ILLINOIS BANKERS®

# 2023 Bank Counsel Conference

December 1, 2023
Chicago, Illinois

# PROGRAM

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| 8:00 - 9:00 | Registration and Continental Breakfast |
| 9:00 - 10:00 | *Illinois Update – Recent Developments in Banking Law*<br>Carolyn Settanni, Executive Vice President and General Counsel, IBA |
| 10:00 - 10:15 | Networking Break |
| 10:15 - 11:45 | *Regulatory Roundtable – Current Legal Issues from the Regulators' Perspectives*<br>Jayesh Hines-Shah, Deputy General Counsel for Banking, IDFPR<br>Rachel Grundmeier, Specialist Counsel, Federal Reserve Bank of Chicago<br>Jerry Savoy, District Counsel, Office of the Comptroller of the Currency<br>John J. Schroeder, Regional Director, Consumer Financial Protection Bureau<br>Monica M. Tynan, Regional Counsel, Federal Deposit Insurance Corporation |
| 11:45 - 12:30 | Networking Lunch |
| 12:30 - 1:30 | *The Unique Ethical and Legal Challenges in Advising Regulated Institutions*<br>John Geiringer, Partner, Barack Ferrazzano Financial Institutions Group<br>Scott Alvarez, Retired General Counsel, Federal Reserve Board |
| 1:30 - 2:30 | *Lincoln the Lawyer: Professionalism, Ethics, and Civility*<br>John Lupton, Executive Director, Illinois Supreme Court Historic Preservation Commission |
| 2:30 - 2:45 | Networking Break |
| 2:45 - 3:45 | *Commercial Lending Update – Recent Trends in State & Federal Court Decisions and Legislation*<br>Michael L. Weissman, Of Counsel, Levin Ginsburg |
| 3:45 - 4:45 | *Consumer Banking Update – Recent Trends in Consumer Financial Services*<br>Marc P. Franson, Partner, Chapman and Cutler LLP |
| 4:45 - 6:00 | Networking Reception |

## IBA BANK COUNSEL CONFERENCE
## DECEMBER 1, 2023
## CHICAGO, ILLINOIS

**This program has been approved for 6.50 hours of Illinois MCLE credit, including 2.00 hours of Professional Responsibility credit.**
**ABA Professional Certifications has approved this conference for 6.75 CRCM credits.**

# 2023 Bank Counsel Conference
## December 1, 2023

(pre-registered)
List shows registration as of 11/29/23

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|---|---|---|---|
| Jennifer | Aden | Banterra Administration | Marion |
| Sandra | Aguilera | Manetti Aguilera Seiler LLC | Bannockburn |
| Scott | Alvarez | Federal Reserve Board | Chicago |
| Lauren | Barney | CIBC Bank USA | Chicago |
| Mary Anne | Benden | Federal Deposit Insurance Corporation | Chicago |
| Carly | Berard | Illinois Bankers Association | Chicago |
| Edmund | Boland | Carey White Boland Murnighan & Murray LLC | Chicago |
| Lorelei | Botner Abrams | Illinois Department of Financial & Professional Regulation | Springfield |
| Timothy | Breems, Sr. | Ruff Breems LLP | Palos Park |
| Karl | Brorson | Performance Trust Capital Partners, LLC | Chicago |
| Erica | Byrd | Valentine Austriaco & Bueschel, P.C. | Chicago |
| Ian | Campbell | Comptroller of the Currency | Chicago |
| Ana | Casanueva Perochena | Byline Bank | Chicago |
| Michele | Casey | Illinois Department of Financial & Professional Regulation | Chicago |
| Giovanna | Cavallo | Comptroller of the Currency | Chicago |
| Jessica | Cheever | Iroquois Federal Savings & Loan Association | Watseka |
| Nicholas | Chulos | Old National Bank | Chicago |
| Dane | Cleven | Community Savings Bank | Chicago |
| Gelique | Cortez | Old Second National Bank | Aurora |
| Ron | Damashek | Dickinson Wright PLLC | Chicago |
| Andrew | Degman | CIBC Bank USA | Chicago |
| William | Deligiannis | Pan American Bank & Trust | Melrose Park |
| Tejal | Desai | Howard & Howard Attorneys PLLC | Chicago |
| Brett | Dey | Illinois Department of Financial & Professional Regulation | Springfield |
| Timothy | Divis | Legal Aid Chicago | River Forest |
| Kerri | Doll | Busey Bank | Champaign |
| Alexander | Domanskis | Boodell & Domanskis, LLC | Chicago |
| William | Dunn | Amalgamated Bank of Chicago | Chicago |
| Cherie | Duve | Amalgamated Bank of Chicago | Chicago |
| Julie | Egan | Egan & Alaily LLC | Chicago |
| Joe | Eisenbart | Heartland Bank and Trust Company | Monticello |
| Ilana | Ekstein | Byline Bank | Chicago |
| Tricia | Estela | Byline Bank | Chicago |
| Thomas | Evans | Federal Deposit Insurance Corporation | Chicago |

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| Maureen | Faller | Prairie State Bank and Trust | Springfield |
| Renee | Fehr | Heartland Bank and Trust Company | Bloomington |
| Lyndee | Fein | Illinois Bankers Association | Springfield |
| Angel | Fox | The PrivateBank and Trust Company | Chicago |
| Marc | Franson | Chapman and Cutler LLP | Chicago |
| Richard | Freeman | Rammelkamp Bradney PC | Jacksonville |
| Shari | Friedman | Marwedel Minichello & Reeb, P.C. | Chicago |
| Scott | Fryzel | Dykema Gossett PLLC | Chicago |
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| John | Geiringer | Barack Ferrazzano Kirschbaum & Nagelberg LLP | Chicago |
| Peter | Glick | PCBB | Chicago |
| Jack | Griffin | Performance Trust Capital Partners, LLC | Chicago |
| Rachel | Grundmeier | Federal Reserve Bank of Chicago | Chicago |
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| Katherine | Haennicke | TMX Finance | Willowbrook |
| Richard | Hagen | Amalgamated Bank of Chicago | Chicago |
| James | Hannon | First Security Trust and Savings Bank | Elmwood Park |
| Jann | Harley | Federal Deposit Insurance Corporation | Chicago |
| Lindsay | Henry | Dykema Gossett PLLC | Chicago |
| Casey | Hicks | Weltman, Weinberg & Reis Co., LPA | Chicago |
| Jayesh | Hines-Shah | Illinois Department of Financial & Professional Regulation | Springfield |
| Kenneth | Holman | Liberty Bank for Savings | Chicago |
| Thomas | Homberg | Godfrey & Kahn, S.C. | Milwaukee, WI |
| Brandon | Hudson | Illinois Department of Financial & Professional Regulation | Springfield |
| Randy | Hultgren | Illinois Bankers Association | Springfield |
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| Matthew | Imburgia | Illinois Bankers Association | Lockport |
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| Ben | Jackson | Illinois Bankers Association | Chicago |
| Daniel | Jordan | Comptroller of the Currency | Chicago |
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| Eugene | Kraus | Scott & Kraus, LLC | Chicago |
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| Adam | Lawler | Lawler Brown Law Firm | Marion |
| Robert | Leavitt | Dykema Gossett PLLC | Chicago |
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| Karin | Lee | The Northern Trust Company | Chicago |
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| Deanna | Litzenburg | Mathis, Marifian & Richter, Ltd. | Belleville |
| Nolan | Longest | First Neighbor Bank, N.A. | Toledo |
| John | Lupton | Illinois Supreme Court Historic Preservation Commission | Springfield |
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| April | Mack | CIBC Bank USA | Chicago |
| John | Madden | FNBC Bank & Trust | La Grange |
| Solomon | Maman | Noonan & Lieberman, Ltd. | Chicago |

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| James | Mullally | Illinois Department of Financial & Professional Regulation | Springfield |
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| Ryan | Murphy | The Federal Savings Bank | Chicago |
| John | Mussman | Rimon, P.C. | Chicago |
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| James | Noonan | Noonan & Lieberman, Ltd. | Chicago |
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| David | Obstein | Heartland Bank and Trust Company | Bloomington |
| Paul | Osborn | Ward Murray Pace & Johnson | Sterling |
| Terry | Oznick | Merchants Bancorp | Carmel, IN |
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| Tonya | Parravano | Byline Bank | Chicago |
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| Andrew | Plasz | First American Bank | Elk Grove Village |
| Stephen | Pokorny | Pokorny & Marks, LLC | Chicago |
| John | Polster | Old National Bank | Chicago |
| Marc | Primack | Dressler & Peters, LLC | Chicago |
| Kevin | Purtill | Meltzer, Purtill & Stelle LLC | Schaumburg |
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| Jon | Racklin | TrustBank | Olney |
| Andrew | Roselle | INB, National Association | Springfield |
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| Michael | Schasane | Illinois Bankers Association | Chicago |
| Bryan | Schneider | Manatt, Phelps & Phillips | Chicago |
| John | Schroeder | Consumer Financial Protection Bureau | Chicago |
| Marshall | Seeder | Illinois Department of Financial & Professional Regulation | Chicago |
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| Rachel | Selvaggio | Illinois Bankers Association | Springfield |
| Carolyn | Settanni | Illinois Bankers Association | Chicago |
| Steven | Siebers | Schmiedeskamp Robertson Neu & Mitchell LLP | Quincy |

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| Joseph | Silvia | Dickinson Wright PLLC | Chicago |
| Nick | Sladek | Illinois Bankers Association | Chicago |
| Aimee | Smith | Illinois Bankers Association | Springfield |
| Frederick | Snow | First American Bank Corporation | Elk Grove Village |
| Michael | Spaniak | Evergreen Bank Group | Oak Brook |
| Callan | Stapleton | Illinois Bankers Association | Springfield |
| Robert | Stearn | Illinois Department of Financial & Professional Regulation | Springfield |
| Susannah | Strange | Comptroller of the Currency | Chicago |
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| Martin | Tasch | Momkus LLP | Lisle |
| Sandra | Tatoian | Goldenberg, Heller & Antognoli, P.C. | Edwardsville |
| Angela | Taylor | Holcomb Bank | Rochelle |
| Kathy | Thompson | CIBC Bank USA | Chicago |
| Roberto | Tirona | Old Second National Bank | Aurora |
| Laura | Turnquest | Federal Home Loan Bank of Chicago | Chicago |
| Monica | Tynan | Federal Deposit Insurance Corporation | Chicago |
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| Trevor | Van Tubbergen | Merchants Bancorp | Carmel, IN |
| Joseph | VanFleet | Howard & Howard Attorneys PLLC | Peoria |
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| Janet | Wagner | Chuhak & Tecson, P.C. | Chicago |
| Steven | Wallace | Goldenberg Heller & Antognoli, P.C. | Edwardsville |
| Zachary | Walston | Lawler Brown Law Firm | Marion |
| Michael | Weissman | Levin Ginsburg | Chicago |
| Hannah | Wendling | Comptroller of the Currency | Chicago |
| Michael | White | Carey White Boland Murnighan & Murray LLC | Chicago |
| Melissa | Widen | First Women’s Bank | Chicago |
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| Lauren | Zelechowski | Comptroller of the Currency | Chicago |
| Nicholas | Zlevor | Vedder Price P.C. | Chicago |
| Tim | Zollinger | Sauk Valley Bank & Trust Company | Sterling |

## *Speaker Biographies*

***Scott Alvarez*** is Adjunct Professor of Law for the Georgetown University Law Center and served as General Counsel to the Board of Governors of the Federal Reserve System and the Federal Open Market Committee for thirteen years. As the chief legal officer for the Board, Scott provided legal and policy advice on a wide range of regulatory, administrative, organizational, legislative, and other issues related to the duties and operations of the Federal Reserve Board, Federal Reserve System, and FOMC. During his tenure at the Board, Scott drafted regulations, legislation, testimony, and legal and policy memoranda for members of the Board of Governors and other senior officers of the Federal Reserve, managed the Legal Division, and represented the Federal Reserve on the Financial Stability Oversight Council. Scott has testified more than a dozen times before Congress on issues of banking regulation and the Federal Reserve and before the Financial Crisis Inquiry Commission and the Congressional Oversight Panel regarding the 2007–2009 financial crisis. He has also provided legal and technical assistance to Congress on various regulatory and legislative matters. Scott received an A.B. in Economics from Princeton University and his J.D. from Georgetown University Law Center.

***Marc P. Franson*** is a partner in the law firm of Chapman and Cutler. Before joining Chapman, he was Vice President and General Counsel of the Credit Card Services division of Household International. Marc's practice concentrates on representing financial institutions, finance companies, retailers,s and other creditors on a wide array of matters, including consumer credit transactions, mergers and acquisitions, regulatory compliance, private banking and trust services, non-deposit products, electronic commerce, portfolio acquisitions and divestitures, and securitizations and other asset-backed transactions. Marc has served on the Visa/MasterCard Legal Advisory Committee, and he is a regular speaker for both the Conference on Consumer Financial Law and Thomson Financial programs. Marc obtained a B.S.B.A., *magna cum laude*, from Drake University in 1977, an M.B.A. with honors from Drake University, also in 1977, and his J.D. from Drake University in 1980, where he graduated *Order of the Coif*.

***John M. Geiringer*** is the Regulatory Section Leader of the Barack Ferrazzano Financial Institutions Group, where he advises a wide variety of financial institutions around the country about the full spectrum of legal, regulatory, and supervisory issues that they face. He is a frequent speaker and author in the financial institutions area on issues surrounding banking regulations, examinations, and enforcement actions, as well as on cybersecurity. Geiringer teaches banking law and regulation at Chicago-Kent College of Law's Graduate Program in Financial Services Law and serves on the Board of Advisors of its Institute for Compliance. He is a past vice-chair of the American Bar Association's Banking Law Committee and served as the chairman of its subcommittees on Legislation and Regulation; Enforcement, Insider Liability and Troubled Banks; and Bank Secrecy Act/Anti-Money Laundering. Prior to joining BFKN in 1999, John served as legal counsel for the Illinois bank regulatory agency, now the Illinois Department of Financial and Professional Regulation. He also obtained practical experience with respect to bank operations and compliance issues as a regulatory consultant with a regional accounting firm, performing compliance reviews and training for a variety of financial institutions. John received his B.A. from American University and his J.D. from DePaul University College of Law.

***Rachel Grundmeier*** is Specialist Counsel for the Federal Reserve Bank of Chicago. Rachel provides legal support to the Reserve Bank's Supervision and Regulation Function. Before joining the Reserve Bank in June 2020, Rachel was a Senior Counsel at the Federal Reserve Board's Legal Division in the Banking Regulation and Policy Group, which she joined in 2014. Rachel has also worked at the U.S. Securities and Exchange Commission after graduating law school. Rachel received her undergraduate degree from the University of Michigan and her law degree from The George Washington University Law School.

***Jayesh Hines-Shah*** serves as Deputy General Counsel for Banking with the Illinois Department of Financial and Professional Regulation. Jay previously served in legal positions with the Illinois Department of Human Services, IDFPR and the Illinois Commerce Commission, where he was General Counsel and Ethics Officer. Before serving in state government, Jay was an attorney at the law firms of Gibson, Dunn & Crutcher, Morgan Lewis, and Bryan Cave, where he managed commercial, consumer, and securities litigation on behalf of high-technology, financial services, and manufacturing clients. Jay was a law clerk to the Honorable Keith P. Ellison of the United States District Court for Southern Texas. Jay received his B.A. from the University of Chicago and his law degree from the University of Chicago. Jay also holds a master's degree in history from the Johns Hopkins University.

***John Lupton*** is Executive Director of the Illinois Supreme Court Historic Preservation Commission and has served the commission since 2009. He has worked in the fields of legal history and Abraham Lincoln for nearly thirty years. He has served as editor for two prize-winning publications: *The Law Practice of Abraham Lincoln: Complete Documentary Edition* and *The Papers of Abraham Lincoln: Legal Documents and Cases*. John has published several chapters in books and articles and is an expert in determining the authenticity of Abraham Lincoln's handwriting, appearing in the popular PBS show, "The History Detectives." John received his B.A. from Southern Illinois University at Carbondale and a M.A. in History from the University of Illinois at Springfield.

***Jerry Savoy*** is District Counsel in the Office of the Comptroller of the Currency's Central District office in Chicago. Jerry oversees the OCC's Central District legal staff responsible for providing advice and legal counsel to OCC examiners and supervisors. His legal staff also counsels national banks and federal savings associations, which are part of the OCC's Community, Midsize, and Large Bank supervision programs. He began his career with the OCC in Chicago in 1992, after clerking for the Honorable Lyle E. Strom, Chief Judge, United States District Court, District of Nebraska, and the Honorable Dale Fahrnbruch, Associate Justice, Nebraska Supreme Court. Before his relocation to Chicago, Jerry worked as a Senior Counsel in the Northeastern District in New York and as a Special Counsel in the OCC's former Southeastern District in Atlanta. Jerry is a graduate of Creighton University School of Law and Louisiana State University.

***John J. Schroeder*** is Regional Director for the Office of Supervision Examinations with the Consumer Financial Protection Bureau, where he leads a team of managers, examiners and analysts in coordinated supervisory efforts. John joined the Bureau in 2013 and has served as the Assistant Regional Director and as a field manager in the Midwest region. John previously served at the Indiana Department of Financial Institutions for twenty-three years, most recently as General Counsel and Deputy Director of Consumer Credit, along with a number of other roles. John also worked in retail management with the former Bank One and in Corporate Finance with Raffensperger Hughes and Company, a regional investment bank in Indianapolis. John earned his B.A. in Finance with a minor in Economics from the Indiana University Kelley School of Business and received his J.D. *magna cum laude* from the Indiana University McKinney School of Law.

***Carolyn Settanni*** serves as Executive Vice President and General Counsel for the Illinois Bankers Association. She joined the IBA's Law Department in 2011, where she has frequently presented on Illinois banking laws and researched thousands of bank compliance questions, in addition to assisting with internal legal matters and the IBA's legislative efforts. She received her law degree from the Chicago-Kent College of Law in 2010, where she was the Executive Articles Editor of the law review and her undergraduate degree from the University of North Carolina at Chapel Hill.

***Monica Maria Tynan*** is Regional Counsel for the Federal Deposit Insurance Corporation, where she provides legal advice on compliance and enforcement matters involving insured financial institutions and related third parties. Monica also represents the FDIC in litigation and other matters, including administrative enforcement actions. Previously, Monica served in the FDIC's Washington D.C. office as Counsel in the Assessments and Legislation Unit, Enforcement Unit, and Professional Liability Unit. Monica has extensive experience managing investigations and litigation of professional liability claims related to the receiverships of failed financial institutions, including those against directors and officers, attorneys, accountants, appraisers, and others for negligence, gross negligence, and breaches of fiduciary duty. Monica's private practice experience includes serving as first and second chair in complex commercial, product liability, and general tort litigation. She received her B.S. from the University of Illinois and her J.D. from Chicago-Kent College of Law.

***Michael L. Weissman*** is of counsel to the Chicago law firm of Levin Ginsburg, where his practice is devoted to financial and business transactions representing financial institutions in civil and bankruptcy matters and lender liability lawsuits. Mike is the former Chairman of The Illinois Institute for Continuing Legal Education (IICLE) and a former director of the Association of Commercial Finance Attorneys. He is the author of *Commercial and Industrial Loan Documentation*, published and republished by IICLE, as well as several other IICLE publications, including *Secured Transactions*. Mike also writes the monthly IICLE "Flashpoints" column on recent developments for financial services attorneys. Mike also authors a monthly column called The Legal Corner for the Risk Management Association, serves on the Editorial Board of The RMA Journal, and teaches classes on Commercial Loan Documentation for the RMA.  Mike has taught banking classes in Latvia, Laos, South Africa, Tanzania, Uganda and the United Arab Emirates. He is an active member of the ISBA's Section Counsel on Commercial Banking, Bankruptcy and Collections. Mike received his J.D. from Harvard Law School, B.S. from Northwestern University, M.B.A. from the Wharton Graduate Division of the University of Pennsylvania, and he was a Fulbright Scholar at the University of Sydney (Australia) Faculty of Law.

# IBA Bank Counsel Conference

***December 1, 2023***

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# Illinois Update
# Recent Developments in Banking Law

Carolyn Settanni
Executive Vice President and General Counsel
Illinois Bankers Association

# Regulatory Roundtable

## Current Legal Issues from the Regulators' Perspectives

Jayesh Hines-Shah
Deputy General Counsel for Banking
IDFPR

# Illinois Department of Financial and Professional Regulation

## Table of Contents

1. Narrative Document — Bank Community Reinvestment

**Bank Community Reinvestment Comment Responses (38 IAC Part 345)**

The Illinois Community Reinvestment Act ("ILCRA") became law with the enactment of Public Act 101-657 on March 23, 2021. The purpose of the ILCRA is to ensure that covered financial institutions are equitably providing financial services, including low income and moderate-income neighborhoods, and areas where there is a lack of access to safe and affordable banking and lending services. The ILCRA is modeled off the federal Community Reinvestment Act ("federal CRA") but expands the scope of covered financial institutions to include credit unions and entities licensed pursuant to the Residential Mortgage License Act of 1987 which lent or originated 50 or more mortgages in the previous calendar year which are not covered pursuant to federal law. After the passage of the ILCRA, the Department conducted four public meetings and received feedback from industry, consumer advocates, and other stakeholders. The Department incorporated public feedback and suggestions in its Notice of Proposed Rules – Bank Community Reinvestment ("Proposed Rules") published in the Illinois Register on December 16, 2022. See Illinois Register, Pages 19794-19855.[1]

The Department has received over a dozen written comments in response to its Proposed Rules from banks, consumer advocates, and other stakeholders. On March 2, 2023, the Department held a public hearing on the Proposed Rules at which a number of individuals provided testimony relating to the Proposed Rules.[2]

The Department thanks each person and entity who provided comments and testimony relating to the Proposed Rules. The Department reviewed and carefully evaluated each comment received relating to the Proposed Rules. The Department also considered all testimony provided at the March 2, 2023, public hearing on the Proposed Rules. Below is the Department's response to the issues and concerns raised in the comments and testimony.[3] The Department has incorporated feedback and suggestions in the second notice draft of the Proposed Rules when recommendations were appropriate and consistent with the objectives of ILCRA and proper regulatory supervision. The Department is committed to working collaboratively with the Joint Committee on Administrative Rules ("JCAR") and stakeholders prior to adopting the Proposed Rules.

