Secrecy Act (e.g., structuring transactions to avoid currency transaction reporting), or (iii) "has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the bank knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction." 31 USC §5318(g) and 31 CFR §103.18. A bank must file a report no later than 30 calendar days after the date of initial detection of facts that may constitute a basis for filing. 31 CFR §103.18(b) (3) and Instructions to Suspicious Activity Report Form, TD F 90-22.47. If no suspect is identified on the date of the detection of the incident requiring the filing, a bank may delay filing a report for an additional 30 calendar days to identify a suspect. In no case is reporting to be delayed more than 60 calendar days after the date of initial detection of a reportable transaction.

In cases requiring immediate attention, a bank should notify law enforcement of the activity by telephone, but such notification does not relieve the bank of its obligation to file a suspicious activity report.

To comply with these rules, a bank must be able to determine whether transactions are in fact reportable. Therefore, a bank is required to have in place systems to identify the kinds of transactions and accounts that may be of a high risk for money laundering or that exhibit indicia of suspicious activity, considering the type of products and services it offers and the nature of its customers. Otherwise, a bank cannot assure that it is in fact reporting suspicious transactions as required by the Bank Secrecy Act. In this case, the record shows that AmSouth had information about its customers and their transactions that caused it to "know, suspect, or have reason to suspect" that certain transactions were reportable suspicious transactions. However, AmSouth failed to report these transactions or delinquently reported them because its procedures to identify, analyze, and report suspicious activity were inadequate. As a result, AmSouth violated 31 USC §5318(g) and 31 CFR §103.18.

## 2. Basic Deficiencies in Suspicious Activity Reporting Procedures and Filings

As a result of the defects in its anti-money laundering program described above, AmSouth regularly failed to identify for review accounts in which suspicious activity might be occurring. Even when personnel at the various business units had knowledge of suspicious activity in certain accounts, the Bank's lack of training and/or referral procedures often prevented this information from being brought to the attention of the persons responsible for suspicious activity reporting. In some instances, Bank personnel incorrectly believed that reporting was not required because there was no loss to AmSouth. In other instances, certain Bank personnel would not file suspicious activity reports on activity that had been telephonically reported to law enforcement.<sup>2</sup> The lack of management oversight and review of the program exacerbated these problems.

## 3. Examples of AmSouth's Reporting Violations

AmSouth failed to timely file suspicious activity reports regarding the following objectively suspicious activity by its customers:

- The perpetrators of a fraudulent investment scheme maintained accounts at AmSouth to handle funds contributed by individual investors. AmSouth did not perform adequate due diligence on the perpetrators, which could have revealed financial and prior regulatory problems. Further, AmSouth ignored red flags, including concerns communicated to Bank management by several employees at various AmSouth branches indicating the accounts were being used in furtherance

<sup>2</sup> Telephonic notice has never been permitted as a substitute for filing a suspicious activity report because all of the information required to be in a report must be available to all appropriate local, state, and federal law enforcement users that might be investigating related crimes or patterns of criminal activity.

of a Ponzi scheme. Despite such warnings, AmSouth failed to file a suspicious activity report until two years after it knew or should have known about the suspicious nature of the activity and millions had been deposited and then withdrawn from related accounts at the Bank. The perpetrators ultimately were convicted of money laundering and money laundering conspiracy.

