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BSA COMPLIANCE REMAINS TOP REGULATORY PRIORITY

The financial press is no longer reporting daily stories about Riggs National Bank. The $25 million civil money penalty and allegations of international political corruption are gradually fading from the spotlight. Do not let the absence of headlines mislead anyone. Bank Secrecy Act ("BSA") compliance is and will remain the dominant issue on the regulatory agenda for the foreseeable future. Moreover, it is a significant issue for banks of all sizes, regardless of location. Just as the bank regulators must take into account Community Reinvestment Act performance when considering various applications by banks, so too must bank regulators now take into account BSA compliance when considering applications by banks.

The war on terrorism has caused basic changes in BSA compliance. What was once a weapon in the war on drugs has been retooled to help fight the war on terrorism. Ten or fifteen years ago, the focus of BSA compliance was whether currency transaction reports ("CTRs") were being filed appropriately. Immediately after the terrorist attacks of September 11, 2001, the primary focus was OFAC (Office of Foreign Asset Control) compliance. With the effective date (October 1, 2003) of the Customer Identification Program ("CIP") regulations, examiner focus has broadened. Suspicious activity reports ("SARs") are the new focus of BSA compliance.

Bankers are reporting more rigorous examinations in the BSA area. Examiners are questioning significant cash withdrawals and deposits, regardless of whether CTR filing requirements are triggered. Use of cashier's checks, wire transactions and foreign transactions are all being subjected to greater scrutiny. The point of all this questioning is simple: examiners want to know whether the legitimate business activity of the customer can support the kind of activity occurring in the account. Without an adequate explanation from the bank that can justify the transactions, examiners are apt to criticize the bank for a deficient BSA compliance program and question the bank as to why it is not filing SARs on the customer.

The CIP regulations make all of this possible. The new account procedures have received the bulk of the publicity, with trite stories about little old ladies having

16th Annual Banking Law Institute

Tuesday, October 5, 2004

8:00 a.m. to 11:30 a.m.
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- **Trends in Regulatory Enforcement**
- **Executive Compensation**

Keynote Speaker: William M. Daley
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difficulty opening a new account. The real story is that CIP is not limited to new accounts. Bankers are expected to have a methodology to segment accounts into risk categories. For those accounts with a higher risk category (e.g., higher cash volumes, wire transfers, cashier's checks or foreign transactions), more documentation is expected. Examiners expect bankers to visit their higher risk customers, and to document the reasons for the higher risk transactions.

When a bank is unable to justify the reasons for the higher risk transactions, examiners criticize the adequacy of the bank's BSA compliance program. As of last October, a CIP program is to be part of every bank's BSA compliance program. In addition, where the transaction 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, an SAR may be required. While there is no legal requirement to close an account after repeated SAR filings, examiners are questioning the judgment of those bank managers who fail to close accounts after several SAR filings.

> ***"Examiners are questioning significant cash withdrawals and deposits, regardless of whether CTR filing requirements are triggered."***

The increased priority of BSA among the bank regulators is reflected in the publicly available enforcement actions. Enforcement actions, both civil money penalties and cease and desist orders, involving BSA issues are more commonplace this year than in times past. The bank regulators and FinCEN (Financial Crimes Enforcement Network, a bureau inside of Treasury) appear to have worked out at least an informal understanding on jurisdiction. Routine enforcement issues will be coordinated with FinCEN, but will remain with the bank regulators. FinCEN will assume primary responsibility for major BSA related cases.

The typical bank regulator BSA cease and desist order or agreement parallels a safety and soundness enforcement action. Just as a safety and soundness order might require the adoption of a new or revised loan policy, a BSA enforcement action would typically require a new or revised BSA policy. Depending upon the regulator's confidence in management, the regulator may require the use of a consultant acceptable to the regulator for assistance in developing the policy. Bank management that does not have the confidence of the regulator is more likely to be required to retain a consultant for assistance.The BSA policy to be adopted by the bank under an enforcement action would have all the elements of a sound BSA policy. Accordingly, among other provisions, the policy would be required to address such matters as controls designed to capture all reportable CTR transactions and suspicious transactions; requirements for independent compliance reviews and capable management; and provisions requiring ongoing training.