Unless otherwise indicated, a modification or a retraction of a proposed rule does not reflect that the Department agrees with the substance or reasoning of the comment or testimony.

## I. Issues Raised by Consumer Advocates

*A. Whether and how the ILCRA Proposed Rules should be race conscious to establish a regulatory framework that explicitly and intentionally aims to reverse the profoundly negative consequences of redlining.*

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[1] The Department's Notice of Proposed Rules – Credit Union Reinvestment ("Credit Union Proposed Rules") and Notice of Proposed Amendment – Rules Governing the Request for Reconsideration of Examination Findings were also published in the Illinois Register on December 16, 2022.

[2] Public hearings on the Mortgage Proposed Rules and the Credit Union Proposed Rules were conducted on March 2, 2023, and March 8, 2023, respectively.

[3] While the Department reviewed and considered all comments received in their totality, the below response does not specifically address each and every issue and concern raised by commenters. Unless otherwise specified, all references to "commenters" includes witnesses from public hearings.

Numerous commenters stressed that ILCRA must explicitly have a racial equity lens in order to directly address history and systemic redlining. They pointed to the legislative intent of ILCRA as well as to the shortcomings of the federal Community Reinvestment Act. Several related comments are summarized below.

- The ILCRA requires review of the Illinois Human Rights Act as well as the federal fair lending laws in the evaluation of institutions covered by the ILCRA. As such, the law already requires the consideration of discrimination and incorporates directly in its text the laws that define race as a protected class.
- The requirement for banks to serve all communities provides room for the Department to incorporate race into the ILCRA performance context, performance tests, and ratings in specific circumstances in order to encourage institutions to rectify decades of redlining, as well as ongoing discrimination. This can be done to complement an analysis of bank performance based on income.
- IDFPR should incorporate the definitions used to reflect local economic conditions (including unemployment, poverty, and population changes) towards the purpose of identifying distressed or underserved communities, and to do so in a manner that includes all geographies within the State of Illinois that satisfy those conditions, irrespective of metropolitan, nonmetropolitan or income status of the geographies. Including this additional lens of analysis to the ILCRA examination procedure would assist in the identification and assessment of financial product and service disparities in the most vulnerable communities throughout Illinois. It would also provide a portion of the protections envisioned by the inclusion of race in the ILCRA to majority-minority communities. While not as effective or all-encompassing as a blanket inclusion of race in the ILCRA, it would be better than nothing.

The Department welcomes these comments. As noted in the revisions to the Proposed Rules, the Department intends to retain one or more qualified persons to design and conduct a study, and prepare and report findings and conclusions to the Secretary (1) to identify and describe geographies in Illinois experiencing ongoing discrimination or exhibiting significant disparities by race or other protected characteristics in access to relevant financial products or services, and (2) to develop methods and procedures to identify policies, procedures, patterns, or practices that have disparate impact or discriminatory effects. Following the publication of this study, the Secretary will incorporate the findings, conclusions and other results from the study into the examination process.

The Department's ILCRA examination procedure will identify and assess banking and financial product and service disparities consistent with the findings of the study. Specifically, part of the evaluation for receiving an outstanding rating will be whether an institution's activity does not show significant disparities in any geographies identified by a study as more broadly exhibiting disparities on account of race or other protected characteristics.

The revisions to the Proposed Rules also include performance criteria in the lending, investment and service tests, and evaluation criteria to the guidance for outstanding ratings under the lending, investment and service tests.

The study will also aid the Department in identifying evidence of discriminatory or prohibited practices during the ILCRA evaluation by developing methods and procedures that can be used to identify policies, procedures, patterns, or practices that have disparate impact or discriminatory effects based on race or other protected characteristics.

Finally, because the Department's revisions to the Proposed Rules will, following publication of the disparity study, allow ILCRA examiners to analyze evidence that disparities in certain geographies are caused by or coincide with policies or practices employed by a covered financial institution, it is unnecessary to modify the definitions of distressed or underserved communities as suggested by one commenter.

*B. Whether IDFPR should proactively monitor for disparate patterns and practices in lending activities throughout the state and in various localities.*

One commenter stated that the Department should proactively monitor for disparate patterns and practices in lending activities throughout the state and in various localities through review of lending data, news stories, engagement with community organizations and other available information. In addition to incorporating the results of the disparity study concerning discriminatory credit practices into ILCRA examination procedure, the Department intends to engage in ongoing review and discussions with stakeholders to identify disparate patterns and practices, but believes it is not necessary to include this proposal.

*C. Whether bank affiliates should be automatically included on ILCRA exams, and not optional at the bank's choosing.*

Several commenters stated that affiliates are engaging in activity on behalf of the bank and as such should be automatically included on ILCRA examinations. They pointed to inclusion of affiliates by many of the largest banks during federal CRA examinations. For example:

- Since a sizable number of banks already include affiliates in their exams, a more expansive consideration of their activities on exams should not deter banks from including them and some banks may welcome heightened consideration. Automatic inclusion of affiliates also prevents covered institutions from cherry picking only the best performing affiliates and asking that only they be included on exams. Furthermore, the proposal to make the inclusion of affiliates optional gives banks and credit unions the ability to avoid evidence of discriminatory or illegal credit practices being factored into an evaluation of their ILCRA performance.

The Department notes that affiliates are not necessarily located in the same community as the Bank. Automatic inclusion of an affiliate has the potential to expand a bank's reach for ILCRA purposes without satisfying the community's needs. Moreover, the problem of cherry-picking affiliates is generally addressed under federal CRA, which requires an institution that elects to have a particular category of affiliate lending in a particular assessment area considered must include all loans of that type made by all of its affiliates in that particular assessment area. Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestment, 81 Fed. Reg. 48506, 48539-40 (July 25, 2016).

Based on banks' familiarity with the applicable federal limitations, and due to the breadth of the proposal and the inclusion of additional information without a clear purpose, the Department believes that automatic inclusion of affiliates is premature. The Department may further evaluate the issue after completing its initial ILCRA examinations.

*D. Including "Middle Income" in the assessment criteria.*

One commenter recommended revising Section 345.200 ("Assessment Criteria") by allowing covered financial institutions to receive ILCRA credit for offering loans and community development to "middle income neighborhoods" (between 80% of AMI and up to 120% of AMI).

The Department appreciates the desire of financial institutions to serve middle income persons. However, this proposal is inconsistent with the ILCRA's specific focus on "low-income and moderate-income neighborhoods" and inconsistent with the federal CRA.

*E. Data Collection of community development loans, investments and services, and of small business lending data.*

Several commenters recommended that data on community development loans, investments, and services be reported where applicable on an individual activity level and on the census tract-level, that it be made available as part of the public file, and that management of this data remain within the Department.

The Department believes that this data should be reported on an individual activity and census tract-level and has revised the Proposed Rules accordingly. Banks generally have this information and also have the capability to geocode the applicable entities. To the extent that an institution may have limited resources to geocode, it may request a one-year waiver from the Department.

Regarding the commenters' request that the Department make the above data available as part of the public file, under the Department's control, the Department believes that the expense of this data management is not fully justified.

*F. Whether the Department should collect small business lending data pursuant to Section 1071 of Dodd-Frank.*

Several commenters recommended that the ILCRA include the collection of small business lending data as required by the Consumer Financial Protection Bureau's (CFPB) Final Rule adopted pursuant to Section 1071 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203. The CFPB's rule requires compliance on October 1, 2024, April 1, 2025, and January 1, 2026, depending on the financial institution's transaction volume for small businesses.

The Department believes that collection of small business lending data consistent with the CFPB's Final Rule is appropriate under ILCRA and has revised the Proposed Rules accordingly. Small businesses will be able to self-identify as women-, minority-, or LGBTQI+-owned, and lenders will be able to rely on the financial and other information provided by the small business. Importantly, loan officers will not be required to make their own determinations of an applicant's race, ethnicity, or any other demographic information.

Financial institutions would be required to report small business loan data under ILCRA to the same extent and timing as the CFPB's Final Rule. Therefore, if pending litigation were to affect compliance requirements, including but not limited to timing, under the CFPB's final rule, the requirements under ILCRA would remain consistent.

*G. Whether the Department should establish a Public Registry to facilitate comments on banks' ILCRA performance.*

Several commenters recommended that the Department establish a public registry that community organizations can use to sign up as an organization with input on community needs and bank performance.

The Department is committed to collecting input from a diverse range of organizations, including organizations led by people of color and women. However, due to the number and prioritization of IT solutions necessary to implement ILCRA, the Department believes that creating this registry is not fully justified at this time.

*H. Whether the Department should list Special Purpose Credit Programs as an example of innovative or flexible lending practices that would receive positive consideration in the performance criteria of the lending test.*

Several commenters recommended that the ILCRA Proposed Rules list Special Purpose Credit Programs (SPCPs) as an example of innovative or flexible lending practices that would receive positive consideration in the performance criteria of the lending test.

Under Federal law, lenders are permitted to design and implement SPCPs to extend credit to a class of persons who would otherwise be denied credit or would receive it on less favorable terms, under certain conditions. In particular, the Equal Credit Opportunity Act, 15 U.S.C. § 1691(c) (ECOA) and Regulation B, 12 C.F.R. § 1002.8, permit creditors to offer or participate in SPCPs and other credit programs to meet special social needs through:

1. Any credit assistance program expressly authorized by Federal or state law for the benefit of an economically disadvantaged class of persons;

2. Any credit assistance program offered by a not-for-profit organization, as defined under section 501(c) of the Internal Revenue Code of 1954, as amended, for the benefit of its members or for the benefit of an economically disadvantaged class of persons; or

3. Any special purpose credit program offered by a for-profit organization, or in which such an organization participates to meet special social needs.

12 C.F.R. § 1002.8(a)(1)-(3). The Department believes that special credit programs, including SPCPs, should be given consideration to the extent they conform with and are authorized by ECOA and Regulation B, and has revised the Proposed Rules to list them in Section 345.220(b)(5).

*I. Whether and how the Department should modify the Fair Lending criteria for the effect of (a) a finding of any civil rights, equal protection or consumer protection* *violations, (b) a pending Fair Lending investigation during the ILCRA examination, and (c) covered discriminatory practices.*

(1) Several commenters recommended that if a financial institution is found to have violated any civil rights, equal protection, or consumer protection laws, and irrespective of whether the institution settles without admitting guilt, the institution should be immediately downgraded to "Substantial Noncompliance" in its current or next ILCRA assessment.

The Department appreciates the desire to provide certain consequences in the event nondiscrimination laws are violated. However, a settlement, by itself, is not evidence of a violation. Furthermore, an automatic downgrade could discourage financial institutions from entering into such settlements which would deprive communities and individuals of settlement benefits, whether through a change in in the financial institution's policies and procedures and/or monetary relief, that they may otherwise receive.

The Department believes the Proposed Rules provide the Secretary sufficient authority to require such a downgrade. Specifically, Section 345.280(c)(1) provides: "The Secretary's evaluation of a bank's ILCRA 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." The rule further specifies that violations of a number of nondiscrimination laws are "evidence of discriminatory or other credit practices that violate an applicable law, rule, or regulation." Section 345.280(c)(1)(A)-(H).

(2) Several commenters recommended that the Proposed Rules be revised in the event that a fair lending investigation is pending during the ILCRA examination. Specifically, either (i) the pending fair lending investigation should be noted during the ILCRA examination and appropriate follow-up actions taken once the investigation is concluded or (ii) the ILCRA examination should be kept open until the fair lending investigation is completed.

The Department does not believe it is appropriate to comment on pending investigations in the ILCRA examination. If a pending fair lending investigation results in a less than satisfactory rating, federal CRA already requires that the bank "shall include in its public file a description of its current efforts to improve its performance in helping to meet the credit needs of its entire community" and "shall update the description quarterly." 12 CFR 345.43(b)(5). If the investigation does not result in a less than satisfactory rating, no follow-up is required. Regarding the alternative of keeping the examination open, due to the anticipated volume of ILCRA examinations, the Department believes it is important that the ILCRA evaluation be finalized.

(3) Several commenters recommended that Section 345.280(c) of the ILCRA Proposed Rules not be limited to "discriminatory or other illegal credit practices," and that the word "credit" be removed, consistent with the federal agencies' CRA Notice of Proposed Rulemaking [87 Fed. Reg. 33884, § __.28(d)(1)].

The Department appreciates the goal of broadening nondiscrimination language, but believes it is more appropriate to review and evaluate the language that is adopted in the final federal CRA rule and make necessary amendments at that time. The assessment factors lready encompass "evidence of discriminatory and prohibited practices." See Section 345.200(h).

*J. Whether the ILCRA lending test and Appendix A should expressly include an assessment factor for discrimination by banks.*

One commenter recommended that Section 345.220 (Lending Test) and Appendix A expressly refer to an assessment of a bank's record of discrimination and fair lending. The comment is premised on the text of Section 345.210 (Performance Tests), which requires the Secretary to apply the assessment factors set forth in Section 345.200 (Assessment Factors) to each of the lending, investment, and service tests. 345.210(a)(1). The commenter asserts that, because the lending test and Appendix A do not expressly refer to consideration of discrimination and fair lending, these assessments are somehow missing.

First, as addressed above, the Department believes that the revisions to the Proposed Rules address the substance of the comment by incorporating the proposed disparity study's conclusions and other results into the examination process—including a review of whether disparities are caused by a bank's policies or practices. See Response to Consumer Advocate Comments, Section A, above. The Department further notes that the existing language of the Proposed Rules achieves the commenter's goal. Section 345.220(b) states: "The Secretary evaluates a bank's lending performance *considering the assessment factors in Section 345.200* and pursuant to the following criteria." One of the assessment factors referenced here is "evidence of discriminatory and prohibited practices." Section 345.200(h). Likewise, Appendix A specifically provides that ratings may be adjusted "on the basis of evidence of discriminatory or other illegal credit practices." Appendix A, Section (a)(1).

*K. Whether "community development needs" should be defined to include loan originations and other activities that reduce significant, existing racial disparities.*

One commenter recommended defining the term "community development needs," which appears in Section 345.230 (Investment Test), Section 345.250 (Community Development Test), and Appendix A to include "loan originations and other activities that reduce significant, existing racial disparities in the number and volume of mortgage loans in the assessment area or majority-minority geographies within the assessment area."

As stated in Section I.A., above, the Department believes that the revisions to the Proposed Rules address the substance of the comment by incorporating the proposed disparity study's conclusions and other results relating to nondiscrimination into the examination process—including the Investment Test in Section 345.230. Further, the existing language of the Proposed Rules defines "community development" broadly. Many loans whose primary purpose is community development will, by virtue of addressing the needs of low- or moderate-income individuals, also reduce racial disparities in mortgage lending.

*L. Whether the ILCRA should provide additional protections for the elderly, disabled, and veterans.*

One commenter recommended that the Department include additional protections for lending practices relating to seniors and people with disabilities, because these populations are particularly vulnerable to predatory lending or scams. Another commenter stated that veterans are also a part of underserved communities whose needs should be met.

The Department appreciates the comment, but believes the broad nondiscrimination provisions in Section 345.280(c)(1) of the Proposed Rules will adequately protect the elderly, disabled, veterans, and other vulnerable populations.

### M. *Whether to weight loan purchases differently than loan originations, and to exclude second purchases.*

Several commenters addressed the possibility of "loan churn" based on the treatment of purchased and originated loans under ILCRA. For example:

- A key area of concern by advocates and the financial industry alike as it relates to the Federal CRA is the issue of purchased loans and "loan churn." Since the Federal CRA's treatment of purchased loans as equal to originated loans, a market has grown for the continuous and repeated purchase of loans eligible for CRA consideration. Under current procedures, a single loan can be bought and sold multiple times over its lifetime, appearing for consideration on many, many exams without providing new investment in the community. Federal bank regulatory agencies are proposing that CRA consideration should only be given for origination and the initial purchase of a loan. This issue is not mentioned or addressed in the NPR, and should be.

Another commenter recommended going a step further, by treating loan originations and purchases as separate product lines:

- Retail loan purchases should not be treated as the equivalent to loan originations. We recommend that purchases have some consideration on lending tests out of recognition that some banks have business models that involve large scale purchasing from brokers, but purchased loans should not receive the same weight as originated loans. Purchasing activity should be evaluated as a separate product line and receive less weight than originations on the lending test.

The Department appreciates the concern generally, and has revised the Proposed Rules to limit credit under the ILCRA to the origination of a loan and the initial sale or purchase of a loan. With respect to the proposal to weight loan purchases differently, the Department intends to monitor practices involving purchased loans in case further action is necessary.

### N. *Whether the ILCRA should expressly prohibit banks from using their charters to allow third parties to offer predatory loans.*

Several commenters, observing the pattern of banks that engage in indirect consumer lending through non-bank partners to make loans structured to evade interest rate caps and consumer protection laws, recommended that the ILCRA Proposed Rules expressly prevent covered entities from allowing their charters to be used as a mechanism by which third parties can provide predatory loans.

The Department is not aware of any covered financial institutions (*i.e.,* Illinois state-chartered or licensed banks subject to the ILCRA) currently engaged in the practices described by commenters. Moreover, the Department believes the Proposed Rules are consistent with the statutory objectives of the ILCRA and provide sufficient authority to address lending products that fail to meet the needs of the covered financial institutions' assessment area on a case-by-case basis, including predatory lending. Further evaluation is necessary to determine whether an explicit bright-line rule could be drafted that adequately accounts for all relevant federal and state laws in this area and accounts for differences in business models.

*O. Whether the Department should create a user-friendly list of all entities subject to ILCRA.*

One commenter recommended that the Department create "a user-friendly list on its website" of all entities subject to the ILCRA. Although the Department's website currently allows the public to identify banks (as well as credit unions and mortgage lenders) generally, it welcomes the request and is working to implement a list that is specific to ILCRA. Creating and maintaining such a list does not require a rule.

*P. Publication of examination schedule*s

One commenter suggested that the ILCRA examination schedules should be published 60 days in advance instead of 30 days.

The requirement to publish the examination schedules at least 30 days in advance is consistent with the federal CRA and Proposed Rules. The examination schedule will depend on a number of factors that the Department may not be able to fully resolve more than sixty days before the examination. For example, examinations may need to be rescheduled to address staffing availability for both the Department and covered financial institutions. Furthermore, the Proposed Rules permit the Department to publish the examination schedule earlier if feasible. The Department intends to provide notice at the earliest possible time.

*Q. Definition of community development.*

One commenter stated that definitions of community development for banks should include activities that "directly and tangibly increase climate resilience in low income to moderate-income neighborhoods; or mitigate environmental harm in low-income to moderate-income neighborhoods."

Another commenter stated that the definition of community development should be revised to ensure that multifamily lending avoids displacement and contributes to the availability of affordable housing in order to receive community development credit. The commenter also recommended that the Department add that multifamily housing must be *permanently affordable*, kept in good condition, and targeted to households with low to moderate income in order to receive positive credit.

The Department believes the current definition of "community development" adequately includes climate resilience and affordable housing, and provides the flexibility necessary to fairly address the unique ways covered financial institutions serve their assessment area.

*R. Anti-gentrification*

Several commentators requested clarification on anti-gentrification considerations found in each of the Proposed Rules for covered institutions. The Department believes the Proposed Rules provide the flexibility necessary to fairly evaluate this issue.

*S. Changes to the federal CRA*

One commenter pointed out that Federal banking regulatory agencies are in the process of considering major revisions that may make ILCRA exams more rigorous and the Department should consider updating the Proposed Rules to align with any revisions and make exams more rigorous and comprehensive.

The Proposed Rules incorporate rules as they stand now with adjustments the Secretary deems necessary. The Department may amend the rules to address future changes to the federal CRA.