- The Chief Financial Officer of an AmSouth corporate customer embezzled several million dollars from the corporation over three years using forged and improperly authorized checks. Although AmSouth employees noticed that the Chief Financial Officer was conducting a number of highly unusual transactions, the Bank did not file a suspicious activity report because it suffered no loss.
- A municipal official contacted the manager of a local AmSouth branch regarding the suspected misappropriation by another municipal official of approximately \$450,000 through the fraudulent endorsement of a number of city checks. Shortly thereafter, the responsible party acknowledged the misappropriation in a suicide note. Nonetheless, AmSouth did not file a suspicious activity report because the suspect was dead. Another municipal employee was eventually indicted for his role in the fraud.
- Another matter involved an employee of AmSouth's broker-dealer who allegedly committed fraud in clients' accounts by, among other things, forging customer signatures on numerous documents. The broker-dealer reported this employee's misconduct to the National Association of Securities Dealers ("NASD"). The broker-dealer also had a duty to report what it knew to be suspicious activity by its own employee to FinCEN, and it failed to do so. AmSouth now acknowledges that a SAR should have been filed in this matter, and recently filed a SAR.
- An employee of a car dealership formed his own corporation and then opened an account at AmSouth under the name of the corporation "dba" (doing business as) the name of the car dealership. Over a year, the employee deposited several hundred thousand dollars worth of checks made payable to his employer into the AmSouth account. The employer ultimately sued AmSouth concerning these transactions. AmSouth handled the litigation without conducting a review to determine whether a SAR should be filed.
- An individual operated a fraudulent multi-million dollar trading operation for five years before being arrested. More than \$20 million in assets from investors in the program were frozen in various banks, including AmSouth. AmSouth received Securities and Exchange Commission and grand jury subpoenas seeking information on the matter. Months after the individual pleaded guilty to felony charges of securities fraud, money laundering and wire fraud, AmSouth closed the last of his accounts without ever having filed a suspicious activity report.



- A corporate customer deposited into its AmSouth account an official check for \$220,000 drawn on another U.S. bank. Six days later, the customer initiated a wire transfer of \$190,000 from its AmSouth account to a bank in a foreign country. All but \$30,000 of the wired funds were then withdrawn from the foreign bank. Nine days after its deposit, the check was returned unprocessed to AmSouth because the amount had been altered. Although AmSouth notified local law enforcement of the incident, and fully cooperated with the government investigation, it did not file a suspicious activity report.
- A bank cashier at another bank embezzled money from his employer by wiring funds from an account maintained by his employer to deposit accounts at AmSouth held in his or his wife's name. The bank cashier then invested these funds in investment accounts at AmSouth's broker-dealer subsidiary. The employer contacted AmSouth about the bank cashier's accounts. Although AmSouth notified federal law enforcement of the incident, it never filed a suspicious activity report.

In addition, the Federal Reserve's June 2004 examination disclosed that AmSouth had not filed suspicious activity reports on a number of instances of check kiting activity involving possible losses above \$5,000, which appeared on an AmSouth internal report. In response to the examination, AmSouth has now filed suspicious activity reports on several of the matters identified by the Federal Reserve. Various cases involving fraudulent activity by customers of the bankcard business unit, and matters identified by the fraud prevention unit, also were not reported.

#### D. Willful Nature of BSA Violations

The conduct of a bank may be characterized as willful if it demonstrates a reckless disregard for its obligations under law or regulation. As a bank supervised by the Federal Reserve, AmSouth was aware of the anti-money laundering program and suspicious activity reporting requirements of the Bank Secrecy Act and its implementing regulations. AmSouth had material deficiencies in the basic elements of its anti-money laundering program, which led to violations of the suspicious activity reporting requirements in a number of significant instances. These violations were systemic and serious. FinCEN has determined that AmSouth's violations of the Bank Secrecy Act and its implementing regulations were willful.

#### IV. CIVIL MONEY PENALTY

FinCEN has determined that by failing to establish and implement an adequate anti-money laundering program and to file and file timely suspicious activity reports as described in Section III, above, the AmSouth willfully violated the anti-money laundering program and suspicious activity reporting provisions of the Bank Secrecy Act and its implementing regulations a civil money penalty is due pursuant to 31 USC §5321 and 31 CFR §103.57(f).

## V. CONSENT TO ASSESSMENT

In order to resolve this matter, and only for that purpose, AmSouth, without admitting or denying either the facts or determinations described in Sections III and IV above, except as to jurisdiction in Section II, which is admitted, consents to the assessment of a civil money penalty against it in the sum of \$10 million. This penalty assessment shall be concurrent with the \$10 million penalty assessed against AmSouth by the Federal Reserve. The penalty assessment of FinCEN and the Federal Reserve referenced above shall be satisfied by one payment of \$10 million to the Department of the Treasury.