Perhaps the most onerous of all provisions found in these BSA enforcement actions is that which highlights the importance of having an adequate system to capture possible suspicious transactions. Where a bank has failed to implement such a satisfactory system, the regulators are requiring a consultant to review all bank transactions for a one or two year period to determine whether SAR requirements were properly followed. In the most recent enforcement actions, these reviews are required to be performed by an outside consultant who then presents the findings to both the regulator and the bank. The regulator not only signs off on the consultant and its qualifications, but also on the methodology to be used in searching for the suspicious transactions and the conclusions that are reached as a result of the review. The magnitude of such an undertaking should be sufficient motivation to encourage any bank without an adequate system to identify suspicious transactions to immediately implement one. Moreover, one has to wonder whether the regulators will use these consultant reports as the basis for further administrative action, such as civil money penalties.

Times have changed. BSA compliance is a much more complicated task than it was only a year ago. With that more complicated task has come more expense through increased compliance cost. The old regulatory saying about "Pay me now or pay me later" is still true. Banks that do not pay up now by upgrading their BSA systems will pay later, except that the costs at the later date will be higher.

THE FUTURE OF ANTI-TYING REGULATION

Section 106 of the Bank Holding Company Act Amendments of 1970 (the "BHCA") generally prohibits a bank from conditioning the availability or price of a traditional product or service on the requirement that the customer also obtain (or provide) a nontraditional product or service from (or to) the bank or one of its affiliates (the "anti-tying restriction"). For example, it prohibits a bank from conditioning a loan on the requirement that the customer also purchase an insurance product from the bank or an affiliate.

Recently, both government officials and bank customers have expressed increasing concern about possible illegal tying by banks. These concerns have been fueled, in part, by passage of the Gramm-Leach-Bliley Act (the "GLB Act") which, among other things, expanded the ability of financial service providers to offer customers a wider range of products and services. The GLB Act, however, did not make any changes to the anti-tying restriction in Section 106 of the BHCA. In addition, members of the banking industry have noted a lack of guidance from regulators with respect to the anti-tying rules. In light of these developments, the Federal Reserve has proposed to adopt an interpretation and related supervisory guidance to explain the application of the anti-tying restriction. The Federal Reserve is currently reviewing comments on the proposal and is expected to issue a final statement in the coming months.

> ***"The primary purpose of the anti-tying rules is to restrict the ability of banks to force their customers to obtain (or provide) a tied product in order to prevent anti-competitive behavior by banks."***

First, it is important to note that the anti-tying rules apply to banks and their subsidiaries, but generally not to the affiliates of banks. The primary purpose of the anti-tying rules is to restrict the ability of banks to force their customers to obtain (or provide) a tied product in order to prevent anti-competitive behavior by banks. Consistent with this purpose, the Federal Reserve's proposed interpretation and guidance focuses on banks and their actions with respect to tying arrangements. The proposed interpretation lists the elements of a prohibited tying arrangement as follows:

(1) the arrangement involves two or more separate products—the customer's desired product(s) and one or more *separate* but tied products; and

(2) the bank must *force* the customer to obtain (or provide) the tied product(s) from (or to) the bank or an affiliate in order to obtain the desired product(s) from the bank.

The interpretation stresses that the bank must force or coerce the customer into obtaining (or providing) a separate, tied product from (or to) the bank or its affiliates. There must be a finding that both of the elements listed above have been met to conclude that there has been an anti-tying violation. As noted above, a fact-specific analysis is required to make this determination. In an attempt to provide guidance in making such determinations, the Federal Reserve states in the proposed interpretation that the terms of the bank's offer to the customer will provide the best evidence of whether or not a customer was forced to obtain a separate, tied product. In particular, the proposed interpretation notes the following as relevant factors to be examined:

- the timing and sequence of the offers by the bank;
- the nature of any conditions imposed by the bank in connection with the transaction; and
- any correspondence between the bank and the customer.