## II. Issues Raised by the Banking Industry

*A. Whether the Department should clarify the ILCRA Proposed Rules' definitions of unbanked and underbanked persons.*

One commenter recommended clarifying the definitions of "unbanked" and "underbanked" as used in the ILCRA Proposed Rules. There was particular concern that the proposed definition of "unbanked" might exclude creative and effective programs that are clearly marketed to and designed for unbanked and underbanked populations, such as programs creating a limited checking account for the purpose of picking up and cashing government checks for a nominal fee. In the commenter's view, banks cannot verify whether an individual has a checking or savings account with another insured depository institution.[4]

The commenter does not identify the potential magnitude of programs that would fall outside the ILCRA's definitions of "unbanked" and "underbanked." The lack of specifics is problematic because the FDIC's definitions for purposes of federal CRA are quite similar. The FDIC defines an "unbanked" person as someone who does not hold either a checking or savings account with a federally insured banking institution. <u>2021 FDIC National Survey of Unbanked and Underbanked Households</u> at 11. Unbanked people transact primarily in cash and store all their assets only in physical, offline formats. A person who is "underbanked" maintains a federally-insured checking or savings account but regularly uses alternative financial services such as payday lending. <u>Id.</u> People who are underbanked may be obligated to frequently use costly financial services like check cashing, payday lending, and money transfer services because they have limited access to better banking options.

*B. Whether the ILCRA Proposed Rules should exclude from coverage banking offices of foreign corporations issued a certificate of authority in Illinois.*

[4] The same commenter also requested clarification of other undefined terms in the Proposed Rules, such as "small business lender" in Section 345.200. However, that term is immediately followed by the phrase "loans to businesses with gross annual revenues of $1,000,000.00 or less," making clarification unnecessary.

Several commenters recommended excluding from coverage banking offices of foreign bank corporations issued a certificate of authority in Illinois—particularly when the foreign bank office already complies with federal CRA. First, they contend that because such banking offices were not expressly included in the ILCRA's statutory definition of a "covered financial institution," it is impermissible for the ILCRA Proposed Rules to include them in its scope. Second, although the commenters acknowledge that the assessment areas of such bank offices would be limited to areas within Illinois, they express concern with potential costs of examinations, as well as the travel expenses of Department examiners who could insist on inspecting books and records located in these institutions' offices outside the United States. Third, the commenters note that the Department's proposed rules for covered mortgage licensees do not apply to offices of foreign mortgage lenders or credit unions.[5]

The Department appreciates the comment, particularly the concern with the reasonableness of expenses for ILCRA examinations. The commenters' statutory construction argument is limited to whether banking offices of foreign bank corporations are expressly identified in the ILCRA statute. The commenters tacitly concede that these offices are within the scope of the statute's language: "any other financial institution under the jurisdiction of the Department." 205 ILCS 735/35-5. Nor do they deny that a "banking business" is being conducted at these offices. See 205 ILCS 5/2. Thus, there should be no surprise that these institutions are included in the Department's Proposed Rules.[6] Second, there is no justification to categorically prohibit travel expenses related to examinations of banking offices of foreign bank corporations. The Department has the authority to conduct safety and soundness examinations in foreign countries. No argument is put forth as to why ILCRA examinations should be treated differently. The Department further refers to its response in Section II.H., below.

*C. Whether the ILCRA Proposed Rules should count investments made through a foreign bank office and clarify whether a bank that is not in the business of extending home mortgage, small business, small farm, or consumer loans to retail customers is automatically considered a wholesale bank.*

As an alternative if the Department does not adopt the preceding comment, one commenter recommended (1) counting ILCRA-eligible investments made by a foreign bank office through other offices and subsidiaries and (2) clarifying in Section 345.250(b) of the Community Development Test for Wholesale or Limited Purpose Banks that a bank not in the business of extending home mortgage, small business, small farm, or consumer loans to retail customers is automatically considered a wholesale bank and does not need to be designated as such.

The Department appreciates the suggestions contained in this comment. As to the first recommendation, the Department is unaware of a similar provision under federal CRA that permits this aggregation of investments. As to the second recommendation, the Department notes that federal CRA rules already have a procedure for designation as a wholesale or limited bank. See 12 C.F.R. § 345.25(b). The federal procedure similarly does not provide an exception for institutions not designated as wholesale.

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[5] There is no equivalent of the Foreign Banking Office Act for credit unions.

[6] The Department defers to the Illinois General Assembly on whether an amendment to the definition of "covered financial institution" is necessary and appropriate.

*D. Whether the Department should include examples and adopt the federal agencies' illustrative list of qualifying activities that are eligible for ILCRA credit.*

One commenter recommended including a list of qualifying activities for banks modeled on Appendix C to the proposed ILCRA Proposed Rules for credit unions. The commenter suggested that the list of examples could identify activities that clearly should qualify for credit, such as investments in the Federal Home Loan Bank of Chicago's Affordable Housing Program General Fund.

The Department has included in its revisions to the Proposed Rules a new Appendix C that contains a list of examples of lawful investments, deposits, membership shares, and grants which may be deemed to have the primary purpose of community development, based on Appendix C to the Credit Union Proposed Rules and the Office of the Comptroller of Currency's Illustrative List of Qualifying Activities (May 20, 2020).

*E. Whether the Department should exclude bank affiliates from examination under the ILCRA.*

One commenter, while acknowledging the ILCRA's consideration of lending and other CRA-eligible activities by a bank's affiliates, recommended excluding such affiliates from examination "as if they were independently covered by the Illinois CRA's requirements." The commenter cites what it believes is a lack of statutory authority, as well as inconsistency with the federal CRA, and the unworkability for many bank affiliates such as insurance and investment companies.

For the reasons stated in Section I.C., above, affiliates are *not* automatically included in ILCRA examinations. Rather, a bank must elect whether to choose to include affiliates.[7] Further, the claim that the Department lacks statutory authority to examine an affiliate under appropriate circumstances ignores the plain language of the ILCRA statute, which provides authority to examine "each covered financial institution"—that is, "any other financial institution under the jurisdiction of the Department." 205 ILCS 735/35-15(a), 35-5. The authority to examine affiliates under ILCRA is also consistent with the Department's general authority to examine affiliates under the Illinois Banking Act [205 ILCS 5/48(2)(a)] and Savings Bank Act [205 ILCS 205/9004(a)].

*F. Whether the Department should remove from the ILCRA Proposed Rules' Lending and Community Development tests the requirement that banks monitor and keep records of members of a consortium have claimed CRA credit for a particular loan origination or purchase.*

One commenter recommended removing from the Lending (Section 345.220(d)) and Community Development (Section 345.250(d)(2)) tests the requirement that banks "monitor and keep records of whether" members of a consortium and/or affiliates have claimed CRA credit for a particular loan origination or loan purchase. Failure to remove the monitoring requirement, the comment states, will cause banks "to partner exclusively with non-covered entities in lending consortiums, as the only way to guarantee that the other consortium members could not claim CRA credit for

[7] Similarly, loans by an affiliate of a credit unions are evaluated at the option of the credit union. See Proposed Rules, Section 185.220(c).

the origination or purchase."

The Department appreciates the comment. However, the monitoring requirement is necessary to avoid a situation in which multiple participants or investors claim the same loan origination or purchase. The commenter would inappropriately place the burden on the Department, rather than the bank seeking ILCRA credit, to be informed about the actions of other members.

*G. Whether the Department's fee structure for ILCRA examinations is reasonable.*

Several commenters expressed concerns about the general costs of complying with ILCRA, where those costs could instead be deployed through additional lending and investment, marketing to low- and moderate-income communities, and promoting financial literacy. They also questioned the proposed annual increase of this fee by 5% each year. One commenter referred to the Department's fee structure as "excessive and vague in scope." Another commenter questioned what it characterized as "unlimited reimbursements for out-of-state travel expenses."

One commenter also posed a series of more specific questions about how the per-day examination fee would be applied:

- "[W]hat constitutes an examination day?"
- Is "spend[ing] a half hour answering a question … considered an examination day?"
- "What if the examiner reviews documents for multiple separate bank examinations on the same day?"
- "What proof will the Department provide to substantiate its billings?"

Regarding the general costs of compliance, the Department recognizes that the ILCRA will likely result in increased costs for Illinois banks. The Department believes the Proposed Rules minimize any burden while still fulfilling the statutory objectives of ILCRA. The Department has mitigated the costs and impact of ILCRA whenever possible, consistent with the statutory scheme.

Regarding the 5% annual increase in the examination fee, this increase is not arbitrary but necessary to cover the Department's anticipated costs over time. Most Department employees receive yearly cost of living wage adjustments and salary increases pursuant to the union contract or Illinois law. Other costs such as employee benefits also generally increase over time. The Department's fiscal team anticipates that total ILCRA costs will increase by approximately five percent a year annually. Accordingly, the examination fee must increase to cover these costs. However, the Department will amend the Proposed Rules to (1) limit the examination fee increase to "up to 5% per year" and (2) reflect that the annual assessment shall increase by no more than 5% annually. (Section 345.480(b)). The Department does not intend to increase the examination fee unless necessary to cover the Department's reasonable costs of the Proposed Rules.

As to the specifics of examination fees, including potential reimbursement for out-of-state travel by Department employees in conducting ILCRA examinations, the commenter overlooks that similar travel expenses for safety and soundness examinations have been reimbursed by banks for years. In the case of savings banks, this included per-hour examination fees until 2018. No claim is made that these similar practices caused undue financial hardship or confusion.

*H. Whether the ILCRA Proposed Rules should limit travel by the Department's examiners.*

One commenter recommended that Department examiners limit travel, particularly for the bulk of examination activities that easily could be conducted remotely. This commenter recommended more severe limitations on out-of-state and international travel.

The Department believes that travel should be limited to situations where it is necessary, particularly in the case of out-of-state and international travel. However, it is unnecessary to enshrine this principle in rule, particularly where commenters have failed to propose any reasonable limitation.

*I. Whether the Department should extend the implementation period of the ILCRA Proposed Rules beyond 6 months.*

Several commenters asserted that they desired a longer time period than the 6 months under Section 345.490 to comply with the Proposed Rules, in order to succeed in achieving the goals of the ILCRA. These commenters asserted that Illinois banks are already subject to federal CRA, and are in the process of complying with the small business loan reporting requirements of Section 1071 of Dodd-Frank.[8] They also asserted that past and present federal CRA laws permitted an implementation period of one year, and more.

The Department carefully considered the implementation timeline for the ILCRA examinations and believes the implementation period is reasonable and consistent with the statutory objectives of ILCRA. For the following reasons, the Department has not adopted this proposal.

First, the Department believes ILCRA is important and should be implemented as soon as practical. The Department will provide ample assistance and guidance to banks as they and the Department go through examinations for the first time. The Department views the ILCRA examination as an opportunity to provide Illinois state-chartered banks critical feedback which will help ensure their long-term success in meeting their ILCRA obligations and furthering the vital role banks play in our financial system.

Second, the length of the implementation period is sufficient due to the additional one-year period under Section 345.490(b), during which examinations will not be initiated (subject to certain exceptions).

Third, concerns raised by banks relating to the implementation period (e.g., how and when required data must first be submitted) can be addressed without unnecessarily delaying the first ILCRA examinations.

*J. Whether the ILCRA Proposed Rules should align with federal CRA through modifying examination schedules and conducting joint examinations.*

Several comments focused on the timing of ILCRA examinations under the Proposed Rules, and

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[8] As noted in Section I.F., the Department's revisions to the Proposed Rules will require reporting of small business and farm loans consistent with the federal final rule for Section 1071.

coordination with federal CRA examinations. One commenter was concerned that, due to differing federal and Illinois examination cycles, a bank may experience both a federal CRA and ILCRA examination in consecutive years. Another commenter recommended that ILCRA examinations be required to follow the examination schedule of the federal CRA examiner, and if possible have the examinations conducted jointly.

The Department appreciates the comments. However, providing predictability in examination schedules is essential to ensuring the objectives of ILCRA are satisfied. The ILCRA statutory language also promotes "efficient regulation and effect[ing] cost reduction," 205 ILCS 735/35-25(c), but expressly maintains the Department's "authority … to independently conduct examinations." 205 ILCS 735/35-25(b). Although the Department intends to coordinate examinations with the federal CRA regulators in most cases, coordination will not be possible if the ILCRA rating assessment differs from the federal CRA rating—in which case, the examination cycle may change. Further, joint examinations will only be possible if the federal CRA regulator permits them.

*K. Whether the ILCRA Proposed Rules should afford banks with "outstanding" or "satisfactory" ratings under the federal CRA as if these were ILCRA ratings.*

Several commenters recommended affording banks with "outstanding" or "satisfactory" ratings under the federal CRA the same relief as if these were Illinois CRA ratings, particularly in the years before a bank has received any rating under the Illinois CRA.

The Department appreciates the comments. However, given the number of banks that receive these ratings under federal CRA, the proposal would have the effect of delaying many ILCRA examinations for several years.

*L. Whether the ILCRA Proposed Rules should include an evaluation of banks' fair lending practices.*

One commenter questioned the ILCRA Proposed Rules including an evaluation of a bank's fair lending. It noted that at the federal level, fair lending examinations are conducted outside of federal CRA. The Department appreciates the comment. However, we note that fair lending evaluations are an important part of ILCRA. The statute expressly provides authority for the Secretary to evaluate "compliance with applicable State and federal fair lending laws," and adopt applicable rules. 205 ILCS 735/35-15(a); 205 ILCS 735/35-35(ii).

*M. Whether the ILCRA Proposed Rules should have enforcement provisions for other covered financial institutions who fail to comply with ILCRA.*

One commenter observed a potential disparity in the ILCRA Proposed Rules for banks and the rules for other covered financial institutions relating to enforcement actions. The Department has proposed revisions to the Proposed Rules for covered mortgage licensees that would also make these institutions subject to enforcement actions or referrals, should they fail to comply with requirements of ILCRA.

## Appendix A – ILCRA Comments

The Department reviewed and considered all comments received. Many commentators did not identify whether their comment related to the Bank Community Reinvestment Rules, Mortgage Community Reinvestment Rules, or Credit Union Community Reinvestment Act Rules. For this reason, below is a list of persons and entities who provided a comment relating to any of the proposed rules or testified at any of the public hearings.

Comments by Credit Unions and Credit Union Associations

- 1st MidAmerica Credit Union
- 2 Rivers Area Credit Union
- Abri Credit Union
- Access Credit Union
- ACME Continental Credit Union
- Advantage One Credit Union
- ALEC Credit Union
- Alliant Credit Union
- Archer Heights Credit Union
- Area Educational Credit Union
- Baxter Credit Union (BCU)
- Berean Credit Union
- Bethel Ame Church Credit Union
- Bloomington Municipal Credit Union
- BNSF Railway Credit Union
- Cambio Credit Union
- CAFCU (Corporate America Family Credit Union)
- Catholic & Community Credit Union
- CEFCU (Citizens Equity First Credit Union)
- Central Illinois Credit Union
- Chicago Municipal Employees Credit Union
- Chicago Post Office Employees Credit Union
- Community Plus Federal Credit Union
- Consumers Credit Union
- Cooperative Choice Network Credit Union
- Cornerstone Credit Union
- Credit Union1
- Decatur Earthmover Credit Union
- Deere Employees Credit Union
- DuPage Credit Union
- Elite Community Credit Union

- Faith Based Credit Union Alliance[9]
- Fellowship Baptist Church Credit Union
- Financial Plus Credit Union
- First Financial Credit Union
- Gale Credit Union
- GBCU (Galesburg Burlington Credit Union)
- GECU (Gas & Electric Credit Union)
- Governors Board of Credit Union Advisors
- GCS Credit Union (Granite City Steel Credit Union)
- Great Lakes Credit Union
- Healthcare Associates Credit Union
- Heartland Credit Union
- Heights Auto Workers Credit Union
- IAACU (IAA Credit Union)
- IHMVCU (IH Mississippi Valley Credit Union)
- Illinois Credit Union League
- Illinois Educators Credit Union (IECU)
- Imperial Credit Union
- Inclusiv
- Israel Methcomm Federal Credit Union
- Joliet Firefighters Credit Union
- KCT Credit Union (Kane County Teachers Credit Union)
- Land of Lincoln Credit Union
- Landmark Credit Union
- Maroon Financial Credit Union
- Maternity B.V.M. Credit Union
- MEA Credit Union
- Members Alliance Credit Union
- Members First Community Credit Union
- Mercer Credit Union
- Midwest Coalition of Labor Credit Union (MCL Credit Union)
- Midwest Members Credit Union
- Moline Municipal Credit Union
- MWRD Employees' Credit Union (Metropolitan Water Reclamation District)
- Northern Illinois Federal Credit Union
- Northwest Community Credit Union

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[9] Representing the following credit unions: Fellowship Baptist Church, *Israel Methcomm, Park Manor Christian Church, *South Side Community, *Unified Homeowners, St. Mark, Berean, *CTAFC, *CTA 74th Street Depot, *CTA South, St. Helena Parish, Bethel, St. Gregor Parish, Imperial, Pilgrim Baptist, *Shiloh Englewood, *St. Martin De Porres Parish, St. Jude, and *Trinity UCC. Asterisks denote federal credit unions.

- Numark Credit Union
- Park Community Credit Union
- Park Manor Christian Church Credit Union
- Partnership Financial Credit Union
- Pilgrim Baptist Credit Union
- Pontiac Dwight Prison Employees Credit Union
- Rock Valley Credit Union
- Salem School System Credit Union
- Scott Credit Union
- Select Employees Credit Union
- Service Plus Credit Union
- Shiloh Englewood Federal Credit Union
- SIU Credit Union
- SIUE Credit Union
- Springfield Firefighter's Credit Union
- St. Helena Parish Credit Union
- Streator Onized Credit Union (SOCU)
- Staley Credit Union
- United Community Credit Union
- United Equity Credit Union
- U of I Community Credit Union
- Urbana Municipal Employees Credit Union
- Western Illinois School Employees Credit Union

<u>Comments by Banks and Banking Associations</u>

- BMO Financial Group
- Community Bankers Association of Illinois
- Illinois Bankers Association

<u>Comments by Mortgage Lenders and Mortgage Lending Associations</u>

- Community Home Lenders of America
- Greater Midwest Lenders Association of America
- Illinois Mortgage Bankers Association
- Mortgage Bankers Association
- Rocket Mortgage
- USA Mortgage Corporation

<u>Comments by Consumer Advocates, Other Stakeholders, and Members of the Public</u>

- Kenya Barbara
- Center for Disability & Elder Law

- Chicago Community Trust Group
- Comer Family Foundation
- Conant Family Foundation
- Field Foundation of Illinois
- Sandy Deters
- Housing Action Illinois (Kristin Ginger)
- Illinois CRA Coalition[10]
- Illinois Hispanic Chamber of Commerce
- Illinois People's Action
- National Community Reinvestment Coalition
- Neighborhood Housing Services of Chicago
- Polk Brothers Foundation
- Josh Silver
- Woods Fund Chicago
- Woodstock Institute

<u>Credit Union Public Hearing Testimony</u>

- Senator Jacqueline Collins[11]
- Ianna Kachoris – Chicago Community Trust
- Kerry Fearn – Area Educational Credit Union
- Martha Shine – Park Manor Christian Church Credit Union

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[10] Representing the following Non-Profit Organizations, Small Businesses, and Elected Officials: AIDS Foundation Chicago, Alderperson Andre Vasquez's Office, Chicago's 40th Ward, Alderwoman Maria Hadden, Chicago's 49th Ward, Alliance to End Homelessness in Suburban Cook County, Beau Group, LLC, BPI Chicago, Chicago Community Loan Fund, Chicago Community Trust, Chicago Housing Trust, Chicago Jewish Coalition for Refugees, Chicago Lawyers' Committee for Civil Rights, Chicago Rehab Network (CRN), Chicago Urban League, Claretian Associates, Community and Economic Development Association of Cook County, Inc. (CEDA), Corporation for Supportive Housing (CSH), Disability Resource Center, Economic Growth Corporation, Embarras River Basin Agency (ERBA), Garfield Park Community Development Corporation, Gorman and Company, Grass Roots Organizing Works, Greater Southwest Development Corporation, Habitat for Humanity Chicago, Habitat for Humanity DuPage & Chicago South Suburbs, Habitat for Humanity of Champaign County, Heartland Alliance, Hemp Heals Body Shop, HOPE Fair Housing Center, Housing Action Illinois, Housing Opportunities & Maintenance for the Elderly (H.O.M.E.), Illinois Network of Centers for Independent Living, Illinois People's Action, Jacqueline Collins, Former Illinois State Senator for the 16th District, James B. Moran Center for Youth Advocacy, Jewish Free Loan Chicago, Lake County Housing Authority, Latin United Community Housing Association (LUCHA), Law Center for Better Housing, Lawndale Christian Development Corporation, Legal Action Chicago, Manufactured Home Owners Association of Illinois, Mid Central Community Action, Neighborhood Housing Services of Chicago, North West Housing Partnership, Oak Park Regional Housing Center, Open Communities, Primed for Life, Inc., Progress Center for Independent Living, Rebirth of Greater Roseland, Renaissance Collaboration, Respond Now, Self-Help Federal Credit Union, Share Our Spare, Shelter Care Ministries, Shriver Center on Poverty Law, Small Business Minority, South Suburban Housing Center, Southern Illinois Center for Independent Living, Spanish Coalition for Housing, St. John's Episcopal Church, St. Louis Equal Housing & Community Reinvestment Alliance (SLEHCRA), Statewide Independent Living Council of Illinois, Tanzanian Midwest Community Association, The Resurrection Project, Tipping Point Consultancy, UIC Law Fair Housing Legal Support Center, Universal Housing Solutions CDC, Woodstock Institute, Working Family Solidarity, Youth Advocacy Foundation Inc. Also representing the following individuals: Judi L. Angell, Claire Bacon, Allison Fradkin, Susan Grossman, PhD, Katrina Stoutmire, Ocie Whitten.