AmSouth agrees to pay the amount of \$10 million upon the assessment of the civil money penalty. Such payment shall be:

- a. made by certified check, bank cashier's check, or bank money order or by wire;
- b. made payable to the United States Department of the Treasury;
- c. evidenced by a check or money order or copy of the wire transfer, hand-delivered or sent by overnight mail to Nicholas A. Procaccini, Acting Associate Director, Administration and Communications, FinCEN, 2070 Chain Bridge Road, Suite 200, Vienna, Virginia 22182; and
- d. submitted under a cover letter, which references the caption and file number in this matter.

AmSouth recognizes and states that it enters into the CONSENT freely and voluntarily and that no offers, promises, or inducements of any nature whatsoever have been made by FinCEN or any employee, agent, or representative of FinCEN to induce AmSouth to enter into the CONSENT, except for those specified in the CONSENT.

AmSouth understands and agrees that the CONSENT embodies the entire agreement between AmSouth and FinCEN relating to this enforcement matter only, as described in Section III above. AmSouth further understands and agrees that there are no express or implied promises, representations, or agreements between AmSouth and FinCEN other than those expressly set forth or referred to in the CONSENT and that nothing in the CONSENT or this ASSESSMENT is binding on any other agency of government, whether federal, state, or local.

## VI. RELEASE

AmSouth understands that its execution of the CONSENT and compliance with the terms of this ASSESSMENT and the CONSENT constitute a complete settlement of civil liability for reporting and recordkeeping violations of the Bank Secrecy Act, and the

regulations promulgated thereunder, which were identified by the Federal Reserve prior to the date hereof.

By: 

William J. Fox, Director  
FINANCIAL CRIMES ENFORCEMENT NETWORK  
U.S. Department of the Treasury

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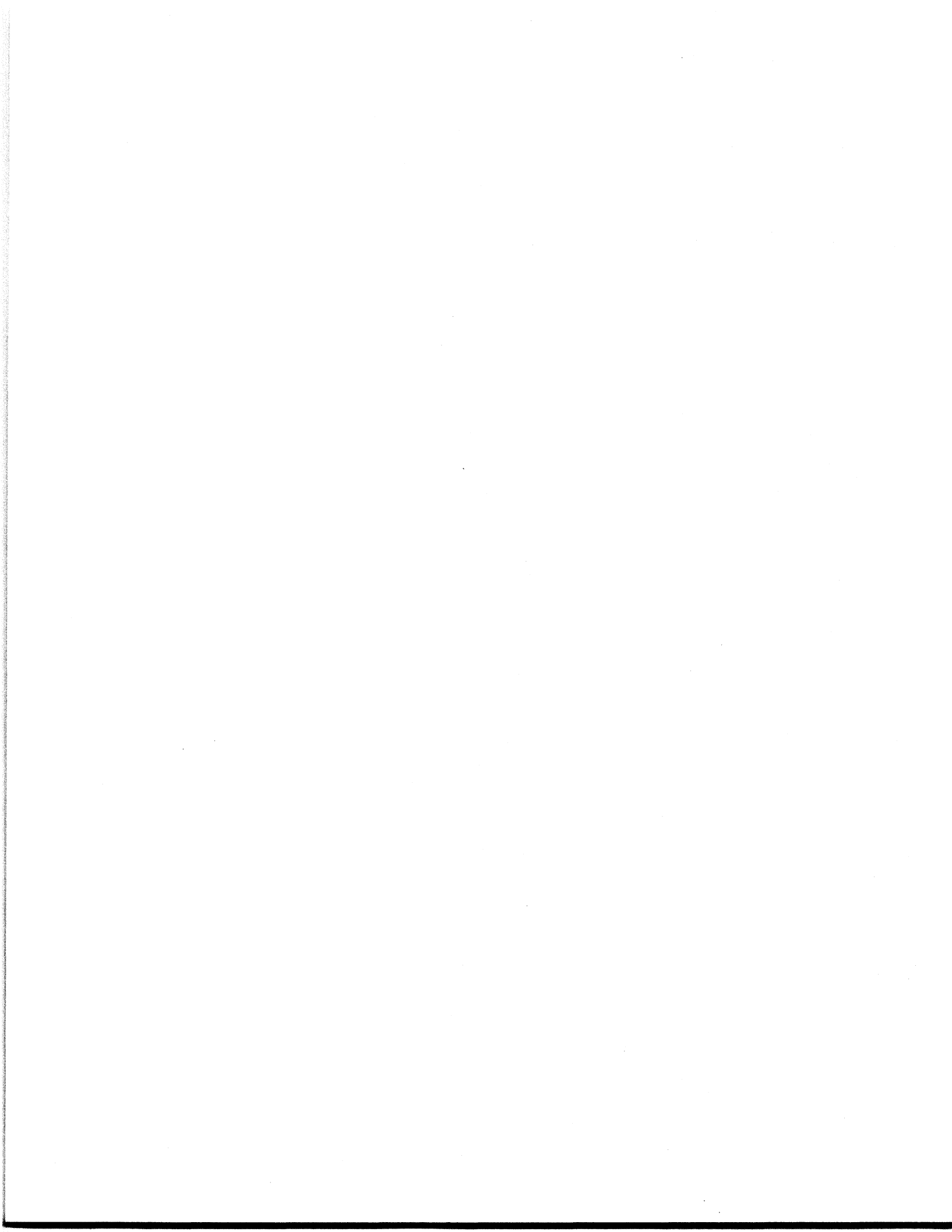
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**INSURANCE REGULATION:  
BACKGROUND AND ISSUES AFFECTING BANKS**