This fact-intensive inquiry focuses on the bank's actions to determine if there was an anti-tying violation. The affiliate of a bank, however, may condition a customer's ability to obtain a desired product on the customer's obtaining another product from its banking affiliate. For example, an insurance company may offer a discount on premiums to a customer if the customer also obtains a loan or establishes a deposit account with its banking affiliate. The bank and its affiliated insurance company must be careful, however. If the affiliate nominally imposes a condition on its customers that a bank would be prohibited from imposing and the affiliate does it at the request, or on behalf, of the bank, then the bank would be deemed to be involved in an illegal anti-tying scheme. For instance, the existence of an understanding between the bank and the insurance company regarding the insurance company's imposition of conditions would tend to show that the affiliate was nominally imposing a condition on its customers.

The proposed interpretation and guidance also describes exceptions to the anti-tying rules. These include:

- tying arrangements requiring customers to obtain another product that is a "traditional bank product" such as all types of credit extensions, including loans, lines of credit, and financial guarantees, and all forms of deposit accounts, including demand, negotiable orders of withdrawal, savings, and time deposit accounts;

- tying arrangements involving a "mixed-product arrangement" where the customer is required to obtain another product from the bank, which can be either a "traditional" bank product or "nontraditional" bank product, but the customer must have a meaningful option in choosing between a traditional product and a nontraditional product;

- reciprocity exceptions, which include situations where the tied product is to be provided to the bank or its affiliate by the customer and is related to and usually provided in connection with a loan, discount, deposit, or trust service, such as requiring the customer to obtain insurance, for the benefit of the bank, to protect the value of pledged collateral;

- exclusive dealing exceptions where the condition was reasonably imposed by the bank in a credit transaction to ensure the soundness of the credit, such as conditioning the availability of a loan to a customer on the requirement that the customer not borrow from other sources or pledge any collateral securing the loan to other entities during the term of the loan; and

- regulatory safe harbors for certain combined-balance discounts (*i.e.*, discounts on products based on the customer's maintaining a combined minimum balance on certain products, including deposit products) and foreign transactions (*i.e.*, transactions with foreign entities or individuals).

"Prudence dictates that bankers, especially those with excess stock in the FHLB of Chicago, carefully monitor the coming changes."

The proposal also discusses internal controls that banks should have in place to ensure compliance with the anti-tying restriction. To ensure that a bank is complying with the anti-tying rules, the bank should:

- have an anti-tying policy in place that provides examples of conduct that violates, and conduct that is consistent with, the anti-tying rule, and the policy should also instruct personnel with questions regarding anti-tying issues to speak with the bank's legal or compliance department;

- ensure that its lenders and other personnel who market products receive regular anti-tying training;

- structure employee compensation plans so that they do not create incentives for employees to tie products in a manner that would violate Section 106 of the BHCA; and

- periodically review its anti-tying policy to ensure that it is consistent with the requirements of the anti-tying rule.

The foregoing information highlights the actions a bank should, and should not, take in order to comply with the anti-tying rules and the Federal Reserve's proposed interpretation and guidance. Banks should keep in mind that the underlying purpose of the anti-tying restriction is to prevent anti-competitive conduct. When reviewing a possible tying situation, it is helpful to ask if a bank's requirement that a separate product be obtained by a customer falls within one of the enumerated exceptions listed above, or if conditions or requirements are being imposed merely to increase fees or interest income by forcing a customer to purchase an additional service or product. To remove the risk of an anti-tying violation, a bank should engage only in tying arrangements that clearly fall within one of the enumerated exceptions, and the bank should establish and maintain a strong anti-tying internal compliance program.