[11] Senator Jacqueline submitted written comments in lieu of testimony.

- Steve Olson – Illinois Credit Union League
- Suzie Branch – Select Employees Credit Union
- Deborah Fears – Chicago Post Office Employees Credit Union
- Brian Laufenberg – IH Mississippi Valley Credit Union
- Victoria Johnson – Imperial Credit Union
- Joe Trosclair – Abbott Laboratories Employees Credit Union
- Jose Garcia – Northwest Community Credit Union
- Amber Scott – 1st MidAmerica Credit Union
- Joe Webb – Cooperative Choice Network Credit Union
- Meredith Ritchie – Alliant Credit Union
- Jody Dabrowski – Illinois Educators Credit Union
- Steve Bugg – Great Lakes Credit Union
- Diane Shelton – DuPage Credit Union
- Frank Padak – Scott Credit Union
- Mary Ann Pusateri – Partnership Financial Credit Union
- Matthew Parrott – SIUE Credit Union
- Gregg Brown – South Side Community Federal Credit Union
- Pete Fauth – Financial Plus Credit Union
- Darlyne Keller – Rock Valley Credit Union
- R. Michael Lee – KCT Credit Union
- Eugene Smith – Fellowship Baptist Church Credit Union
- Tom Kane – Illinois Credit Union League
- Mary Ann Egizio – Abri Credit Union
- Brent Adams – Woodstock Institute
- Emily Coffey – Chicago Lawyers' Committee for Civil Rights
- DeMario Greene, Chicago Community Loan Fund

<u>Bank Public Hearing Testimony</u>

- Senator Jacqueline Collins
- Carolyn Settanni – Illinois Bankers Association
- Horacio Mendez – Woodstock Institute
- Kevin Hill – National Community Reinvestment Coalition
- Kevin Jackson – Chicago Rehab Network
- Falon Young – Neighborhood Housing Services of Chicago
- Jerry Peck – Community Bankers Association of Illinois
- DeMario Greene, Chicago Community Loan Fund

<u>Mortgage Public Hearing Testimony</u>

- Senator Jacqueline Collins
- Jane Doyle –Woodstock Institute

- Bob Perry – Greater Midwest Lenders Association
- Adam Karno – Asset Mutual Mortgage
- Jerri Lynn Fox – USA Mortgage Corp.
- Nathan Durst – Home Mortgage Specialists Inc.
- Emily Coffey – Chicago Lawyers’ Committee for Civil Rights
- Falon Young – Neighborhood Housing Services of Chicago
- Nathan Britsch – Illinois Mortgage Bankers Association

# Regulatory Roundtable

## Current Legal Issues from the Regulators' Perspectives

Rachel Grundmeier
Specialist Counsel
Federal Reserve Bank of Chicago

# Federal Reserve Bank of Chicago

## Table of Contents


1. Memorandum — Final Rule Establishing Risk-Based Capital Requirements
2. Compliance Spotlight — Representment Fees
3. Announcement — Novel Activities Supervision

Date: August 31, 2023

To: Board of Governors

From: Staff[1]

Subjects: Final rulemaking to establish a risk-based capital requirement for depository institution holding companies significantly engaged in insurance activities, with accompanying reporting requirements

**ACTIONS REQUESTED:** Approval of (1) the attached draft final rule, which would establish minimum risk-based capital requirements applicable to bank holding companies and savings and loan holding companies significantly engaged in insurance activities (Supervised Insurance Organizations or SIOs), (2) the implementation of a new reporting form (FR Q-1) to collect data relevant to the rule, and (3) the attached order delegating authority to staff to take certain actions under the draft final rule that do not raise significant legal or policy issues. Staff also requests authority to make technical, nonsubstantive changes to the draft final rule and associated reporting form to prepare them for publication.

**EXECUTIVE SUMMARY:**

- Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires the Board to establish, on a consolidated basis, minimum risk-based capital requirements for depository institution holding companies, including SIOs, that are not lower than the risk-based capital requirements for insured depository institutions (IDIs).[2] Currently, SIOs are excluded from the Board's risk-based capital rule for depository institution holding companies.[3] Staff expects that the Board would supervise five SIOs at the time this draft rule would become effective.[4]

[1] Michael Gibson, Arthur Lindo, Lara Lylozian, Matt Walker, and Jay Muska (Division of Supervision and Regulation) and Mark Van Der Weide, Dafina Stewart, Andrew Hartlage, Jonah Kind, and Jasmin Keskinen (Legal Division).

[2] 12 U.S.C. § 5371.

[3] 12 CFR part 217 (Regulation Q).

[4] These SIOs are Ameriprise Financial, Inc.; The Auto Club Group; First American Financial Corporation; Ohio Farmers Insurance Company; and United Services Automobile Association. Another SIO, TIAA Board of Governors, sold its subsidiary savings association, now named EverBank, National Association, and is expected to deregister as a savings and loan holding company.

- In September 2019, the Board invited comment on a notice of proposed rulemaking (NPR or proposal) that would establish minimum risk-based capital requirements for SIOs.[5] The NPR proposed an enterprise-wide approach, called the Building Block Approach (BBA), which aggregated the available capital and required capital of a top-tier company in an SIO with those of its subsidiaries, as determined according to each subsidiary's applicable capital framework. An additional calculation would have ensured compliance with section 171 of the Dodd-Frank Act (section 171 calculation).

- Commenters strongly supported using an aggregation approach to determining enterprise-wide capital requirements. However, most commenters argued that the section 171 calculation was unnecessary, that the overall calibration was too high, that the limits on certain types of capital instruments were too low, and that senior debt should qualify as capital.

- The draft final rule would be largely consistent with the proposal published in September 2019. However, in response to comments, the draft final rule would make certain changes to better align SIO capital requirements with the requirements for other depository institution holding companies, including by changing the size of the proposed capital conservation buffer and adding a tier of eligible capital instruments, additional tier 1 capital instruments. The draft final rule does not allow senior debt to be considered capital and does not change the proposed section 171 calculation.

- Although the proposed requirements are higher than current state capital requirements, most insurers operate at multiples of the current state capital requirements. None of the affected firms would need to raise capital to comply with the rule.

**DISCUSSION:**

**A. Background**

The Dodd-Frank Act requires that the Board establish minimum risk-based capital requirements on a consolidated basis for depository institution holding companies, IDIs, and nonbank financial companies supervised by the Board under Title I of the Dodd-Frank Act. The Act also provides that the Board may not require a supervised firm that is also a state-regulated insurer and files financial statements utilizing only Statutory Accounting Principles (SAP) to prepare such financial statements in accordance with U.S. generally accepted accounting principles (GAAP).[6] The Board currently supervises six SIOs, all of which are savings and loan holding companies. Although all these firms are significantly engaged in insurance activities,

[5] Regulatory Capital Rules: Risk-Based Capital Requirements for Depository Institution Holding Companies Significantly Engaged in Insurance Activities, 84 Fed. Reg. 57240 (October 24, 2019).

[6] 12 U.S.C. § 5371(c)(3)(A).

the portfolio exhibits significant variety in ways that are relevant to an enterprise-wide capital requirement. SIOs have been excluded from the Board's banking capital rule until an approach could be developed that would appropriately address the range of firm structures and insurance-related risks.

This draft final rule follows the issuance of two documents for comment by the Board. In 2016, the Board published an advance notice of proposed rulemaking (ANPR) on using an aggregation approach to setting capital requirements for SIOs. The ANPR described the concept of the BBA as a capital framework and sought input on all aspects of its development at an early stage.[7] The Board considered this feedback and invited comment on a detailed BBA proposal in the NPR.[8]

**B. Overview of Proposed BBA**

The NPR proposed risk-based capital requirements for SIOs. In addition to the enterprise-wide capital requirement based on the BBA framework, the proposal would have applied a minimum risk-based capital requirement to the enterprise using the flexibility afforded under amendments enacted in 2014 to section 171 of the Dodd-Frank Act to exclude certain state- and foreign-regulated insurance operations.[9]

The proposal would have aggregated the capital requirements of companies under an insurance depository institution holding company, with adjustments to harmonize treatment of risks and loss absorbing resources and would have expressed the aggregate in terms of a common capital framework. To best reflect all material risks and streamline implementation burden, the BBA would have used state insurance regulators' risk-based capital (RBC) frameworks, as set forth by the National Association of Insurance Commissioners (NAIC) as the common capital framework for insurance entities.

The BBA would have applied to an organization through the following steps:

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[7] Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 Fed. Reg. 38631 (June 14, 2016).

[8] Regulatory Capital Rules: Risk-Based Capital Requirements for Depository Institution Holding Companies Significantly Engaged in Insurance Activities, 84 Fed. Reg. 57240 (October 24, 2019).

[9] Pub. L. No. 111-203, 124 Stat. 1376, 1435–38 (2010), as amended by Pub. L. No. 113-279, 128 Stat. 3017 (2014).

1. Compile an inventory of all the companies in the insurance depository institution holding company's enterprise;[10]
2. Group the companies in the inventory into sub-groups termed "building blocks," generally based on whether the companies directly or indirectly fall under a distinct capital framework; [11]
3. Determine the available capital and capital requirements (the numerator and denominator, respectively, in a required capital ratio) for the parent company of each building block (the "building block parent") under its applicable capital framework;
4. Apply any adjustments to available capital and capital requirements within each building block, as required under the BBA, to harmonize the reflection of loss-absorbing resources and risks across the enterprise;
5. As needed, translate the adjusted available capital and capital requirement amounts from the applicable capital framework for each building block parent to their equivalents under the common capital framework;
6. Aggregate the translated, adjusted available capital and capital requirement amounts for each building block parent, making deductions to avoid double counting and double leverage; and
7. Determine whether the aggregate ratio meets the Board's minimum requirement and capital conservation buffer.

These steps have not been changed in the draft final rule.

**C. Summary of Comments Received**

The Board received substantive comments on the proposal from 18 commenters. The Board's Insurance Policy Advisory Committee (IPAC) also made recommendations on several aspects of the BBA. Most commenters supported the BBA's general framework and strongly preferred applying this framework, rather than other frameworks like the banking capital rule.

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[10] This inventory would generally be determined by taking the set of entities shown on the firm's insurance statutory financial statements together with those shown in its submission of the Board's Forms FR Y-6 and FR Y-10. All companies under the insurance depository institution holding company would be included in the BBA.

[11] For example, where an insurance depository institution holding company has U.S. banking, life insurance and non-life insurance operations, the BBA would group each of the firm's banking, life insurance, and non-life insurance operations into distinct building blocks.

Although commenters were supportive of the framework, some commenters expressed concerns regarding calibration, qualifying capital instruments, and one aspect of the reporting that they considered burdensome. The following are some of the main issues that were raised by commenters:

- *Section 171 Calculation* – Most commenters argued that the section 171 calculation was unnecessary because the BBA itself would comply with section 171 of the Dodd-Frank Act.
- *Calibration* – Under the proposal, the minimum ratio of enterprise-wide available capital to enterprise-wide required capital would have been 250 percent along with a capital conservation buffer of 235 percent above the minimum requirement. The proposed minimum ratio was derived by translating the 8 percent of risk-weighted assets requirement under the banking capital rule to an equivalent value for the BBA using a scaling methodology. In addition to this equivalent value, the proposed rule would have also included a margin of conservatism to provide a heightened degree of confidence that the BBA's requirement would be compliant with section 171 of the Dodd-Frank Act. Like the proposed minimum requirement, the proposed capital buffer was determined based on the capital conservation buffer under the Board's banking capital rule, translated to its equivalent under the BBA's common capital framework. Most commenters supported setting the BBA's requirement equal to other banking capital requirements based on the indicated results from the scaling white paper and not including the proposed additional margin of conservatism.
- *Qualifying Capital Instruments and Limits* – The proposed capital instrument criteria were aligned with the Board's banking capital rule (instruments failing these criteria, including senior debt, would not qualify as regulatory capital under the BBA) except that additional tier 1 capital was not included due to the composition of the capital structures of SIOs. Additionally, in the proposal, the tier 2 capital limitation was 62.5 percent. Most commenters argued that the Board's proposed capital instrument qualification criteria were too narrow, and that senior debt should qualify as capital, although several commenters disagreed. Some commenters argued for increasing the proposed limits on less loss-absorbing tiers of capital instruments. They expressed a concern that the conservative nature of statutory accounting distorts the ratio of tier 2 capital instruments to common equity tier 1 capital, which causes the 62.5 percent to be overly conservative. Some commenters

also argued that surplus notes, a form of subordinated debt issued by U.S. insurers, should qualify as tier 1 capital and, alternatively, if they are included as tier 2 capital, then no limits should apply. Commenters also requested the inclusion of additional tier 1 capital to allow SIOs flexibility in their capital structures.

- *Reporting Burden* – Under the proposed form FR Q-1, SIOs would have needed to report certain basic information (for example, total assets and total liabilities) for all inventory companies. Commenters expressed concern with the burden associated with reporting assets and liabilities of potentially thousands of inventory companies. The commenters asserted that SIOs could not easily calculate the total assets of subsidiaries multiple levels down their organization chart. To avoid this burden, these commenters argued for excluding immaterial, non-operating entities from the inventory.

**D. Key aspects of the Draft Final Rule**

***Covered institutions*** – The draft final rule applies to a depository institution holding company where the top-tier depository institution holding company (1) is an insurance underwriting company or (2) held, as of June 30 of the previous year, 25 percent or more of its total consolidated assets[12] in insurance underwriting companies (other than assets associated with insurance underwriting for credit risk).[13]

***Scaling*** – The draft final rule includes the concept of scaling, which is a mechanism by which a building block's available capital and capital requirement under one capital framework would be translated to their equivalents in another framework. Because of the importance of scaling when aggregating numbers in different regulatory capital frameworks, a white paper

[12] The SIO would calculate its total consolidated assets in accordance with GAAP, or, if the firm does not calculate its total consolidated assets under GAAP for any regulatory purpose (including compliance with applicable securities laws), the firm may estimate its total consolidated assets, subject to review and adjustment by the Board.

[13] All current SIOs, including one predominantly engaged in title insurance, would be subject to the proposed BBA. At the legal entity level, U.S.-based title insurance companies are not subject to a risk-based capital standard promulgated by the NAIC. The proposed BBA would adopt the Board's banking capital rule for an insurance depository institution holding company that is predominantly engaged in title insurance. In applying this rule, the BBA proposes to add, in the denominator of this framework's ratio, the firm's claim reserves relating to title insurance business, risk weighted at 300 percent. This risk weight was based on review of data from historical title claim reserves that showed a risk comparable to assets that have been assigned a 300 percent risk weight in the Board's banking capital rule.

explaining the development of the scalars was published along with the NPR.[14] This white paper introduced a methodology for determining scalars from an analysis of defaults—in particular, the relationship between pre-default solvency ratios and observed default rates. Because all current SIOs are U.S.-based insurers that own IDIs, the draft final rule would include a scaling mechanism to translate between federal banking capital rules and the states' insurance RBC frameworks. The draft final rule does not include scalars between non-U.S. insurance capital frameworks and the states' insurance RBC frameworks because of the limited international insurance operations of SIOs and limited international default data.

***Minimum requirement*** – In the draft final rule, the minimum ratio of enterprise-wide available capital to enterprise-wide required capital is 250 percent.

***Capital buffer*** – The draft final rule includes a 150 percent capital conservation buffer, rather than the 235 percent buffer proposed in the NPR. This smaller capital conservation buffer better aligns the BBA's stringency with the Board's banking capital rule. Thus, the minimum capital requirement, together with the buffer, under the BBA would be 400 percent (analogous to 10.5 percent of risk-weighted assets under the banking capital rule).

***Companies not subject to capital rules*** – In the draft final rule, companies in an SIO that are not subject to company-level capital regulations are generally treated as they are under the indicated capital framework for the parent of the building block of which they are members.[15] However, in certain cases, such a company that is a financial entity can have characteristics (such as risk exposure, activities, structure, complexity, affiliate guarantee, or size) that render it significant in the insurance depository institution holding company's enterprise. In these cases, the draft final rule would place such a company, termed a "material financial entity" (MFE), into a distinct building block. When an MFE is not engaged in insurance or reinsurance underwriting, the draft final rule would use the Board's banking capital rule to assess the available capital and capital requirements of the MFE and any of its subsidiaries in the same building block. When an MFE is engaged in insurance or reinsurance underwriting (for example, a captive reinsurance company), the draft final rule would use the RBC capital

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[14] *Comparing Capital Requirements in Different Regulatory Frameworks,* September 2019, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190906a1.pdf.

[15] For example, if a SIO has life insurance operations grouped into one building block, and the building block parent had a nonfinancial subsidiary not subject to capital regulations, the nonfinancial subsidiary would be treated in the BBA the same way that it is treated under the life insurance risk-based capital framework.

framework to assess the available capital and capital requirements for this entity and any subsidiaries in its building block.

***Adjustments to capital requirements and available capital*** – To determine available capital and capital requirements for each building block, an SIO would begin by computing available capital and capital requirements for the building block parent under its indicated capital framework. The draft final rule would then require the SIO to apply certain adjustments to ensure uniform treatment, appropriate reflection of risks and loss absorbing resources, and fulfillment of the Board's supervisory objectives. For capital requirements (the denominator of the ratio), the draft final rule includes the following adjustments:

1. Elimination of (i) permitted and prescribed accounting practices[16] and (ii) transitional measures in jurisdictions' solvency frameworks;
2. Optional elimination of capital charges for credit risk of affiliates and allocation of an MFE's risks to affiliates within the supervised organization;[17]
3. Addition of claim reserves relating to title insurance business, subject to a risk weight of 300 percent; and
4. Changes to required capital resulting from deduction of investments in own capital instruments, consistent with the Board's banking capital rule.

For available capital (the numerator of the ratio), the draft final rule includes the following adjustments:[18]

1. Application of the criteria to qualify as tier 1 additional capital under the Board's banking capital rule with a limitation of 100 percent of the building block capital requirement for the top-tier parent.
2. Application of the criteria to qualify as tier 2 capital under the Board's banking capital rule (instruments failing these criteria, including senior debt, would not qualify as regulatory capital under the BBA). The draft final rule also includes a limitation on tier 2

[16] Some U.S. states have local permitted and prescribed accounting practices that depart from the standard insurance SAP as promulgated by the NAIC. These practices result in inconsistent application of insurance RBC within the United States and can allow for regulatory arbitrage.

[17] These adjustments may involve effort on the part of the insurance depository institution holding company such that the firm may not find the benefits to exceed implementation burden. The proposed BBA would thus have left this adjustment at the firm's option to apply.

[18] The proposal generally followed the banking capital rules, although it only included two tiers of capital because no SIO had issued additional tier 1 capital. In following the banking rules, surplus notes issued by mutual insurers would have been considered tier 2 capital instruments subject to the tier 2 limitation.

capital instruments to be no more than 150 percent of the building block capital requirement for the top-tier parent.

3. Elimination of the deduction of the regulatory capital requirement for insurance underwriting risks under the Board's banking capital rule;[19]

***Aggregation*** – Under the draft final rule, following the applications of adjustments and scaling, data from the building blocks would be aggregated to calculate the enterprise-wide available capital and capital requirement. In so doing, intercompany transactions in which capital is downstreamed within the enterprise would be appropriately deducted to avoid double-counting.

***Form FR Q-1*** – Under the draft final form FR Q-1, SIOs would only be required to report the assets and liabilities of inventory companies whose parents represent more than one percent of the group's assets.

## E. Section 171 Calculation

Under section 171(b) of the Dodd-Frank Act, the Board must establish minimum risk-based and leverage capital requirements, on a consolidated basis, for all depository institution holding companies. These capital requirements must be (i) not less than the capital requirements generally applicable to IDIs, and (ii) not quantitatively lower than the generally applicable capital requirements in place for IDIs on July 21, 2010. In order to establish a capital framework for SIOs that meets the requirements of section 171, the draft final rule includes a simple, supplemental minimum risk-based capital calculation that is separate from the BBA.

The draft final rule allows each SIO two alternative paths to demonstrate compliance with section 171. First, the company may choose to demonstrate that it meets, on a fully consolidated basis, the minimum risk-based capital requirements that apply to IDIs. Second, consistent with flexibility provided in section 171, the SIO may choose to demonstrate that it meets the minimum IDI risk-based capital requirements on a partially consolidated basis, excluding the assets and liabilities of certain subsidiary insurers. Under this second path, the draft final rule allows two possible treatments for unconsolidated insurance subsidiaries: (1) a deduction from qualifying capital of the aggregate amount of the outstanding equity investment

[19] In lieu of this deduction, which applies when a bank or bank holding company has an insurance underwriting subsidiary, under the BBA, the insurance subsidiary would be in a distinct building block from its banking parent. The insurance subsidiary's risks, and resources, would be aggregated in the BBA rather than deducted.

in the subsidiary, including retained earnings; or (2) inclusion of the net investment in the subsidiary as an asset subject to a risk weight of 400 percent, consistent with the current treatment of certain equity exposures under the regulatory capital rules applicable to IDIs.

### F. Impact Assessment of the Final Rule

Based on several different empirical exercises, staff does not presently anticipate that any current SIO would need to raise additional capital to meet the requirements of the BBA, including the proposed buffer, or the separate section 171 calculation. Moreover, staff has attempted to limit burden on SIOs by relying on existing capital frameworks and accounting standards, and by proposing reporting forms that would use information already reported to company-level regulators. Staff believes that the draft final rule would fulfill the statutory mandate for a capital requirement in an appropriate and efficient manner that places streamlined implementation burden upon SIOs.