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**SECTION J**





- ◆ In the 1700's and 1800's, state legislatures granted "special" charters for insurance companies. New Hampshire was one of the first states to create a formal agency to regulate insurance in 1851.
- ◆ The U.S. Supreme Court formally recognized the state system of insurance regulation in *Paul v. Virginia* in 1868, ruling that insurance transactions were "local in nature."
- ◆ In 1944, in *U.S. v. South-Eastern Underwriters Association*, the Supreme Court reversed *Paul v. Virginia*, holding that the business of insurance was interstate commerce and insurance companies were subject to antitrust and other federal laws.

- ◆ The McCarran-Ferguson Act (1945) nullified the effect of *U.S. v. South-Eastern Underwriters Association*, and exempted the insurance industry from the Commerce Clause and antitrust laws. The Act permits states to act as the primary regulatory authority over the business of insurance.
- ◆ States must “regulate” insurance to a sufficient extent in order to preempt federal law. Generally, if a situation falls within the “business of insurance,” a state statute will suffice to preempt federal law.
- ◆ As a result of the Act, states enacted legislation covering insurance rate regulation to preempt the Sherman Antitrust Act and other federal law. In addition, many states adopted legislation addressing unfair trade practices in order to preempt the Federal Trade Commission Act.

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- ◆ The preemption of federal law has been consistently upheld, including recently by the 11<sup>th</sup> Circuit in Atlanta in November, 2004, in the case of *Gilchrist v. State Farm, Allstate, Nationwide, GEICO et al.* In this case, the court upheld the federal antitrust exemption for insurance companies and ruled that the repair of automobiles and the manner in which they are repaired pursuant to policies of insurance are the business of insurance. Consequently, these matters are within the purview of state laws and regulations, and not federal law.
- ◆ The court also ruled that the plaintiffs did not satisfy the “boycott” exemption under McCarran-Ferguson, which would have permitted federal regulation if the insurers had failed to deal in a collateral transaction in a way that would have coerced action in the primary transaction.