CHANGES COMING IN FHLB CAPITAL STRUCTURE

Over the last several years, the stock of the Federal Home Loan Bank of Chicago ("FHLB of Chicago") has become a popular investment for financial institutions. As well it should. In a world of interest rates still hovering around forty-year lows, the FHLB of Chicago has been paying dividends at annualized rates of 6.5% and 7.0%. The stock of the FHLB of Chicago offers more than a return better than many loans. Standard and Poor's rates the FHLB of Chicago as AAA. Not only does the FHLB of Chicago have the highest rating available, its stock is a liquid investment. While the FHLB of Chicago has the right to require six months' notice before it repurchases any stock necessary to support activity levels at the FHLB of Chicago, the reality is that the FHLB redeems excess stock (that is, stock held by a financial institution over and above what is necessary to support activity levels) on request. Bank examiners are willing to consider the stock a liquid investment and have afforded FHLB stock a risk weighting of only 20% for capital adequacy purposes. In 2003, the State of Illinois passed legislation allowing banks to hold FHLB stock without any limitation based upon capital and surplus.

Changes are coming. Prudence dictates that bankers, especially those with excess stock in the FHLB of Chicago, carefully monitor the coming changes. While the Gramm-Leach-Bliley Act ("Gramm-Leach") of 1999 is best known for its repeal of some of the depression-era laws separating banking from other areas of commerce, Gramm-Leach also required new capital structures for each of the twelve Federal Home Loan Banks. The capital structure of each of the twelve banks is to meet certain minimum capital ratios, based upon both a leverage standard and a risk-based capital requirement. Capital is to be divided into Class A (having many similarities to preferred stock) and Class B (permanent capital).

The change in the capital structure of the FHLB of Chicago will be implemented later in 2004 or in early 2005. Under the FHLB of Chicago plan posted on its web site, Class A stock will have a stated dividend that is at least equal to the 13-week moving average of 3-month LIBOR. Dividends on Class A stock will be cumulative and will be preferred to Class B stock. Class A will have no voting rights. Dividends on Class B stock will be noncumulative and payable only after Class A dividends, both cumulative and current, have been paid. Payment of dividends on both Class A and Class B may be made in stock (either Class A or B) or cash or any combination thereof. Dividends on both classes of stock remain at the discretion of the board of directors of the FHLB of Chicago. Gramm-Leach prohibits dividends by any FHLB if it is not in compliance with the capital standards.

Member institutions of the FHLB of Chicago will have the option of satisfying required stock obligations with either Class A or Class B, although Class B stock will be more heavily weighted. Member institutions will continue to have the opportunity to hold Class A and Class B as excess stock. Stock redemption rights of Class A and Class B stock are markedly different and are meant to parallel the traditional treatment of preferred and common stock. In the event of liquidation, Class A stock is redeemed at par value and must be redeemed in full before any Class B stock is redeemed. Class B stock functions like common stock and would be redeemed only after all creditors and Class A stockholders were paid.

The current stock of the FHLB of Chicago, to the extent it is required to support activities at the FHLB of Chicago, is subject to a six-month redemption notice. In practice, the FHLB of Chicago has been willing to redeem excess stock upon request. Under the new plan, Class A stock necessary to support membership or activities will continue to have a six-month notice period. Class B stock necessary to support membership or activities will have a five-year notice period. A stiff penalty will be imposed if a financial institution gives notice of redemption and then cancels that redemption notice.

Under the new plan, excess stock may be redeemed upon ten days' prior written notice to the FHLB of Chicago. Just as with the current stock, whether to grant the redemption request will be at the discretion of the FHLB of Chicago. The FHLB of Chicago will also be subject to general restrictions on stock redemptions, *e.g.*, it will grant no redemptions that would cause the FHLB of Chicago to operate in an unsafe or unsound manner or fail to have adequate capital against a potential risk not adequately reflected in the capital minimums applicable to the FHLB of Chicago. It is uncertain what change, if any, these new redemption rules will have upon the willingness of the bank regulators to consider the stock of the FHLB of Chicago to be a liquid investment. The prospect of a five-year redemption period could prompt the bank regulators to find Class B stock necessary to support activity levels to be a long-term investment. Nor is it certain whether the bank regulators will afford the current 20% risk weighting attached to FHLB stock under the capital adequacy guidelines to both Class A and Class B stock. Clearly, the credit risk posed by Class A and Class B is different. At some point, the bank regulators might recognize the difference in that risk by either increasing the risk rating on Class B or lowering the risk weighting on Class A.