### G. Paperwork Reduction Act

Under the Paperwork Reduction Act (PRA), the Board must undertake a review prior to implementing a new collection of information. In connection with the attached draft final rule, staff recommends that the Board finalize the implementation of form FR Q-1 as a new collection of information. The Office of Management and Budget has delegated to the Board the authority to review and approve collection of information requests and requirements pursuant to the PRA.[20] The Federal Reserve's review of the collection of information should include: (1) an evaluation of the need for the collection of information, (2) a description of the information to be collected, (3) a plan for the collection of information, (4) a specific estimate of burden, (5) an evaluation of whether burden may be reduced by use of information technology, (6) a test of the collection through a pilot program, if appropriate, and (7) a plan for the efficient management and use of the information to be collected.[21]

The draft form FR Q-1 would comply with the PRA, and the information is not available from other sources. The information that would be collected by the form FR Q-1 would be necessary for the Board to administer the BBA, if it is adopted in final form. The estimated

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[20] See 5 CFR 1320.16.

[21] See 5 CFR 1320.8(a).

annual burden associated with the form FR Q-1 is 1,097 hours (878 for initial setup and 219 hours for ongoing compliance). The Board invited public comment on the need for the information in the proposed collection of information; the estimated burden; suggestions for improvements to the quality, utility, and clarity of the information; and suggestions to minimize the burden on the respondents, and the only comment received on burden was the amount of subsidiary entities where firms would have to report total asset and total liabilities. The draft final FR Q-1 would substantially decrease this burden by only require reporting with respect to material entities.

**RECOMMENDATIONS:** For the reasons discussed above, staff recommends that the Board approve the attached draft notice of final rulemaking, Form FR Q-1, and the attached draft delegation order. Staff also recommends that the Board authorize staff to make technical, non-substantive changes to the materials prior to publication.

Attachments

September 22, 2023

Consumer Compliance Outlook®

A Federal Reserve System Publication Focusing on Consumer Compliance Topics

Compliance Spotlight — Focusing on a Specific Compliance Topic

# Supervisory Observations on Representment Fees

### BACKGROUND AND OBSERVATIONS

Through supervisory examinations, the Federal Reserve recently analyzed the practice of imposing fees on represented transactions at several supervised institutions for compliance with applicable federal consumer financial laws.

As background, a representment occurs when, after a bank declines to pay a debit transaction from a consumer's checking account because of insufficient funds, the merchant presents that same transaction again to the bank for payment. Examiners identified more than one institution that charged a nonsufficient funds (NSF) fee when a transaction was first presented and declined and also charged additional NSF fees each time the same transaction was represented and declined.

At more than one supervised institution, examiners cited the assessment of NSF fees on represented transactions as an unfair practice in violation of Section 5 of the Federal Trade Commission (FTC) Act, which prohibits unfair or deceptive acts or practices (UDAP), based on the following findings:

- The assessment of NSF fees on represented transactions resulted in a substantial injury in the form of monetary harm that affected a large number of consumers.
- Consumers were not in a position to reasonably avoid this harm because:
    - once the bank had declined to pay a transaction because of insufficient funds, the merchant controlled the number and timing of representment; and
    - the bank determined whether it paid or declined the represented transaction, and whether it assessed an NSF fee on the represented transaction.
- NSF fees on represented transactions were retained by the bank and did not provide benefits to consumers or competition that outweighed the consumer harm.[1]

### MANAGING RISKS

Examiners identified the following methods that institutions had effectively used to mitigate UDAP risk related to the assessment of fees on represented transactions:

- Institutions refrained from assessing an NSF fee on a represented transaction after the bank assessed an NSF fee on the transaction when it was initially presented for payment.
- Institutions that relied on a third party for their systems monitored the third party's system settings for compliance with applicable laws and regulations, including the prohibition on UDAPs. Examiners also found it helpful when institutions informed their Federal Reserve contact if a third party was unable to comply with their directions relating to representments.[2]
- Institutions took steps to ensure that the information provided to consumers about represented transactions was accurate and consistent with the bank's policy and any systems limitations.

This list is based on supervisory observations to date and does not impose any legal obligations on banks. Other methods may also assist banks in managing their UDAP risks.

# Endnotes

1 Section 5(a) of the FTC Act (15 U.S.C. §45(a)) prohibits "unfair or deceptive acts or practices in or affecting commerce" and applies to all persons engaged in commerce, including banks. Under Section 5(a) of the FTC Act, a three-part test is used to determine whether an act or practice is unfair. See *Unfair or Deceptive Acts or Practices by State-Chartered Banks* (March 11, 2004). First, the act or practice must cause or be likely to cause substantial injury to consumers. Second, the injury cannot be reasonably avoided by consumers. Finally, the consumer harm must not be outweighed by countervailing benefits to consumers or competition. Multiple federal financial regulatory agencies have issued public statements addressing the risks of unfair or deceptive acts or practices related to assessing fees on representment transactions, including the OCC, *Overdraft Protection Programs: Risk Management Practices* (April 2023); the CFPB, *Supervisory Highlights Junk Fee Special Edition* (March 2023); and the FDIC, *Consumer Compliance Supervisory Highlights* (March 2022).

2 "Whether activities are performed internally or via a third party, banking organizations are required to operate in a safe and sound manner and in compliance with applicable laws and regulations. A banking organization's use of third parties does not diminish its responsibility to meet these requirements to the same extent as if its activities were performed by the banking organization in-house." *Interagency Guidance on Third-Party Relationships: Risk Management* (June 7, 2023).



# Press Release

August 08, 2023

## Federal Reserve Board provides additional information on its program to supervise novel activities in the banks it oversees

For release at 4:30 p.m. EDT

The Federal Reserve Board on Tuesday provided additional information on its program to supervise novel activities in the banks it oversees. Novel activities include complex, technology-driven partnerships with non-banks to provide banking services to customers; and activities that involve crypto-assets and distributed ledger or "blockchain" technology.

The goal of the novel activities supervision program is to foster the benefits of financial innovation while recognizing and appropriately addressing risks to ensure the safety and soundness of the banking system. The program will be integrated into the Federal Reserve's existing supervisory processes, with program experts working alongside current supervisory teams to oversee banks engaged in novel activities.

Also on Tuesday, the Board provided additional information on the process for a state bank supervised by the Federal Reserve to follow before engaging in certain dollar token or stablecoin activity, including demonstrating to its Federal Reserve supervisors that it has appropriate safeguards to conduct the activity safely and soundly.

Today's announcements are part of the Federal Reserve's ongoing work to create greater clarity for all parties as financial services and related technologies continue to evolve. These announcements build on the Board's January policy statement, which provides clarity on limitations on certain activities, promoting a level playing field for banks with a federal supervisor.

For media inquiries, please email media@frb.gov or call 202-452-2955.

SR 23-7: Creation of Novel Activities Supervision Program

SR 23-8 / CA 23-5: Supervisory Nonobjection Process for State Member Banks Seeking to Engage in Certain Activities Involving Dollar Tokens

Last Update: August 08, 2023

# Regulatory Roundtable

## Current Legal Issues from the Regulators' Perspectives

Jerry Savoy
District Counsel
Office of the Comptroller of the Currency

# Office of the Comptroller of the Currency

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# Interagency Statement on Model Risk Management for Bank Systems Supporting Bank Secrecy Act/Anti-Money Laundering Compliance

**April 9, 2021**

## Introduction

The Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) (collectively, the agencies), in consultation with the Financial Crimes Enforcement Network and the National Credit Union Administration, are issuing this statement regarding industry questions on model risk management. This statement addresses how the risk management principles described in the agencies' "Supervisory Guidance on Model Risk Management"[1] (referred to as the "model risk management guidance" or MRMG) relate to systems or models used by banks[2] to assist in complying with the requirements of Bank Secrecy Act laws and regulations.

The MRMG (like all supervisory guidance) does not have the force and effect of law. The agencies support efforts by banks to innovate and update their Bank Secrecy Act/Anti-Money Laundering (BSA/AML) systems and models to quickly adapt to an evolving threat environment. The agencies recognize that not all banks use models such as those described in the MRMG for BSA/AML compliance or have formalized model risk management (MRM) frameworks. This statement is intended to clarify how the MRMG may be a useful resource to guide a bank's MRM framework, whether formal or informal, and assist with BSA/AML compliance. Whether a bank characterizes a BSA/AML system (or portions of that system) as a model, a tool, or an application, risk management of such a system should be consistent with safety and soundness principles[3] and the system should promote compliance with applicable laws and regulations.

This statement does not alter existing BSA/AML legal or regulatory requirements, nor does it establish new supervisory expectations. In addition, this statement does not suggest that a bank change existing risk management practices if the bank uses them to effectively manage its risk.

The MRMG is principles-based and articulates the agencies' general views regarding appropriate practices for MRM. It is intended to assist banks that rely on models to do so in a safe and sound

[1] Refer to the "Supervisory Guidance on Model Risk Management," Federal Reserve SR Letter 11-7; OCC Bulletin 2011-12; and FDIC FIL 22-2017.

[2] The term "bank" is used here as in Bank Secrecy Act regulations at 31 CFR 1010.100(d) other than subsection (d)(6). This interagency statement does not apply to credit unions. The term "bank" as used in this interagency statement does include each agent, agency, branch, or office within the United States of banks, savings associations, and foreign banks.

[3] Refer to the "Interagency Guidelines Establishing Standards for Safety and Soundness," 12 CFR 208, Appendix D-1 (Federal Reserve); 12 CFR 364, Appendix A (FDIC); and 12 CFR 30, Appendix A (OCC).

manner, and in compliance with applicable laws and regulations.[4] The MRMG principles provide flexibility for banks in developing, implementing and updating models, including those used for BSA/AML activities. While the MRMG provides a comprehensive discussion of all aspects of model risk management, the practical application of any principle discussed in the MRMG by a bank depends, in part, on the bank's reliance on, and the nature of, its models. While models used for BSA/AML compliance may be different from other models, appropriate model testing and validation processes typically take these differences into account.

**Background**

Banks routinely use models for a broad range of activities. Models can help to inform and improve business decisions, save money, and reduce the risks that banks face. The use of models can also impose costs, including the potential for unintended and adverse consequences from decisions based on model output that is either incorrect or misused. As reflected in the MRMG, effective model risk management is important because of the potential for poor business and strategic decisions, financial losses, noncompliance with laws and regulations, or damage to a bank's reputation arising from deficient or misapplied models.

Consistent with a risk-based approach, the rigor and sophistication of sound risk management practices are generally commensurate with the bank's overall use of models, the complexity and materiality of its models, and the size and complexity of the bank's operations. If the bank's use of models is less prevalent and has less material impact on the bank's financial condition, operations, or compliance, then a less sophisticated approach to MRM may be appropriate. When models and model outputs could have a material impact on business decisions, including decisions related to risk management, and capital and liquidity planning, and when model failure would have a particularly harmful impact on a bank's financial condition, operations, or compliance, a more extensive and robust MRM framework may be appropriate.

**BSA/AML Systems and the MRMG**

The agencies' BSA program regulations require a bank to have a reasonably designed compliance program[5] that includes, among its components, a system of internal controls to assure ongoing compliance with BSA regulatory requirements. In this context, effective internal controls are typically based on the bank's risk profile.

BSA/AML systems and a bank's policies, procedures, and processes to identify, research, and report unusual activity, commonly known as suspicious activity monitoring and reporting systems, are critical internal controls for ensuring an effective BSA/AML compliance program. BSA/AML systems may include a surveillance monitoring system, sometimes referred to as an automated transaction monitoring system. Some of these automated transaction monitoring systems may involve the use of modeling.

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[4] Refer to the "Interagency Statement Clarifying the Role of Supervisory Guidance," issued on September 11, 2018, Federal Reserve Supervision and Regulation Letter 18-5, FDIC Financial Institution Letter (FIL)- 49-2018, OCC News Release 2018-97.

[5] 12 CFR 208.63 (Federal Reserve), 12 CFR 326.8(b) and (c) (FDIC), and 12 CFR 21.21 (OCC), require a bank to establish and maintain a BSA/AML compliance program. *See also* 31 CFR 1020.210 (FinCEN).

There is no definition in statute or regulation of what constitutes a model for the purposes of model risk management; however, the MRMG uses the following definition of a model:

> The term *model* refers to a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates.[6]

The MRMG lists the following three components of a model:

1. An information input component, which delivers assumptions and data to the model.
2. A processing component, which transforms inputs into estimates.
3. A reporting component, which translates the estimates into useful business information.

While some BSA/AML systems may constitute models under this description, others may not. The determination by a bank of whether a BSA/AML system is considered a model is bank-specific, and a conclusion regarding the system's categorization should be based on a consideration of all relevant information. There are no required categorizations of particular BSA/AML systems, including those used to monitor for suspicious activity. Categorizations vary based on the bank's BSA/AML program and the individual features of the bank's BSA/AML systems. The following examples likely would not be considered models, as defined by the MRMG, because they may lack one or more of the three components discussed above:

- Stand-alone, simple tools that flag transactions based on a singular factor, such as reports that identify cash, wire transfer, or other transaction activity over certain value thresholds.
- Systems used to aggregate cash transactions occurring at the bank's branches for the purposes of filing Currency Transaction Reports.

Regardless of whether a bank characterizes a BSA/AML system as a model, a tool, or an application, there is no specific organizational structure required for oversight by the bank. Oversight of BSA/AML systems might be conducted solely by the bank's compliance area, an MRM group, another functional area, or some combination of these functions. Sound risk management and procedures for evaluating the effectiveness of compliance programs are both key components to an effective BSA/AML compliance program.

The MRMG is nonbinding and provides principles that may be helpful in managing the BSA/AML compliance program. There is no requirement or supervisory expectation that banks have duplicative processes for complying with BSA/AML regulatory requirements. For automated transaction monitoring systems, prudent risk management involves periodically[7] reviewing and testing the filtering criteria and thresholds to ensure that they are still effective, as

[6] The definition of "model", as described in the MRMG, also covers quantitative approaches whose inputs are partially or wholly qualitative or based on expert judgment, provided that the output is quantitative in nature.

[7] Model reviews and validations are generally performed using a risk-based approach, and with a frequency appropriate for (or when there are changes to) a bank's risk profile. BSA/AML risk profile changes may include new or revised bank products, services, customer types, or geographic locations, or if the bank expands through mergers and acquisitions. Material changes to models likely warrant validation.

well as independently validating the monitoring system's methodology and effectiveness to ensure that the monitoring system is detecting potentially suspicious activity.

Further, there is no requirement that a bank perform duplicative independent testing activities, including model validation, to ensure compliance with BSA/AML regulations. In certain cases, validation conducted on models may help a bank in its independent testing for BSA/AML purposes; similarly, some aspects of independent testing for BSA/AML purposes may assist a bank in its model validation activities. Generally, the principles for risk management set forth in the MRMG provide a framework that can be used to help support an effective BSA compliance program.

Model risk management includes disciplined and knowledgeable development and implementation processes that are consistent with the situation and goals of the model user and with bank policy.[8] In the context of BSA/AML systems that are considered by a bank to be models, sound model development and validation activities typically align with the purpose of each model and incorporate model objectives, structure, data, methodologies, complexity, and extent of use. The extent and nature of model risk varies across models and banks, and a bank's risk management framework is most appropriately tailored when it is commensurate with the nature and materiality of the risk. For example, a bank's MRM framework may support the implementation of less material changes to models without revalidation, or with the revalidation of certain model components without revalidating the entire model, in appropriate circumstances. Overall, the statements contained within the MRMG are meant to provide useful information for the bank's consideration and are not to be regarded as "templates" or requirements.

The MRMG describes how banks may objectively assess model risk using a sound model validation process, including evaluation of conceptual soundness, ongoing monitoring, and outcomes analysis. A central principle for managing model risk is "effective challenge" of models, which refers to critical analysis by objective, informed parties. For banks that use models to comply with the BSA/AML requirements, it is important that validation be performed by individuals with sufficient expertise and an appropriate level of independence from the model's development and implementation. An appropriate level of independence for individuals performing model validation is also important when banks outsource multiple functions to the same third party.

The agencies recognize that the objectives and structure of BSA/AML models (BSA/AML systems determined by a bank to be models) may differ from those in other business units because the objectives of most BSA/AML models place greater emphasis on coverage over efficiency. BSA/AML models may require quick adjustments to reflect the changing nature of criminal behavior or the bank's risk profile. Similarly, testing and performance monitoring for some BSA/AML models may not include the same techniques as other models because of various factors, such as the lack of information about realized outcomes (e.g., Suspicious Activity Reports). The MRMG notes that the nature of testing and model assessment can vary across models and recognizes that for some models complete information may not be available. A bank's validation methodology may take such differences into account. For example, a bank

[8] The systems, processes, models, or tools used by a bank for BSA/AML purposes must be consistent with relevant laws and regulations.

may choose to accept a reduction in efficiency (such as by producing more alerts) in exchange for greater coverage in its automated transaction monitoring system. Banks typically make these decisions based on risk and change or update controls, as appropriate, to ensure that effective controls are in place.

### Third-Party Models

Third-party models can assist banks in improving the efficacy of their BSA/AML programs, and reasonable due diligence prior to entering into a contractual relationship with a third party is important to a successful relationship. In addition, ongoing monitoring of the third party and the model is important when a bank depends on a third-party model for compliance-related activities, such as currency transaction reporting, monitoring transactions, detection of suspicious activity, or suspicious activity reporting.

Banks are ultimately responsible for complying with BSA/AML requirements, even if they choose to use third-party models to assist with their BSA/AML compliance programs. In doing so, banks may consider the principles discussed in the agencies' third-party risk management issuances and the aspects of the MRMG that address third-party models.[9] Although the proprietary nature of third-party models is a consideration, sound risk management practices include obtaining sufficient information from the third party to understand how the model operates and performs, ensuring that it is working as expected, and tailoring its use to the unique risk profile of the bank. These practices assist in meeting BSA/AML regulatory compliance requirements.[10]

An understanding of how the third-party model operates is important to the bank's ability to effectively negotiate contracts that will protect the bank's needs and rights, including needs and rights concerning privacy and information security. In addition, it is important that banks using third-party models have contingency plans if the third-party model is no longer available or serviced or may no longer be reliable.

### Conclusion

In summary, the extent and nature of model risk varies across models and banks, and effective risk management is commensurate with the nature and materiality of the risk. The agencies are clarifying, in this statement, the following points:

- The MRMG, like all supervisory guidance, does not have the force and effect of law. Banks may use some or all of the principles in the MRMG in their risk management processes to support meeting the regulatory requirements of an effective BSA/AML compliance program. Banks with limited model use may not have formal MRM frameworks.

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[9] Refer to OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance" (OCC), OCC Bulletin 2020-10, "Third-Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29" (OCC); SR 13-19 (Federal Reserve); and FDIC FIL-44-2008, "Guidance for Managing Third-Party Risk" for more information regarding third-party risk management.

[10] Refer to the agencies' third-party risk management issuances noted in footnote 8 and the discussion of third-party models in the MRMG for more information.

- The MRMG is not meant to serve as a set of testing procedures, including with regard to BSA/AML systems.

- The MRMG does not establish any requirements or supervisory expectations that banks have duplicative processes for complying with BSA/AML regulatory requirements.

- Certain processes and systems used in BSA/AML compliance may not be models. The determination by a bank of whether a system used for BSA/AML compliance is considered a model is bank-specific. When making this determination, a bank may consider the MRMG model definition and the three components that characterize models.

- Banks assess different models in different ways. The nature of testing and analysis of models depends on the type of model and the context in which the models are used.

- The MRMG principles provide flexibility for banks in developing, implementing, and updating models. Banks may benefit from employing this flexibility, including for validation activities, to update BSA/AML models quickly in response to the evolving threat environment and to implement innovative approaches. Banks may establish policies that govern when the bank may implement less material changes to models without revalidation, or may choose to revalidate certain model components without revalidating the entire model.

- Banks may choose to use a third-party model. When doing so, banks may consider the principles discussed in the agencies' third-party risk management issuances and the aspects of the MRMG that address third-party models.

- Regardless of how a BSA/AML system is characterized, sound risk management is important, and banks may use the principles discussed in the MRMG to establish, implement, and maintain their risk management framework.

OCC Bulletin 2023-12 | April 26, 2023

# Overdraft Protection Programs: Risk Management Practices

### To

Chief Executive Officers of All National Banks, Federal Savings Associations, and Federal Branches and Agencies; Department and Division Heads; All Examining Personnel; and Other Interested Parties

## Summary

The Office of the Comptroller of the Currency (OCC) is issuing this bulletin to banks[1] to address the risks associated with overdraft protection programs.[2] Overdraft protection programs can present a variety of risks, including compliance, operational, reputation, and credit risks.[3] Specifically, this bulletin discusses certain practices that may present heightened risk of violating prohibitions against unfair or deceptive acts or practices.

The bulletin also describes practices that may assist banks with managing overdraft protection program risks. When supported by appropriate risk management practices, overdraft protection programs may assist some consumers in meeting short-term liquidity and cash-flow needs. The OCC recognizes that some banks have announced changes to their overdraft protection programs that may be consistent with appropriate risk management practices.