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- ◆ State legislatures set broad policy for the regulation of insurance. They establish and oversee state insurance departments, regularly review and revise state insurance laws, and approve state regulatory budgets. State insurance departments employ more than 12,000 personnel.
- ◆ States collect more than \$10 billion annually from insurance sources, approximately 8% of which is used for direct costs in connection with the regulation of insurance. The remaining 92% goes to the general funds of the various states.
- ◆ State laws require every insurance company or related business (TPA, MGA, etc.) to be licensed and subject to regulation in its state of domicile and in any other state in which it conducts business. There are currently more than 7,000 insurance companies in the U.S.

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- ◆ The NAIC serves as a vehicle for state regulators to coordinate their activities and share resources, and it functions as an advisory body and service provider for state insurance departments. Commissioners use the NAIC to pool resources, discuss issues of common concern, and align their oversight of the industry. Each state, however, ultimately controls the regulatory activity in its state.
- ◆ The NAIC's Uniform Certificate of Authority Application (UCAA), a company licensing system, helps states expedite the review process of a new company license. In addition, an NAIC database has been developed to facilitate information sharing on acquisition and merger filings. These databases assist insurance regulators by creating a streamlined and more cost-efficient regulatory process.

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- ◆ Insurance agents and brokers, also known as producers, must be licensed and comply with various state laws and regulations. Currently, more than 3 million such individuals are licensed in the U.S. State insurance departments oversee producer activities in order to protect insurance consumer interests.
- ◆ States also administer continuing education programs to ensure that agents meet required standards. As many as 16,000 producers are fined or have their licenses suspended or revoked each year for failure to comply with regulatory requirements.
- ◆ The NAIC maintains special databases to help states coordinate their activities for producers who operate in multiple jurisdictions. The National Insurance Producer Registry (NIPR), a non-profit affiliate of the NAIC, was established to develop and operate a national repository for producer licensing information.



- ◆ Notwithstanding the foregoing discussion, Congress has chipped away at McCarran-Ferguson over the years. Some of the more notable legislation permitting the federal government to regulate certain aspects of the insurance or related businesses includes the following:
  - ❖ Medicare and Medicaid Acts of 1965;
  - ❖ Employee Retirement Income Security Act of 1974 (ERISA);
  - ❖ Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA);
  - ❖ Product Liability Risk Retention Act of 1981 and Amendments of 1986;
  - ❖ Health Insurance Portability and Accountability Act of 1996 (HIPAA);
  - ❖ Gramm-Leach-Bliley Act of 1999 (GLB); and
  - ❖ Terrorism Risk Insurance Act of 2002 (TRIA).



- ◆ ERISA limits the scope of McCarran-Ferguson by extending federal oversight and regulation to “employee benefit plans.”
- ◆ “Employee benefit plans” are divided into “pension plans” and “welfare plans.”
- ◆ ERISA sets uniform minimum standards to assure that employee benefit plans are established and maintained in a fair and financially sound manner.
- ◆ ERISA is enforced by the U.S. Department of Labor (Pension and Welfare Benefits Administration) and the Internal Revenue Service (IRS).

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- ◆ Originally enacted in 1981 as the Product Liability Risk Retention Act; amended in 1986 to extend to all liability insurance.
- ◆ Permits formation of “risk retention groups” (RRGs) and “risk purchasing groups” (PGs).
- ◆ RRGs are insurance companies formed by groups of persons or companies engaged in similar businesses with similar risk exposures.
- ◆ RRGs can domicile in any state and underwrite liability insurance in all states with minimal regulation (primarily solvency related) outside of the domiciliary state.
- ◆ PGs are groups of similar businesses with similar risk exposures who form an organization (such as a trade association) to purchase liability insurance on a group basis. Insurers who underwrite the risks of PGs have considerably greater regulatory flexibility.

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- ◆ HIPAA affects nearly everyone involved in the health care process, including providers, information systems vendors, and payers (insurance companies, HMO's, MCO's, etc.). The primary goal of HIPAA is to improve portability and continuity of health insurance coverage in order to combat waste, fraud, and abuse within the health insurance industry.
- ◆ The five comprehensive areas of HIPAA are:
  - ❖ Title I: Health Care Access, Portability, and Renewability;
  - ❖ Title II: Preventing Health Care Fraud and Abuse;
  - ❖ Title III: Tax-Related Health Provisions;
  - ❖ Title IV: Application and Enforcement of Group Health Plan Requirements; and
  - ❖ Title V: Revenue Offsets.