When the new capital structure is put into effect in late 2004 or early 2005, all outstanding stock of the FHLB of Chicago will be converted into Class B stock on a one-for-one basis. The minimum investment necessary to be a member of the FHLB of Chicago or to support the activity of the member at the FHLB of Chicago may be comprised of either Class A or Class B stock, although Class B stock will be weighted at 1.25 times for the purposes of these calculations.

CONSUMER LITIGATION REPORT

- It is an uncommon event for the U.S. Supreme Court to take on a Truth in Lending Act case. But the court did so in *Household Credit Services, Inc., et al. v. Pfennig*. No. 02-857 (U.S. Apr. 21, 2004). The Supreme Court found that an overlimit fee on a credit card loan was not a finance charge and did not have to be treated as such. In doing so, the Supreme Court overruled the Sixth Circuit Court of Appeals and gave deference to the Federal Reserve's Regulation Z, which specifically excludes such charges from the definition of a finance charge.

- Regulation Z allows certain charges, including title insurance charges, to be excluded from the finance charge, as long as such charges are "bona fide and reasonable in amount." In *Marquez v. New Century Mortgage Corp.* (No. 03 C 7136, N.D. Ill., April 5, 2004), the plaintiff alleged title insurance costing $665 on a $68,000 loan was not reasonable in amount, claiming such insurance was readily available for $350, and that, as a result, the entire $665 should have been included in the finance charge. The court found that, even if the title insurance charges were unreasonable, only the difference between what was charged and what was reasonable should have been included in the finance charge, and that this lesser amount was not enough to take the lender above the tolerance limit of Regulation Z.

- *Barnes v. Fleet National Bank, N.A.* (No. 03-1027, 1st Cir., June 2, 2004), provides a lesson for banks acquiring the deposit accounts of another bank. Following the merger of Fleet and BankBoston, Fleet mailed more than one million notices to former BankBoston customers about changes in terms to those customers' deposit accounts. Fleet provided a disclosure of the change in terms that implied that one month prior to the system conversion date was the date upon which new changes would take effect. In actuality, the date of the effective change was the first day of the particular customer's statement cycle following the system conversion. The notice also contained statements that "there is nothing you need to do" and "your accounts will transfer to the Fleet accounts most similar to your existing BankBoston accounts." The Appellate Court overruled the lower court and found that Fleet violated the Truth In Savings Act by failing to properly advise customers of the effective date of the change, and by making misleading statements about what a customer needed to do and the similarities between accounts. Just as in the case of a Truth in Lending Act violation, the Court found Fleet liable for statutory damages, regardless of whether the plaintiff suffered any harm as a result of the violation.

- In *Latham v. Residential Loan Centers of America, Inc*. (No. 03 C 7094, N.D. Ill, May 6, 2004), the borrower was presented with a right of rescission under the Truth in Lending Act. At the same time, the borrower was presented with a post-dated "election not to cancel," which was then signed by the borrower. The district court found that a claim could be made by the borrower that he was not given proper notice of his right to rescind the transaction, finding that the simultaneous delivery of the two documents (even though the election not to cancel was post-dated) interfered with the borrower's right to rescind the transaction.

- If a lender and a consumer contract for a rate of interest which the lender may lawfully charge, and the lender subsequently assigns the loan to a second lender, but that second lender lacks the statutory authority to charge interest at the same rate as that charged by the first lender, may the second lender continue to charge interest at the same rate as the first lender? The court said "yes" in *Vicey v. Asset Acceptance, LLC* (No. 03 C 5193, N.D. Ill., July 2, 2004). The most important fact to the court was that the original interest rate was a lawful rate. The Illinois Interest Act regulates only the origination of the loan.

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