This bulletin's focus is consistent with the OCC's mission to ensure that banks operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations. This bulletin also furthers the OCC's support for innovation by banks to meet the evolving needs of consumers, businesses, and communities.

### Note for Community Banks

This bulletin applies to community banks that offer overdraft protection programs.

# Highlights

This bulletin

- provides background information on overdraft protection programs.
- addresses certain practices that may result in heightened risk exposure, including the risk of violating section 5 of the Federal Trade Commission (FTC) Act (Section 5), which prohibits unfair or deceptive acts or practices,[4] and Section 1036 of the Consumer Financial Protection Act of 2010, which prohibits unfair, deceptive, or abusive acts or practices.[5] These practices include
    - assessing overdraft fees on debit card transactions that are authorized when a consumer's available account balance is positive but later post to the account when the available balance is negative, also referred to as "authorize positive, settle negative" (APSN).
    - assessing an additional fee each time a third party resubmits the same transaction for payment after a bank returns the transaction for non-sufficient funds (NSF) (referred to as "representment fees").
- describes certain practices that may help to manage risks associated with overdraft protection programs, including
    - assisting consumers in avoiding unduly high costs in relation to the face value of the item being presented, the amount of their regular deposits, and their average account balances.
    - implementing fees and practices that bear a reasonable relationship to the risks and costs of providing overdraft protection program services.

# Background

The OCC and other agencies set out safety and soundness considerations, legal risks, and best practices for overdraft protection programs in the "Joint Guidance on Overdraft Protection Programs" (2005 Guidance) conveyed by OCC Bulletin 2005-9, "Overdraft Protection Programs: Interagency Guidance." The agencies issued the 2005 Guidance to address concerns raised by institutions, financial supervisors, and the public about the marketing, disclosure, and implementation of overdraft protection programs. Since 2005, the OCC has observed significant developments in the consumer banking landscape, such as

- changes in overdraft protection program-related legal requirements[6] and consumer behavior, including the increased and more frequent use of overdrafts as, in effect, a form of short-term credit.
- overdraft protection programs resulting in consumers paying high costs relative to the face value of items being presented and to deposit amounts and average account balances.

The OCC continues to observe evolution in the consumer banking landscape, such as

- banks offering deposit accounts that do not allow overdrafts.
- banks offering deposit accounts with no fees for overdrafts.
- banks reducing the amount of overdraft fees in existing overdraft protection programs.
- ongoing efforts by banks and other stakeholders to identify opportunities for modifying existing overdraft protection programs in ways to manage the risks of such programs.

The OCC encourages banks to explore offering low-cost accounts, as well as other lower-cost alternatives for covering overdrafts, such as overdraft lines of credit and linked accounts. The OCC recognizes, however, that some consumers with short-term liquidity needs may benefit from the availability of funds from overdraft protection programs via deposit accounts.

Based on examinations of overdraft protection programs at a number of banks in recent years, the OCC has observed that certain overdraft protection program practices may present a heightened risk of violations of Section 5.[7] These include practices known as APSN and representment fees.[8]

## Authorize Positive, Settle Negative Fee Practices

Banks generally maintain a "ledger balance" and an "available balance" on customer deposit accounts for numerous purposes, including assessing overdraft fees. The ledger balance refers to the actual amount of funds in a customer's deposit account after accounting for all items that have settled and posted. The available balance generally reflects the ledger balance minus "holds" for recently deposited funds that have not yet cleared and for authorized but pending debit card transactions. Some banks assess overdraft fees on debit card transactions that authorize when a customer's available balance is positive but that later post to the account when the available balance is negative.

In this scenario, a customer's account has a sufficient available balance to cover a debit card transaction when the transaction is authorized but, due to one or more intervening transactions, has an insufficient available balance to cover the transaction at the time it settles.[9] This is commonly referred to as an APSN transaction. In addition to assessing an overdraft fee on the APSN transaction, some banks also assess an overdraft fee on intervening transactions that exceed the customer's available balance. In this scenario, for example, the bank reduces a customer's available balance by an amount that is more than, equal to, or less than the initial authorized debit card transaction, and subsequently, an intervening transaction further reduces the customer's available balance so that the account no longer has a sufficient available balance. The bank charges an overdraft fee on both the intervening transaction and the initial APSN transaction when posted to the customer's account.[10]

The OCC has reviewed a number of overdraft protection programs that assess overdraft fees on APSN transactions. In some instances, the OCC has found account materials to be deceptive, for purposes of Section 5, with respect to the banks' overdraft fee practices.[11] In these instances, misleading disclosures contributed to findings that the APSN practice was also unfair for purposes of Section 5. In addition, and based on subsequent analysis, even when disclosures described the circumstances under which consumers may incur overdraft fees, the OCC has found that overdraft fees charged for APSN transactions are unfair for purposes of Section 5 because consumers were still unlikely to be able to reasonably avoid injury and the facts met the other factors for establishing unfairness.[12]

The OCC recognizes that compliance risk may exist when banks assess overdraft fees based on either a negative ledger balance or negative available balance for APSN transactions.[13]

## Representment Fee Practices

When a bank receives a check or automated clearing house (ACH) transaction that is presented for payment from a customer's deposit account, and the account has insufficient funds to pay the check or ACH transaction, the bank may decline to pay the transaction and charge the customer an NSF fee. If the same check or ACH transaction is presented to the bank again and the customer's account still has insufficient funds, some banks will either again return the transaction unpaid and assess an additional NSF fee or pay the transaction and assess an overdraft fee. This practice of charging an additional fee each time a single transaction (e.g., ACH transaction or check) is presented for payment by a third party without further action by the customer contributes to customer costs in circumstances in which those customers cannot reasonably avoid the additional charges.[14] Through ongoing supervision, the OCC has identified concerns with a bank's assessment of an additional fee on a representment transaction, resulting in findings in some instances that the practice was unfair and deceptive. Disclosures may be deceptive, for purposes of Section 5, if they do not clearly explain that multiple or additional fees (NSF or overdraft) may result from multiple presentments of the same transaction. Even when customer disclosures explain that a single check or ACH transaction may result in more than one fee, a bank's practice of assessing fees on each representment may also be unfair, for purposes of Section 5, if consumers cannot reasonably avoid the harm and the other factors for establishing unfairness under Section 5 are met. Consumers typically have no control over when a returned ACH transaction or check will be presented again and lack knowledge of whether an intervening deposit will be sufficient to cover the transaction and related fees.

## Additional Practices That May Present Heightened Risk

- **High limits or lack of daily limits on the number of fees assessed:** In the OCC's supervisory experience, charging overdraft or NSF fees with a high limit (or without limit) for multiple transactions in a single day has contributed to determinations that banks' overdraft protection programs as a whole were unfair for purposes of Section 5 because the lack of limits results in high costs for consumers and difficulty in bringing accounts positive.
- **Sustained overdraft fees:** In the OCC's supervisory experience, charging a fixed, periodic fee for failure to cure a previous overdrawn balance has contributed to findings of unfairness and deception, for purposes of Section 5, especially when the bank does not accurately disclose the

circumstances under which the customer could incur these fees. These practices make it more difficult for customers facing liquidity challenges to reasonably avoid these fees by bringing their account balances positive.

## Risk Management Practices

A bank's risk management systems should be commensurate with the bank's size, complexity, and risk profile. Therefore, as part of sound risk management of overdraft protection programs, the OCC encourages a bank to assess and analyze the risks posed by the bank's overdraft protection program activities; adjust the bank's risk management practices; and incorporate oversight of overdraft protection programs into the bank's compliance management system. An effective compliance management system typically should include processes and practices designed to manage compliance risk, ensure compliance with applicable laws and regulations, and prevent consumer harm.[15]

### Board and Management Oversight

A bank's board of directors has ultimate responsibility for overseeing management's implementation of a bank's overdraft protection program. Effective board and management oversight generally includes

- setting and confirming the bank's strategic approach and risk appetite for offering overdraft protection programs.
- providing guidance to senior management.
- ensuring that the bank has an effective change management process.
- performing ongoing monitoring to self-identify and self-correct weaknesses.
- monitoring the program's performance and measures relative to the bank's objectives and risk appetite.
- periodically reviewing information on a bank's overdraft protection program, including an assessment of customer impacts and overdraft product analyses to confirm that these services are fair and transparent.
- ensuring proper and accurate customer disclosures.

Bank management is responsible for developing, implementing, and effectively managing overdraft protection programs in line with the board's direction, the bank's objectives, and the bank's risk appetite, and in compliance with all applicable laws and regulations. Sound risk management generally should include appropriate policies, processes, personnel, and control systems that focus on consumer protection requirements and consider customer outcomes.[16]

### New Activities Processes and Third-Party Risk Management

Banks should have processes in place to manage the risks associated with offering new, modified, or expanded products or services (collectively, new activities), including new overdraft protection programs or changes to existing overdraft protection programs. Effective new activity development processes typically consider the financial attributes of consumers using the products, consumer disclosures, use of new technologies, use of alternative underwriting information, and use of third-party relationships. An effective risk management program should be in place if banks use third-party relationships as part of their overdraft protection programs.[17] Third-party relationships include a bank's arrangement with its service providers that often play a significant role in processing and reprocessing transactions, processing of payments, and providing systems that determine when overdraft or NSF fees are assessed.[18]

## Policies, Processes, and Control Systems

A bank's processes and control systems should align with established policies and incorporate appropriate procedures and practices for managing risks associated with overdraft protection programs. The following non-exhaustive list outlines examples of potentially appropriate risk management practices that banks may consider adopting:

- **Eligibility:** Overdraft limits and account agreement terms that are aligned with eligibility and underwriting criteria that promote fair treatment and fair access. Product structures, including short-term single payment structures, support consumer affordability and successful repayment of negative account balances in a reasonable time frame rather than reliance on regular or repeated reborrowing.
- **Opt-in status:** Policies and procedures that fully comply with the requirements of 12 CFR 1005.17 for one-time debit card and automated teller machine transactions. Policies and procedures should address compliance with these requirements. For other types of transactions (e.g., paper checks and recurring ACH or debit card transactions), consumers are provided the opportunity to affirmatively opt in to and opt out of overdraft protection at any time.[19]
- **Consumer disclosures:** Disclosures that effectively convey policies and practices related to accounts and products offered to consumers via transparent, understandable, and timely communication of account features. These disclosures support informed decision making with regard to overdraft protection programs and their related costs. Banks periodically test operating system settings and parameters to determine whether transaction postings are aligned to disclosures.
- **Overdraft protection product analysis:** A process for reviewing data and analyzing whether overall overdraft protection program revenues are reasonably related to the product risks and costs, as appropriate, at the portfolio, account, and transaction levels. Such analyses can also inform (1) modifications to overdraft protection programs intended to support a bank's longer-term competitive position, consumer satisfaction levels, and customer retention activities; and (2) a

bank's evaluation of the effect of any implemented modifications.

- **Periodic account analysis:** Processes to periodically review accounts of customers who use overdraft protection programs on a regular basis. The objectives of this review are primarily to confirm that customers
  - are provided with readily accessible and understandable tools and information to assist in managing their finances.
  - are not routinely relying on overdraft protection programs.
  - receive fair treatment.
  - are not incurring disproportionate costs relative to the face value of the item being presented, the amount of their regular deposits, and their average account balances.
- **Account monitoring:** Periodic account analyses that result in appropriate changes to overdraft limits, eligibility for continued use, or recommendations to consumers for other appropriate deposit account services when overreliance, excessive costs, or options for more cost-effective credit usage are detected. Overdraft limits and any changes to overdraft limits are clearly and timely communicated to consumers.
- **Grace amounts:** Grace amounts, or de minimis exclusions from fees that are based on transaction size or the magnitude of the overdrawn balance, are meaningful and periodically reviewed.
- **Grace periods:** Grace periods that provide additional time before the assessment of fees sufficient for customers to address a potential or actual negative account balance through an additional deposit or transfer of funds.
- **Online access and timely automated alerts:** Processes to send consumers accurate information in real or near real time through online account access or electronic alerts, such as text messages, online or web-based applications, or emails. In certain circumstances, these technologies may provide opportunities for customers to react to and address negative balances or items being presented for settlement to avoid fees.
- **Single daily fee:** Single daily fee assessments that are reasonably related to the costs of providing either overdraft protection or returned item for NSF services, offer effective transparency to customers, and eliminate confusion caused by item-posting order protocols or the use of available account balances.
- **Timing of fee collection:** A practice of collecting fees related to overdraft protection or NSF services from the next deposit only after all other appropriately presented items have posted or cleared to ensure that a greater amount of the consumers' deposited funds is available for consumer use.
- **Complaints management:** Incorporating overdraft protection-related complaints into a bank's complaint management and resolution processes,[20] which should be commensurate with the bank's size, complexity, and risk profile. Processes should include steps to analyze complaint data and to detect and remediate concerns or problem areas, including potential unfair or deceptive

acts or practices or unfair, deceptive, or abusive acts or practices.[21]

## Corrective Action

The OCC encourages banks to have processes in place to identify and correct risk management weaknesses and violations of laws and regulations. OCC violation findings at specific banks related to overdraft protection programs have typically led to corrective action, including remediation to harmed consumers. The OCC encourages banks to review their overdraft protection programs and related practices to ensure that banks comply with Section 5 and other applicable laws and regulations and take corrective action as appropriate.

## Further Information

Please contact Candace B. Matzenauer, Director for Consumer Compliance Policy, at (202) 649-5470, or Terence W. Culler, Director for Retail Credit Risk Policy, at (202) 649-6670.

Grovetta N. Gardineer
Senior Deputy Comptroller for Bank Supervision Policy

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[1] "Banks" refers collectively to national banks, federal savings associations, covered savings associations, and federal branches and agencies of foreign banking organizations.

[2] This bulletin focuses on automated, discretionary overdraft services for which banks charge fees, rather than the types of products or services described in 12 CFR 1005.17(a)(1)–(4).

[3] Refer to the "Deposit-Related Credit" booklet of the *Comptroller's Handbook* for an overview of the primary risks associated with deposit-related credit generally.

[4] Refer to 15 USC 45(a)(1).

[5] Refer to 12 USC 5536.

[6] For more information, refer to OCC Bulletin 2010-15, "Overdraft Protection: Opt-In Requirements and Related Marketing Issues."

[7] Refer to OCC Advisory Letter 2002-3, "Guidance on Unfair or Deceptive Acts or Practices," for applicable legal standards the OCC uses to evaluate whether an act or practice violates the prohibition on unfair or deceptive acts or practices in Section 5 of the FTC Act.

[8] For information on how the APSN practice relates to the Consumer Financial Protection Act's prohibition on unfair acts or practices (12 USC 5536), refer to the Consumer Financial Protection Bureau's Consumer Financial Protection Circular 2022-06, "Unanticipated Overdraft Fee Assessment Practices" (October 26, 2022).

[9] As used here, the term "intervening transaction" means a transaction that a bank authorizes for payment or that settles against a customer's account after the debit card transaction is authorized but before it posts to the customer's account. For an example, refer to table 1 in CFPB Circular 2022-06.

[10] Refer to table 2 in CFPB Circular 2022-06.

[11] OCC Advisory Letter 2002-3 states that a practice may be found to be deceptive and thereby unlawful under Section 5 if the following

three factors are present (1) there is a representation, omission, act, or practice that is likely to mislead; (2) the act or practice would be deceptive from the perspective of a reasonable consumer; and (3) the representation, omission, act, or practice is material.

[12] OCC Advisory Letter 2002-3 states that a practice may be found to be unfair and thereby unlawful under Section 5 if (1) the practice causes substantial consumer injury; (2) the injury is not outweighed by benefits to the consumer or to competition; and (3) the injury caused by the practice is one that consumers could not reasonably have avoided.

[13] Refer to, for example, *CFPB Supervisory Highlights*, “Junk Fees Special Edition,” Issue 29, at 4 (Winter 2023).

[14] For information on unfairness factors, refer to OCC Advisory Letter 2002-3.

[15] For more information, refer to the “Compliance Management Systems” booklet of the *Comptroller’s Handbook*.

[16] For more information, refer to the “Corporate and Risk Governance” booklet of the *Comptroller’s Handbook* and the *Director’s Book: Role of Directors for National Banks and Federal Savings Associations*.

[17] For more information, refer to OCC Bulletin 2020-10, “Frequently Asked Questions to Supplement OCC Bulletin 2013-29,” and OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance.”

[18] For more information, refer to OCC Bulletin 2017-43, “New, Modified, or Expanded Bank Products and Services: Risk Management Principles,” and OCC Bulletin 2019-62, “Consumer Compliance: Interagency Statement on the Use of Alternative Data in Credit Underwriting.”

[19] For more information, refer to OCC Bulletin 2010-15.

[20] For more information, refer to the “Compliance Management Systems” booklet of the *Comptroller’s Handbook*.

[21] For more information, refer to the “Unfair or Deceptive Acts or Practices and Unfair, Deceptive, or Abusive Acts or Practices” booklet of the *Comptroller’s Handbook*.

Topic(s):
- COMPLIANCE
- CONSUMER PROTECTION
- DEPOSITS & PAYMENTS

OCC Bulletin 2023-27 | August 8, 2023

# Loan Purchase Activities: Legal Lending Limit Guidance

### To

Chief Executive Officers of All National Banks, Federal Savings Associations, and Federal Branches and Agencies; Department and Division Heads; All Examining Personnel; and Other Interested Parties

## Summary

The Office of the Comptroller of the Currency (OCC) is issuing this bulletin to provide banks[1] with guidance regarding the applicability of the legal lending limit (LLL) to purchased loans.

**Note for Community Banks**

This bulletin applies to community banks' purchases of loans.

## Highlights

This bulletin

- provides background information on loan purchase activities and the LLL.
- provides guidance on the applicability of the LLL to purchased loans and types of recourse arrangements.

## Background

Loan purchase activities are long-standing banking practices that serve the legitimate business needs of the buying and selling institutions and the public interest. The extensive network of loan-broker channels and increased involvement of nonbank lenders have resulted in growth in the availability of loans for purchase.[2]

Unless an exception applies, all loans and extensions of credit made by banks are subject to the LLL, which provides limitations on the total amount of loans and extensions of credit to any one borrower.[3] Whether a loan that a bank purchases is attributable to the seller under the LLL regulation depends on specific facts and circumstances. Consequently, bank management would typically consider more information than it would for in-house originations when determining compliance with the LLL regulation for purchased loans.

# Guidance

Aggregate exposures attributable to a single seller must be within the bank's LLL. Loans are attributable to a seller under 12 CFR 32.2(q)(1)(iii) if the bank has direct or indirect recourse to the seller. Direct or indirect recourse can be explicit or implied. Explicit recourse is generally provided under contractual arrangement or other written agreement between the bank and the seller. Implied recourse is established through the bank's course of dealing[4] or conduct with a seller even if the contract or written agreement with the provider does not contain explicit recourse. The following are examples of explicit and implied recourse scenarios:

- **Explicit recourse:** Examples include a requirement or contractual obligation to substitute or repurchase defaulted loans or refill a reserve account, even if no substitutions, repurchases, or replenishments of the reserve account have occurred to date.
- **Implied recourse:** Examples include when the seller has routinely substituted or repurchased loans or refilled or replenished a reserve account even when the contract does not require those actions.

If the bank does not have explicit or implied recourse to the seller, the loans are generally not attributable to the seller under 12 CFR 32.2(q)(1)(iii). In such cases, the purchased loans would generally be attributable under the LLL regulation to only the named borrowers on the loans, unless the direct benefit or common enterprise tests under 12 CFR 32.5 are met or other provisions under the LLL regulation warrant attribution to another party.[5]

# Further Information

Please contact your OCC supervisory office.

Grovetta N. Gardineer
Senior Deputy Comptroller for Bank Supervision Policy

[1] “Banks” refers collectively to national banks, federal savings associations, and federal branches and agencies of foreign banking organizations.

[2] For additional information on loan purchase activities, refer to OCC Bulletin 2020-81, “Credit Risk: Risk Management of Loan Purchase Activities.”

[3] The LLL statute is 12 USC 84, “Lending Limits,” for national banks and 12 USC 1464(u), “Limits on Loans to One Borrower,” for federal savings associations. 12 USC 84 applies to federal savings associations pursuant to 12 USC 1464(u). The regulation for national banks and federal savings associations is 12 CFR 32, “Lending Limits.” “Loans and extensions of credit” are defined in 12 CFR 32.2(q). 12 CFR 32.3(a) provides the combined general limit; 12 CFR 32.3(b) provides loans and extensions of credit that are subject to special lending limits; and 12 CFR 32.3(c) provides loans and extensions of credit that are not subject to the LLL.

[4] Section 1-303 of the Uniform Commercial Code and section 223 of the Restatement (Second) of Contracts (1981) generally describe a course of dealing as a sequence of previous conduct between the parties to an agreement or a particular transaction that is fairly regarded as establishing a common basis of understanding for interpreting their expressions and other conduct. A course of dealing may give meaning to certain terms or supplement or qualify the terms of an agreement.

[5] The direct benefit and common enterprise tests under the combination rules are separate and distinct from 12 CFR 32.2(q)(1)(iii). A loan is subject to the direct benefit and common enterprise tests under the 12 CFR 32.5 combination rules independent of its attribution to a seller under 12 CFR 32.2(q)(1)(iii).