- ◆ HIPAA regulations apply to "covered entities," including healthcare providers, health plans and healthcare clearinghouses who transmit health information in electronic form in connection with transactions covered under HIPAA.
- ◆ HIPAA regulations are comprised of three distinct parts:
  - ❖ **Transaction Standards:** Require the use of common electronic claims standards, code sets and unique identifiers for all payers and providers;
  - ❖ **Privacy Regulations:** Govern the release of individually identifiable health information and specify how covered entities must give notice of privacy policies and procedures to patients and obtain consent for the use of such information; also govern how such information is shared and how patients can access, inspect, copy and amend their medical records; and
  - ❖ **Security Regulations:** Dictate the kind of administrative procedures and physical safeguards covered entities must have in place to ensure the confidentiality and integrity of protected health information.



- ◆ Repealed the Glass-Steagall Act and established a comprehensive framework to permit affiliations among banks, securities firms and insurance companies, while preserving state regulation of insurance.
- ◆ Modernized the U.S. financial system by allowing financial institutions of all types to participate in business outside of their narrow core area.
- ◆ Applies to any institution significantly engaged in financial activities defined in, and permitted under, the Bank Holding Company Act.

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- ◆ **Financial Activities include:**
  - ❖ Lending, exchanging, transferring, investing for others, or safeguarding money or securities;
  - ❖ Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing;
  - ❖ Providing financial, investment, or economic advisory services, including an investment company; and
  - ❖ Underwriting, dealing in, or making a market in securities.

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- ◆ GLB privacy provisions cover “non-public personally identifiable information” (NPPI) about customers, including any list, description or grouping of customers.
- ◆ GLB applies to customers (who have an on-going relationship) and consumers (who inquire about establishing a relationship) who provide NPPI in connection with financial products or services for personal, family or household purposes.
- ◆ GLB requires a privacy notice before any NPPI may be disclosed, if a disclosure does not meet one of the specified exceptions. In addition, any opportunity to “opt out” of disclosures must be provided to the customer or consumer.



- ◆ The following exceptions apply to the notice and opt out requirements:
  - ❖ To non-affiliated entities to perform joint marketing activities;
  - ❖ For processing and servicing transactions;
  - ❖ With consent or at the discretion of the individual;
  - ❖ Pursuant to the Fair Credit Reporting Act;
  - ❖ In connection with the proposed or actual sale, merger or transfer of a business unit; and
  - ❖ For law enforcement activities and fraud investigations.



◆ Standards for safeguarding NPPI (established effective May 23, 2003) apply to all financial institutions over which the FTC has jurisdiction and cover all NPPI (whether that of a customer or provided by another financial institution).

◆ The standards include:

- ❖ Establishing written policies and procedures;
- ❖ Establishing administrative, technical and physical safeguards;
- ❖ Designating employees to run the program;
- ❖ Identifying internal and external risks (including employees, information systems, and system failures/attacks);
- ❖ Designing and implementing safeguards against such risks;
- ❖ Selecting and overseeing service providers (including requiring contractual acceptance of GLB standards); and
- ❖ Ongoing evaluation, adjustment and training.

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◆ Summary of the highlights of GLB include:

- ❖ Preemption of anti-affiliation laws;
- ❖ 60-day limit on review by Dept. of Ins. of proposed affiliations;
- ❖ Preservation of state licensing of agents (National Association of Registered Agents and Brokers would have been established if a majority of states had not enacted uniform agent licensing laws);
- ❖ Establishment of a process for dispute resolution between state insurance regulators and federal bank regulators.

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- ◆ Check separate laws in each state regarding licensing of agents and other aspects of the sale of insurance and receipt of commissions.
- ◆ Agent licensing laws may be different for agents employed by banks.
- ◆ Sale of credit life insurance may be regulated differently.
- ◆ Restrictions on who may receive commissions for the sale of title insurance.
- ◆ Limitations on partnership of a bank with an insurance company.