OCC Bulletin 2023-16 | May 25, 2023

# OCC Enforcement Actions: Revised Policies and Procedures Manual for Bank Enforcement Actions and Related Matters

### To

Chief Executive Officers of All National Banks, Federal Savings Associations, and Federal Branches and Agencies; Department and Division Heads; All Examining Personnel; and Other Interested Parties

## Summary

The Office of the Comptroller of the Currency (OCC) today released a revised *Policies and Procedures Manual* (PPM) for bank enforcement actions and related matters. This revised version of PPM 5310-3 replaces the version issued on November 13, 2018.

## Rescission

This bulletin rescinds OCC Bulletin 2018-41, "OCC Enforcement Actions: OCC Enforcement Action Policies and Procedures Manuals," issued on November 13, 2018.

**Note for Community Banks**

These policies and procedures apply to all OCC-supervised banks.[1]

## Highlights

PPM 5310-3, "Bank Enforcement Actions and Related Matters," now includes a new appendix, "Appendix C: Actions Against Banks With Persistent Weaknesses." The new appendix discusses

- persistent weaknesses a bank may exhibit warranting further action(s) by the OCC against the bank.
- the types of actions, requirements, and restrictions that may be appropriate to address a bank's persistent weaknesses.

## Background

In November 2018, the OCC updated its policies and procedures regarding bank enforcement actions and related matters with the issuance of a revised PPM 5310-3. The 2023 revision of the PPM includes a new appendix C, which generally applies to banks subject to Heightened Standards under 12 CFR 30, appendix D. The new appendix includes information about the OCC's consideration of supervisory and enforcement actions against banks that exhibit persistent weaknesses, including banks with highly complex operations that have failed to correct persistent weaknesses. Appendix C describes enforcement actions the OCC will consider, which could include additional requirements and restrictions, such as requirements that a bank acquire or hold additional capital or liquidity or restrictions on the bank's growth, business activities, or payment of dividends. If a bank has failed to correct its persistent weaknesses in response to prior enforcement actions or other measures, then the OCC will consider further action. Such action could require the bank to simplify or reduce its operations including that the bank reduce its asset size, divest subsidiaries or business lines, or exit from one or more markets of operation.

The revised PPM also incorporates additional clarifications, including updated legal and regulatory citations.

The OCC's enforcement policies reflect the principles important in implementing the OCC's mission to ensure that national banks and federal savings associations operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations.

## Further Information

Please contact the OCC's Enforcement group at (202) 649-6200 or Specialty Supervision Division at (202) 649-6450.

Beverly Cole
Senior Deputy Comptroller for Midsize and Community Bank Supervision

Grovetta N. Gardineer
Senior Deputy Comptroller for Bank Supervision Policy

Greg J. Coleman
Senior Deputy Comptroller for Large Bank Supervision

Benjamin W. McDonough
Senior Deputy Comptroller and Chief Counsel

## Related Link

- PPM 5310-3, "Bank Enforcement Actions and Related Matters" (PDF)

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[1] "Banks" refers collectively to national banks, federal savings associations, covered savings associations, and federal branches and agencies of foreign banking organizations.

Topic(s): ENFORCEMENT ACTIONS EXAMINATIONS

OCC Bulletin 2023-22 | June 26, 2023

# Cybersecurity: Cybersecurity Supervision Work Program

### To

Chief Executive Officers of All National Banks, Federal Savings Associations, and Federal Branches and Agencies; Department and Division Heads; All Examining Personnel; and Other Interested Parties

## Summary

The Office of the Comptroller of the Currency (OCC) recently developed and distributed the Cybersecurity Supervision Work Program for use by examiners. As cyberattacks evolve and as banks[1] adopt various standardized tools and frameworks to assess cybersecurity preparedness, the OCC recognized the need to update its approach to cybersecurity assessment as part of the agency's bank supervision. The Cybersecurity Supervision Work Program (CSW) provides high-level examination objectives and procedures that are aligned with existing supervisory guidance and the National Institute of Standards and Technology Cybersecurity Framework. The CSW Overview page on www.occ.gov links to the CSW References page, which provides cross-references that map the CSW procedures to existing supervisory guidance and industry cybersecurity frameworks. For example, cross-references include the Federal Financial Institutions Examination Council (FFIEC) Cybersecurity Assessment Tool, the Center for Internet Security's Critical Security Controls, and the Cyber Risk Institute's Profile.

The CSW does not establish new regulatory expectations, and banks are not required to use this work program to assess cybersecurity preparedness. The OCC continues to encourage but does not require use of standardized approaches to assess and improve cybersecurity preparedness, and banks may choose from a variety of tools and frameworks available.[2] The CSW does not change the availability of banks' optional use of the FFIEC Cybersecurity Assessment Tool or other cybersecurity frameworks.

### Note for Community Banks

Examiners may use the CSW's examination procedures during examinations of a community bank's cybersecurity preparedness.

## Highlights

The CSW

- is designed to more effectively address evolving risks and support risk-based bank information technology examinations.
- is aligned with the National Institute of Standards and Technology Cybersecurity Framework.
- is informed by the *FFIEC Information Technology Examination Handbook* and common cybersecurity frameworks.
- is designed to focus on cybersecurity preparedness and supplements the OCC's bank information technology examination procedures contained in the "Community Bank Supervision," "Large Bank Supervision," and "Federal Branches and Agencies Supervision" booklets of the *Comptroller's Handbook*.

## Further Information

Please contact Norine Richards, Director of Bank Information Technology Policy at (202) 649-6550.

Grovetta N. Gardineer
Senior Deputy Comptroller for Bank Supervision Policy

## Related Links

- "Cybersecurity Supervision Work Program" (PDF)
- Cybersecurity Supervision Work Program Overview
- Cybersecurity Supervision Work Program References

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[1] "Banks" refers collectively to national banks, federal savings associations, covered savings associations, and federal branches and agencies of foreign banking organizations.

[2] Refer to Federal Financial Institution Examination Council press release titled "FFIEC Encourages Standardized Approach to Assessing Cybersecurity Preparedness," August 28, 2019.

Topic(s):
- BANK INFORMATION TECHNOLOGY (BIT)
- BANK OPERATIONS
- INFORMATION & CYBER SECURITY - BIT

News Release 2023-31 | March 30, 2023

# OCC Establishes Office of Financial Technology

WASHINGTON—The Office of the Comptroller of the Currency (OCC) today announced the establishment of its Office of Financial Technology and the selection of Prashant Bhardwaj to lead the office as Deputy Comptroller and Chief Financial Technology Officer, effective April 10, 2023.

In October 2022, the OCC announced that it would expand upon its Office of Innovation and establish an Office of Financial Technology in early 2023 to bolster the agency's expertise and ability to adapt to the rapid pace of technological changes in the banking industry. The Office of Financial Technology broadens the OCC's focus in this area and ensures the agency's leadership and agility in providing high-quality supervision of bank-fintech partnerships. It further enhances the agency’s knowledge and expertise of financial technology platforms and applications in support of the OCC’s mission.

In his role as Deputy Comptroller and Chief Financial Technology Officer, Mr. Bhardwaj will lead the team responsible for analysis, evaluation, and discussion of relevant trends in financial technology, emerging and potential risks, and the potential implications for OCC supervision. The Office will enhance the OCC’s expertise on matters regarding digital assets, fintech partnerships, and other changing technologies and business models within and that affect OCC-supervised banks.

Mr. Bhardwaj joins the agency after nearly 30 years of experience serving in a variety of roles across the financial sector.

He holds a master's degree in accounting from University of Cincinnati and a master's degree in business administration from the International Management Institute Universiade de Brussels.

## Media Contact

Stephanie Collins
(202) 649-6870

Topic(s): OFFICE OF FINANCIAL TECHNOLOGY

# Regulatory Roundtable

## Current Legal Issues from the Regulators' Perspectives

John J. Schroeder
Regional Director
Consumer Financial Protection Bureau

# Consumer Financial Protection Bureau

## Table of Contents


1. Info Sheet — Small Business Lending Rule Compliance Dates
2. Supervisory Highlights — Junk Fees Special Edition
3. Notice of Proposed Rulemaking for Section 1033 — Personal Financial Data Rights
4. Bulletin 2020-01 — Responsible Business Conduct

Consumer Financial Protection Bureau
1700 G Street NW, Washington, DC 20552

**This document reflects the final rule as issued on March 30, 2023.**

Although the document has been revised since that date, it has not been updated to reflect any effects of ongoing litigation involving the final rule. As a result of that ongoing litigation, the compliance dates in the final rule currently are stayed as to all covered financial institutions.

Small Business Lending Rule Info Sheet:

# When must a financial institution begin collecting data and complying with the small business lending rule?

Generally, the small business lending rule (final rule) requires a financial institution[1] that is a covered financial institution for a given calendar year to collect data and otherwise comply with the final rule for that calendar year. Pursuant to the final rule, a financial institution is a covered financial institution for a given calendar year if it originated at least 100 covered originations in each of the two preceding calendar years. For example, a financial institution is a covered financial institution for 2026 if it had at least 100 covered originations for both calendar year 2024 and calendar year 2025.

However, as discussed below, not all covered financial institutions are required to begin complying with the final rule at the same time. This is because the final rule includes

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This is a Compliance Aid issued by the Consumer Financial Protection Bureau. The CFPB published a Policy Statement on Compliance Aids, available at http://www.consumerfinance.gov/policy-compliance/rulemaking/final-rules/policy-statement-compliance-aids/, that explains the CFPB's approach to Compliance Aids.

[1] For purposes of the final rule, a financial institution is any partnership, company, corporation, association (incorporated or unincorporated), trust, estate, cooperative organization, or other entity that engages in any financial activity.

compliance date tiers that establish different initial compliance dates depending on the number of covered originations that a financial institution originated in 2022 and 2023. Thus, an important implementation step will be to determine the number of covered originations that a financial institution originated in 2022 and to determine the number of covered originations that the financial institution originates in 2023.

Generally, a covered origination is a covered credit transaction that the financial institution originates to a small business.[2] However, amendments, renewals, and extensions of existing transactions are not covered originations, even if they increase the credit line or credit amount of the existing transaction. If a financial institution does not have sufficient information readily available to determine if its originations for 2022 and 2023 were made to small businesses (as that term is defined in the final rule), the financial institution may use any reasonable method to estimate its covered originations for either or both of those two years. For instance, if a financial institution that does not have readily accessible information regarding which of its covered credit transactions were originated to small businesses prior to October 1, 2023, the financial institution can annualize its covered originations based on the number of covered credit transactions it originated to small businesses between October 1 and December 31, 2023 and use that annualized number to determine its covered originations for 2022, 2023, or both years. Also, as illustrated in the examples below, a financial institution may assume that all of the covered credit transactions it originated in 2022 and/or 2023 were made to small businesses.

The chart immediately below illustrates the compliance date tiers that financial institutions will need to consider when determining when they must begin collecting data and otherwise complying with the final rule.

| Compliance date tier | Origination threshold for the compliance date tier | Date that a covered financial institution begins collecting data and otherwise complying with the final rule | Deadline for a covered financial institution to report first year of data to the CFPB |
|---|---|---|---|
| Tier 1 | At least 2,500 covered originations | October 1, 2024 | June 1, 2025 |

[2] Additional information about covered financial institutions, small businesses, covered credit transactions, and compliance dates is available in the Executive Summary of the Small Business Lending Rule, which is available at www.consumerfinance.gov/compliance/compliance-resources/small-business-lending-resources/small-business-lending-collection-and-reporting-requirements.

| Compliance date tier | Origination threshold for the compliance date tier | Date that a covered financial institution begins collecting data and otherwise complying with the final rule | Deadline for a covered financial institution to report first year of data to the CFPB |
|---|---|---|---|
| | in both 2022 and 2023 | | |
| Tier 2 | At least 500 covered originations in both 2022 and 2023 but not 2,500 or more covered originations in both 2022 and 2023 | April 1, 2025 | June 1, 2026 |
| Tier 3 | At least 100 covered originations in both 2022 and 2023 but not 500 or more covered originations in both 2022 and 2023 | January 1, 2026 | June 1, 2027 |
| Additionally, even if it originated fewer than 100 covered originations in 2022 or 2023, a financial institution that originates at least 100 covered originations in 2024 and 2025 must collect data and otherwise comply with the final rule beginning January 1, 2026. | | | |

The remainder of this info sheet discusses whether a financial institution must collect data and otherwise comply with the final rule for specific years.

## Does my financial institution need to comply with the final rule for 2024?

A financial institution is only required to begin collecting data and otherwise complying with the final rule for 2024 if it meets the origination threshold for the Tier 1 compliance date. Thus, a financial institution must begin collecting data and otherwise complying with the final rule on October 1, 2024 if that financial institution originated at least 2,500 covered originations in both 2022 and 2023. If a financial institution is required to collect data for 2024, it must report that data to the CFPB by June 1, 2025. It must also comply with the final rule's other provisions, such as the firewall provision and the recordkeeping provisions, with regard to the data collected for 2024.

The following flowchart may be used to help determine if a financial institution is required to collect data and otherwise comply with the final rule for 2024:

Did the financial institution originate 2,500 or more covered originations in **both** 2022 and 2023?

Yes

**Covered.** Beginning October 1, 2024, the financial institution is required to collect data and otherwise comply with the final rule for 2024.

The financial institution must report 2024 data by June 1, 2025.

No

**Not Covered.** The financial institution is not required to collect data or otherwise comply with the final rule for 2024.

However, the financial institution must determine if it is required to collect data and otherwise comply for later years.

**Example 1:** Lender originates 2,600 covered originations in 2022 and 2,800 covered originations in 2023. Based on its 2022 and 2023 originations, Lender meets the origination threshold for the Tier 1 compliance date and is required to collect data and otherwise comply with the final rule beginning on October 1, 2024. It is required to report the data collected for 2024 to the CFPB by June 1, 2025.

**Example 2**: Lender has 2,000 covered originations in 2022 and 3,000 covered originations in 2023. Although Lender is a covered financial institution for 2024, it does not meet the origination threshold for the Tier 1 compliance date because it did not have at least 2,500 covered originations in 2022. Thus, it is not required to collect data or otherwise comply with the final rule for 2024. However, it must determine if it is required to collect data and otherwise comply for later years.

**Example 3**: In 2022, Lender originates 2,850 transactions that would be covered originations if they were made to small businesses, but Lender does not have sufficient information readily available to determine whether the borrowers are small businesses pursuant to the final rule. Beginning on August 1, 2023, Lender begins asking applicants for business credit transactions whether they had gross annual revenue of $5 million or less in the applicant's prior fiscal year in order to determine if covered credit transactions originated between October 1 and December 31, 2023 are covered originations. Lender originates 650 covered originations between October 1 and December 31, 2023. Lender annualizes this number to determine that it originated 2,600 covered originations and applies this annualized number to 2022 and 2023. Because Lender determines that it originated 2,600 covered originations in both 2022 and 2023, Lender is required to collect data and otherwise comply with the final rule for 2024. It is required to report the data collected for 2024 to the CFPB by June 1, 2025.

**Example 4**: In 2022, Lender originates 1,900 transactions that would be covered originations if they were made to small businesses, but Lender cannot readily determine whether the borrowers were small businesses as defined in the final rule. Lender can assume that all 1,900 of its originations in 2022 are covered originations and use that number to determine that it does not satisfy the origination threshold for the Tier 1 compliance date. Regardless of how many covered originations it has for 2023, Lender does not satisfy the Tier 1 compliance date threshold because it did not have at least 2,500 covered originations for both 2022 and 2023. It is not required to collect data or otherwise comply with the final rule for 2024. However, Lender must determine if it is required to collect data and otherwise comply with the final rule for later years.

**Example 5**: In 2022, Lender originates 3,100 transactions that would be covered originations if they were made to small businesses. Lender obtains some information about applicants' gross annual revenue for these transactions but determines that it does not have sufficient information readily available to determine whether some of the transactions were made to small businesses as defined in the final rule. Lender collects all business credit applicants' gross annual revenue for transactions originated in 2023. Using this information, Lender determines that it originates 2,490 covered originations between January 1 and December 31, 2023. Regardless of the number of covered originations it had in 2022, Lender does not satisfy the origination threshold for the Tier 1 compliance date because it did not have at least 2,500 covered originations in both 2022 and 2023. It is not required to collect data or otherwise comply with the final rule for 2024. However, Lender must determine if it is required to collect data and otherwise comply with the final rule for later years.

**Example 6**: Assume facts similar to those in example 5, above, except that Lender originates 2,510 covered originations in 2023. Lender may assume that all of the covered credit transactions it originated in 2022 were made to small businesses. If it does so, Lender satisfies the origination threshold for the Tier 1 compliance date and is required to collect data and otherwise comply with the final rule for 2024. Alternatively, Lender may use the number of covered originations it originates between October 1, 2023 and December 31, 2023 to determine its compliance date tier. Assume Lender originates 650 covered originations between October 1 and December 31, 2023. Using this number, Lender determines its annualized number of covered originations for 2022 is 2600 (650 x 4= 2,600). Using this annualized number of originations and its actual number of covered originations (i.e., 2,510) for 2023, Lender satisfies the Tier 1 compliance date threshold and is required to collect data and otherwise comply with the final rule for 2024. Finally, although the information is not readily available, Lender may decide to locate or obtain sufficient information to determine which of its 2022 covered credit transactions were made to small businesses. Assume Lender locates or obtains sufficient information to determine that it had no more than 2,499 covered originations for 2022. In this case, Lender does not satisfy the Tier 1 compliance date threshold because it did not originate at least 2,500 covered originations in 2022. Although it is not required to collect data or otherwise comply with the final rule for 2024, it must determine if it is required to collect data and otherwise comply with the final rule for later years.

**Example 7**: Lender originates 75 covered originations in 2023. Regardless of the number of covered originations it had in 2022, Lender is not required to collect data or otherwise comply with the final rule for 2024, but it must determine if it is required to collect data and otherwise comply for later years.

## Does my financial institution need to comply with the final rule for 2025?

If a financial institution that is required to collect data and otherwise comply with the final rule for 2024 (i.e., the financial institution meets the origination threshold for the Tier 1 compliance date) originates at least 100 covered originations in 2024, it must collect data for all of calendar year 2025 and otherwise comply with the final rule for 2025. Among other things, it must collect data for calendar year 2025 and report that data by June 1, 2026. It must also comply with the final rule's other provisions with regard to the data collected for 2025. Conversely, if a financial institution that is required to collect data and otherwise comply for 2024 does not originate at least 100 covered originations in 2024, the financial institution is not a covered financial institution for 2025. It must report the data it collected in 2024 by June 1, 2025, but it is not required to collect data for 2025.

If a financial institution is not required to collect data or otherwise comply for 2024, it must begin collecting data and otherwise complying with the final rule on April 1, 2025 if it:

- **Meets the origination threshold for the Tier 2 compliance date.** This means that it originated at least 500 covered originations in both 2022 and 2023; and
- **Meets the origination threshold to be a covered financial institution for 2025.** This means that it originated at least 100 covered originations in 2023 and 2024.

If a financial institution is required to collect data for 2025, it must report that data to the CFPB by June 1, 2026. It must also comply with the final rule's other provisions with regard to the data collected for 2025.

The following flowchart may be used to help determine if a financial institution is required to collect data and otherwise comply with the final rule in 2025:

Did the financial institution originate at least 500 covered originations in **both** 2022 and 2023?

Yes / No

Did the financial institution originate at least 100 covered originations in 2024?

Yes / No

**Covered.** The financial institution is required to collect data and otherwise comply with the final rule for 2025. If the financial institution is in Tier 1, it must collect data for all of calendar year 2025. If it is in Tier 2, it must collect data beginning April 1, 2025.

The financial institution must report 2025 data by June 1, 2026.

**Not Covered.** The financial institution is not required to collect data or otherwise comply with the final rule for 2025.

However, the financial institution must determine if it is required to collect data and otherwise comply for later years.

**Example 1:** Lender originates 520 covered originations in 2022, 510 covered originations in 2023, and 420 covered originations in 2024. Based on its 2022 and 2023 originations, Lender does not meet the origination threshold for the Tier 1 compliance date, but does meet the origination threshold for the Tier 2 compliance date. Additionally, Leder meets the origination threshold to be a covered financial institution for 2025. Thus, Lender is required to begin collecting data for 2025 on April 1, 2025 and otherwise complying with the final rule on April 1, 2025. Lender is required to report its 2025 data to the CFPB by June 1, 2026.

**Example 2**: Lender originates 510 covered originations in 2022, 502 covered originations in 2023, and 99 covered originations in 2024. Although Lender meets the origination threshold for the Tier 2 compliance date, it does not meet the origination threshold to be a covered financial institution for 2025. It is not required to collect data or otherwise comply with the final rule for 2025. However, it must determine if it is required to collect data and otherwise comply for later years.

**Example 3**: In 2022, Lender originates 510 transactions that would be covered originations if they were made to small businesses, but Lender does not collect information sufficient to determine whether its borrowers are small businesses as defined in the final rule. Lender begins asking applicants whether they had gross annual revenue of $5 million or less in the applicant's prior fiscal year in order to determine if the transactions it originates on or after October 1, 2023 are covered originations. Lender determines that it originated 147 covered originations between October 1 and December 31, 2023. Lender annualizes this number to determine that it originated 588 covered originations and applies this annualized number to 2022 and 2023. Lender originates 485 covered originations in 2024. Because Lender determines that it originated 588 covered originations in both 2022 and 2023, Lender meets the origination threshold for the Tier 2 compliance date. Because Lender determines that it originated 588 covered originations in 2023 and 485 covered originations in 2024, it meets the origination threshold to be a covered financial institution for 2025. It is required to collect data for 2025 and otherwise comply with the final rule beginning on April 1, 2025. It must submit its 2025 data to the CFPB by June 1, 2026.