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- ◆ TRIA was enacted in 2002 to provide a temporary federal program of shared public and private compensation for insured property and casualty losses resulting from acts of terrorism. TRIA is set to sunset on December 31, 2005. Extension of TRIA beyond 2005 is currently pending in Congress.
- ◆ All “insurers” must participate in the program. TRIA defines “insurers” to include all “state licensed or admitted” entities, including captives insurance companies.
- ◆ Insurers must make terrorism risk insurance available in commercial property and casualty insurance policies, and coverage must not differ materially from terms, amounts, and other coverage limitations applicable to losses arising from events other than acts of terrorism.

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- ◆ TRIA includes the following lines of insurance coverage in the program:
  - ❖ Commercial property and casualty;
  - ❖ Excess insurance;
  - ❖ Worker's compensation; and
  - ❖ Surety insurance.
  
- ◆ TRIA excludes the following lines of insurance coverage from the program:
  - ❖ Federal crop insurance;
  - ❖ Private mortgage insurance;
  - ❖ Monoline financial guaranty insurance;
  - ❖ Medical malpractice insurance;
  - ❖ Life or health insurance;
  - ❖ Flood insurance;
  - ❖ Reinsurance;
  - ❖ Fidelity insurance; and
  - ❖ Acts of terrorism committed as part of a course of war declared by Congress.



- ◆ Once an "act of terrorism" is certified, each insurer is responsible for a deductible (10% in 2004 and 15% in 2005) based on its pro rata portion of "direct earned premium" in the previous year. The federal government picks up 90% of payments in excess of the deductible.
  
- ◆ The limit of insured losses subject to the program is \$100 billion during any program year.
  
- ◆ The federal government will recoup a portion of its payments by surcharging commercial property and casualty premiums up to 3% in any one year. The insurance industry must retain \$12.5 billion of risk in 2004 and \$15 billion in 2005.





◆ The litigation aspects of TRIA include the following:

- ❖ Exclusive federal cause of action for claims arising from certified acts of terrorism;
- ❖ Claims consolidation in federal court;
- ❖ Prohibition on federal payments for punitive damages; and
- ❖ A right of subrogation for the U.S. with respect to any claim paid by the U.S. under the program.



- ◆ The states maintain (at the NAIC) the world's largest insurance financial database, which provides a 15-year history of annual and quarterly filings on more than 5,000 insurance companies.
- ◆ Periodic financial examinations occur on a scheduled basis. State financial examiners investigate a company's accounting methods, procedures and financial statement presentation. These exams verify and validate what is presented in the company's annual statement to ascertain whether the company is in good financial standing.
- ◆ When an examination of financial records shows the company to be financially impaired, the state insurance department takes control of the company.



- ◆ Insurance companies may not file for relief under the federal Bankruptcy Code.
- ◆ Insurance company insolvency is governed by state law.
- ◆ When an insurance company experiences financial difficulty, the domiciliary state insurance department may put the company into rehabilitation or supervision in order to protect its assets and provide protection under which the company can continue its business. This step may or may not lead to receivership.
- ◆ Liquidation of an insurance company is normally referred to as “receivership” under state law. When an insurance company is placed into receivership, the state commissioner of insurance normally will appoint a statutory receiver (similar to a bankruptcy trustee).



- ◆ The NAIC now employs a concept known as “risk based capital” (RBC) for states to utilize when determining the solvency of any insurance company and the minimum amount of capital necessary for the conduct of its business. RBC is a complicated formula that compares an insurance company’s assets to its risks and takes into account the types of insurance underwritten and the aggregate limits on its policies. In determining an insurance company’s minimum RBC requirement, the regulators will look at four types of risk: asset, credit, underwriting and off-balance sheet.
- ◆ When an insurance company’s RBC level falls to certain action levels, a state may be permitted or required to place the company into supervision or receivership.



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