**Example 4**: In 2022, Lender originates 215 transactions that would be covered originations if they were made to small businesses, but Lender does not collect information sufficient to determine whether an applicant is a small business pursuant to the final rule. Lender assumes that all 215 transactions are covered originations. Regardless of the number of covered originations it has for 2023, Lender does not satisfy the origination threshold for the Tier 2 compliance date and is not required to collect data or otherwise comply with the final rule for 2025. However, it must determine if it is required to collect data and otherwise comply for later years.

**Example 5**: Lender originates 85 covered originations in 2022, 90 covered originations in 2023, and 105 covered originations in 2024. Lender does not meet the origination threshold to be a covered financial institution for 2025 and is not required to collect data or otherwise comply with the final rule for 2025. However, it must determine if it is required to collect data and otherwise comply for later years.

**Example 6**: Lender is a new company and begins originating covered credit transactions in 2023. It originates 525 covered originations in 2023 and 550 covered originations in 2024. Because Lender did not have any originations in 2022, it does not satisfy the origination threshold for the Tier 2 compliance date and is not required to collect data or otherwise comply with the final rule for 2025. However, it must determine if it is required to collect data and otherwise comply for later years.

## Does my financial institution need to comply with the final rule for 2026 or later years?

For 2026 and later years, the final rule does not have separate origination thresholds for compliance date tiers and institutional coverage. Instead, a financial institution must comply for a given calendar year if it satisfies the general origination threshold for that year (i.e., the financial institution originated at least 100 covered originations in both of the two immediately preceding calendar years). Thus, if a financial institution satisfies the origination threshold to be a covered financial institution for 2026 or for a later year, the financial institution must comply with the final rule for that year. It must collect data for the calendar year and report that data by the following June 1. It must also comply with the final rule's other provisions with regard to the data collected.

For example, if a financial institution originates at least 100 covered originations in both 2024 and 2025, it is a covered financial institution and is required to collect data for 2026 and otherwise comply with the final rule for calendar year 2026. The covered financial institution must report to the CFPB the data collected in 2026 by June 1, 2027.

Similarly, a financial institution that originates at least 100 covered originations in both 2025 and 2026 is a covered financial institution for 2027. It must collect data for calendar year 2027 and report that data to the CFPB by June 1, 2028. It also must otherwise comply with the final rule with regard to the data collected for 2027.

The following flowchart may be used to help determine if a financial institution is required to collect data and otherwise comply with the final rule for 2026 or later years:

Did the financial institution originate at least 100 covered originations in **both** of the immediately preceding calendar years?

**Yes**

**Covered.** The financial institution is required to collect data and otherwise comply with the final rule for the current calendar year.

The financial institution must report data for the current calendar year by the following June 1.

**No**

**Not Covered.** The financial institution is not required to collect data or otherwise comply with the final rule for the current calendar year.

However, the financial institution must determine if it is required to collect data and otherwise comply for future years.

**Example 1:** Lender originates 490 covered originations each year between 2022 and 2025. Based on the compliance date tiers in the final rule, Lender is not required to collect data or otherwise comply with the final rule until January 1, 2026. It must collect data for 2026, report its 2026 data to the CFPB by June 1, 2027, and otherwise comply with the final rule for 2026. If Lender originates at least 100 covered originations in 2026, it will also be a covered financial institution and required to collect data for 2027 and otherwise comply with the final rule for 2027.

**Example 2**: Lender originates 85 covered originations in 2022, 90 covered originations in 2023, 105 covered originations in 2024, and 95 covered originations in 2025. Lender is not a covered financial institution and is not required to collect data or otherwise comply with the final rule for 2024, 2025, or 2026. Additionally, because Lender did not originate at least 100 covered originations in 2025, it will not be a covered financial institution and will not be required to collect data or otherwise comply with the final rule for 2027. However, it must determine if it is required to collect data and otherwise comply for later years.

**Example 3**: In 2022, Lender originates 145 transactions that would be covered originations if they were made to small businesses and assumes that all 145 transactions are covered originations. Because it did not originate at least 500 covered originations in 2022 and 2023, the earliest that Lender could be required to collect data and otherwise comply with the final rule is January 1, 2026. Lender begins asking all applicants for business credit for their gross annual revenues beginning in October 2023 and is able to determine if applicants are small businesses for all covered credit transactions originated on or after January 1, 2024. Lender originates 125 covered originations in 2024 and 95 covered originations in 2025. Lender is not a covered financial institution and is not required to collect data or otherwise comply with the final rule for 2024, 2025, or 2026. Additionally, because Lender did not originate at least 100 covered originations in 2025, it will not be a covered financial institution and will not be required to collect data or otherwise comply with the final rule for 2027. However, it must determine if it is required to collect data and otherwise comply for later years.

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# Supervisory Highlights Junk Fees Special Edition

Issue 29, Winter 2023

Consumer Financial Protection Bureau

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# 1. Introduction

This special edition of *Supervisory Highlights* focuses on the Consumer Financial Protection Bureau's (CFPB or Bureau) recent supervisory work related to violations of law in connection with fees.[1] As part of its emphasis on fair competition the CFPB has launched an initiative, consistent with its legal authority, to scrutinize exploitative fees charged by banks and financial companies, commonly referred to as "junk fees."

Junk fees are unnecessary charges that inflate costs while adding little to no value to the consumer. Theses unavoidable or surprise charges are often hidden or disclosed only at a later stage in the consumer's purchasing process or sometimes not at all.

The CFPB administers several laws and regulations that may touch on fees including, but not limited to, the Credit Card, Accountability, Responsibility and Disclosure Act of 2009 (CARD Act),[2] the Fair Debt Collection Practices Act (FDCPA),[3] Regulation Z,[4] and the prohibition against unfair, deceptive, or abusive acts or practices (UDAAP) under the Consumer Financial Protection Act of 2010 (CFPA).[5]

The findings in this report cover examinations involving fees in the areas of deposits, auto servicing, mortgage servicing, payday and small dollar lending, and student loan servicing completed between July 1, 2022, and February 1, 2023. To maintain the anonymity of the supervised institutions discussed in *Supervisory Highlights*, references to institutions generally are in the plural and the related findings may pertain to one or more institutions.

We invite readers with questions or comments about *Supervisory Highlights* to contact us at CFPB_Supervision@cfpb.gov.

[1] If a supervisory matter is referred to the Office of Enforcement, Enforcement may cite additional violations based on these facts or uncover additional information that could impact the conclusion as to what violations may exist.
[2] 12 C.F.R. § 1026.
[3] 15 U.S.C. § 1692.
[4] 12 C.F.R. § 1026.
[5] 12 U.S.C. §§ 5531, 5536.

# 2. Supervisory Observations

## 2.1 Deposits

During examinations of insured depository institutions and credit unions, Bureau examiners assessed activities related to the imposition of certain fees by the institutions. This included assessing whether entities had engaged in any UDAAPs prohibited by the CFPA.[6]

### 2.1.1 Unfair Authorize Positive, Settle Negative Overdraft Fees

As described below, Supervision has cited institutions for unfair unanticipated overdraft fees for transactions that authorized against a positive balance, but settled against a negative balance (i.e., APSN overdraft fees). They can occur when financial institutions assess overdraft fees for debit card or ATM transactions where the consumer had a sufficient available balance at the time the financial institution authorized the transaction, but given the delay between authorization and settlement of the transaction the consumer's account balance is insufficient at the time of settlement. This can occur due to intervening authorizations resulting in holds, settlement of other transactions, timing of presentment of the transaction for settlement, and other complex processes relating to transaction order processing practices and other financial institution policies. The Bureau previously discussed this practice in Consumer Financial Protection Circular 2022-06, Unanticipated Overdraft Fee Assessment Practices ("Overdraft Circular").[7]

Supervision has cited unfair acts or practices at institutions that charged consumers APSN overdraft fees. An act or practice is unfair when: (1) it causes or is likely to cause substantial injury to consumers; (2) the injury is not reasonably avoidable by consumers; and (3) the injury is not outweighed by countervailing benefits to consumers or to competition.[8]

While work is ongoing, at this early stage, Supervision has already identified at least tens of millions of dollars of consumer injury and in response to these examination findings,

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[6] 12 U.S.C. §§ 5531, 5536.

[7] Consumer Financial Protection Circular 2022-06, Unanticipated Overdraft Fee Assessment Practices (Oct. 26, 2022)("Overdraft Circular"), at 8-12, available at: https://files.consumerfinance.gov/f/documents/cfpb_unanticipated-overdraft-fee-assessment-practices_circular_2022-10.pdf.

[8] 12 U.S.C. § 5531(c).

institutions are providing redress to over 170,000 consumers. Supervision found instances in which institutions assessed unfair APSN overdraft fees using the consumer's available balance for fee decisioning, as well as unfair APSN overdraft fees using the consumer's ledger balance for fee decisioning. Consumers could not reasonably avoid the substantial injury, irrespective of account-opening disclosures. As a result of examiner findings, the institutions were directed to cease charging APSN overdraft fees and to conduct lookbacks and issue remediation to consumers who were assessed these fees.

Supervision also issued matters requiring attention to correct problems that occurred when institutions had enacted policies intended to eliminate APSN overdraft fees, but APSN fees were still charged. Specifically, institutions attempted to prevent APSN overdraft fees by not assessing overdraft fees on transactions which authorized positive, as long as the initial authorization hold was still in effect at or shortly before the time of settlement. There were some transactions, however, that settled outside this time period. Examiners found evidence of inadequate compliance management systems where institutions failed to maintain records of transactions sufficient to ensure overdraft fees would not be assessed, or failed to use some other solution to not charge APSN overdraft fees. In response to these findings, the institutions agreed to implement more effective solutions to avoid charging APSN overdraft fees and to issue remediation to the affected consumers.

The Bureau has stated the legal violations surrounding APSN overdraft fees both generally and in the context of specific public enforcement actions will result in hundreds of millions of dollars of redress to consumers.[9] As discussed in a June 16, 2022 blog post, Supervision has also engaged in a pilot program to collect detailed information about institutions' overdraft practices, including whether institutions charged APSN overdraft fees.[10] A number of banks that had previously reported to Supervision engaging in APSN overdraft fee practices now report that they will stop doing so. Institutions that have reported finalized remediation plans to Supervision state their plans cover time periods starting in 2018 or 2019 up to the point they ceased charging APSN overdraft fees.

[9] See Consumer Financial Protection Circular 2022-06, Unanticipated Overdraft Fee Assessment Practices (Oct. 26, 2022) available at: https://files.consumerfinance.gov/f/documents/cfpb_unanticipated-overdraft-fee-assessment-practices_circular_2022-10.pdf; CFPB Consent Order 2022-CFPB-008, In the Matter of Regions Bank (Sept. 28, 2022), available at: https://files.consumerfinance.gov/f/documents/cfpb_Regions_Bank-_Consent-Order_2022-09.pdf; CFPB Consent Order 2022-CFPB-0011, In the Matter of Wells Fargo Bank, (Dec. 20, 2022), available at: https://files.consumerfinance.gov/f/documents/cfpb_wells-fargo-na-2022_consent-order_2022-12.pdf.

[10] Measuring the impact of financial institution overdraft programs on consumers, (June 16, 2022), available at: https://www.consumerfinance.gov/about-us/blog/measuring-the-impact-of-financial-institution-overdraft-programs-on-consumers/.

## 2.1.2 Assessing multiple NSF fees for the same transaction

Supervision conducted examinations of institutions to review certain practices related to charging consumers non-sufficient funds (NSF) fees. As described in more detail below, examiners conducted a fact-intensive analysis at various institutions to assess specific types of NSF fees. In some of these examinations, examiners found unfair practices related to the assessment of multiple NSF fees for a single transaction.

Some institutions assess NSF fees when a consumer pays for a transaction with a check or an Automated Clearing House (ACH) transfer and the transaction is presented for payment, but there is not a sufficient balance in the consumer's account to cover the transaction. After declining to pay a transaction, the consumer's account-holding institution will return the transaction to the payee's depository institution due to non-sufficient funds and may assess an NSF fee. The payee may then present the same transaction to the consumer's account-holding institution again for payment. If the consumer's account balance is again insufficient to pay for the transaction, then the consumer's account-holding institution may assess another NSF fee for the transaction and again return the transaction to the payee. Absent restrictions on assessment of NSF fees by the consumer's account-holding institution, this cycle can occur multiple times.

Supervision found that institutions engaged in unfair acts or practices by charging consumers multiple NSF fees when the same transaction was presented multiple times for payment against an insufficient balance in the consumer's accounts, potentially as soon as the next day. The assessment of multiple NSF fees for the same transaction caused substantial monetary harm to consumers, totaling millions of dollars. These injuries were not reasonably avoidable by consumers, regardless of account opening disclosures. And the injuries were not outweighed by countervailing benefits to consumers or competition.

Examiners found that institutions charged several million dollars to tens of thousands of consumers over the course of several years due to their assessment of multiple NSF fees for the same transaction. The institutions agreed to cease charging NSF fees for unpaid transactions entirely and Supervision directed the institutions to refund consumers appropriately. Other regulators have spoken about this practice as well.[11]

In the course of obtaining information about institutions' overdraft and NSF fee practices, examiners obtained information regarding limitations related to the assessment of NSF fees. Supervision subsequently heard from a number of institutions regarding changes to their NSF

[11] NYDFS, Industry Letter: Avoiding Improper Practices Related to Overdraft and Non-Sufficient Funds Fees (July 12, 2022), available at: https://www.dfs.ny.gov/industry_guidance/industry_letters/il20220712_overdraft_nsf_fees; FDIC, Supervisory Guidance on Multiple Re-Presentment NSF Fees (Aug. 2022), available at: https://www.fdic.gov/news/financial-institution-letters/2022/fil22040a.pdf.

fee assessment practices. Virtually all institutions that Supervision has engaged with on this issue reported plans to stop charging NSF fees altogether.

Supervision anticipates engaging in further follow-up work on both multiple NSF fee and APSN overdraft fee issues. In line with the Bureau's statement regarding responsible business conduct, institutions are encouraged to "self-assess [their] compliance with Federal consumer financial law, self-report to the Bureau when [they identify] likely violations, remediate the harm resulting from these likely violations, and cooperate above and beyond what is required by law" with these efforts.[12] As the statement notes, "...the Bureau's Division of Supervision, Enforcement, and Fair Lending makes determinations of whether violations should be resolved through non-public supervisory action or a possible public enforcement action through its Action Review Committee (ARC) process." For those institutions that meaningfully engage in responsible conduct, this "could result in resolving violations non-publicly through the supervisory process."

# 2.2 Auto Servicing

During auto servicing examinations, examiners identified UDAAPs related to junk fees, such as unauthorized late fees and estimated repossession fees.[13] Additionally, examiners found that servicers charged unfair and abusive payment fees.

## 2.2.1 Overcharging late fees

Examiners found that servicers engaged in unfair acts or practice by assessing late fees in excess of the amounts allowed by consumers' contracts. Auto contracts often contain language that caps the maximum late fee amounts servicers are permitted to assess. The servicers coded their systems to assess a $25 late fee even though some consumers' loan notes capped late fees at no more than 5% of the monthly payment amount. The $25 late fee exceeded 5% of many consumers' monthly payment amounts. Excessive late fees cost consumers money and thus constitute substantial injury. Consumers could not reasonably avoid the injury because they do not control how servicers calculate late fees, had no reason to anticipate that the servicers would impose excessive late fees, and could not practically avoid being charged a fee. And the injury to consumers was not outweighed by benefits to consumers or competition.

[12] CFPB Bulletin 2020-01, Responsible Business Conduct: Self-Assessing, Self-Reporting, Remediating, and Cooperating, (Mar. 6, 2020), available at: https://files.consumerfinance.gov/f/documents/cfpb_bulletin-2020-01_responsible-business-conduct.pdf.

[13] Note that while involuntary fees are often unfair when they are not authorized by a consumer contract, fees that are disclosed in the contract can also be unfair, depending on the circumstances.

In response to these findings, the servicers ceased the practice and refunded late fee overcharges to consumers.

### 2.2.2 Charging unauthorized late fees after repossession and acceleration

Examiners found that servicers engaged in unfair acts or practices by assessing late fees not allowed by consumers' contracts. Specifically, the contracts authorized the servicers to charge late fees if consumers' periodic payments were more than 10 days delinquent. But, under the terms of the relevant loan agreements, after the servicers accelerated the loan balance, the entire remaining loan balance became immediately due and payable, thus terminating consumers' contractual obligation to make further periodic payments and eliminating the servicers' contractual right to charge late fees on such periodic payments. Despite this, the servicers continued to collect late fees even after they repossessed the vehicles on periodic payments scheduled to occur subsequent to the date on which the loan balances were accelerated. When consumers redeemed their vehicles by paying the full balance, they also paid these unauthorized late fees; these unauthorized fees caused substantial injury to consumers. Consumers could not reasonably avoid the late fees because they had no control over the servicers' late fee practices. And the injury to consumers was not outweighed by benefits to consumers or competition.

In response to these findings, servicers ceased the practice and refunded late fees to consumers.

### 2.2.3 Charging estimated repossession fees significantly higher than average repossession costs

Examiners found that, where servicers allowed consumers to recover their vehicles after repossession by paying off the loan balance or past due amounts, servicers charged a $1,000 estimated repossession fee as part of the amount owed. This estimated repossession fee was significantly higher than the average repossession cost, which is generally around $350. By policy, the servicers returned the excess amounts to the consumer after they received the invoice for the actual cost from the repossession agent.

Examiners found that the servicers engaged in unfair acts or practices when they charged estimated repossession fees that were significantly higher than the costs they purported to cover. The relevant contracts permitted the servicers to charge consumers default-related fees based on actual cost, but here the fees significantly exceeded the actual cost. Charging the fees caused or was likely to cause substantial injury in the form of concrete monetary harm. For consumers who paid the amount demanded, deprivation of these funds for even a short period constituted substantial injury. Furthermore, some consumers may have been dissuaded from recovering their vehicles because the servicers represented that consumers must pay a $1,000 estimated repossession fee in addition to other amounts due. Some consumers may have been able to afford a $350 fee but not a $1,000 fee, and therefore did not pay and permanently lost access to their vehicles. Consumers could not reasonably avoid the injury because they did not control the servicers' practice of charging unauthorized estimated repossession fees. And the injury was not outweighed by countervailing benefits to consumers or competition because the fee exceeded costs necessary to cover repossession.

In response to these findings, the servicers ceased the practice of charging estimated repossession fees that were significantly higher than the actual average amount and provided refunds to affected consumers.

### 2.2.4 Unfair and abusive payment fees

An act or practice is abusive if it "takes unreasonable advantage of … the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service."[14]

Examiners found that servicers engaged in unfair and abusive acts or practices by charging and profiting from payment processing fees that far exceeded the servicers' costs for processing payments, after the consumer was locked into a relationship with a servicer chosen by the dealer. Examiners observed that the servicers only offered two free payment options—pre-authorized recurring ACH and mailed checks—which are only available to consumers with bank accounts. Approximately 90 percent of payments made by consumers incurred a pay-to-pay fee. The servicers received over half the amount of these fees from the servicers' third-party payment processor as incentive payments, totaling millions of dollars.

Examiners concluded that these practices took unreasonable advantage of consumers' inability to protect their interests by charging consumers fees to use the most common payment methods to pay their auto loans, after the consumer was locked into a relationship with a servicer, that far exceeded the servicers' costs. Servicers leveraged their captive customer base and profited off payment fees through kickback incentive payments. These consumers were unable to protect their interests in selecting or using a consumer financial product or service because the dealer, not the consumer, selected the servicer. Consumers thus could not evaluate a servicer's payment processing fees, bargain over these fees, or switch to a servicer with lower-cost or more no-fee payment options.

[14] 12 U.S.C. § 5531(d)(2)(B).

In addition, examiners found that these practices were unfair. The payment processing fees constituted substantial injury. Because consumers did not choose their auto loan servicers, they could not reasonably avoid these costs by bargaining with the servicer over the fees or switching to another servicer; moreover, consumers without bank accounts, who were unaware of the payment structure, or who have other obstacles to ACH or check payments, could not use the free payment methods and thus could not reasonably avoid paying the fees. And the injury to consumers was not outweighed by benefits to consumers or competition.

In response to these findings, Supervision directed the servicers to cease the practice.

# 2.3 Mortgage Servicing

In conducting mortgage servicing examinations, examiners identified a number of UDAAPs and a Regulation Z violation related to junk fees. Examiners found that servicers charged consumers junk fees that were unlawful related to late fee amounts, unnecessary property inspection visits, and private mortgage insurance (PMI) charges that should have been billed to the lender. Servicers also failed to waive certain charges when consumers entered permanent loss mitigation options and failed to refund PMI premiums. And servicers charged consumers late fees after sending periodic statements representing that they would not charge late fees.

## 2.3.1 Overcharging late fees

Examiners found that servicers engaged in unfair acts or practices by assessing late fees in excess of the amounts allowed by their loan agreements. Specifically, where loan agreements included a maximum permitted late fee amount, the servicers failed to input these late fee caps into their systems. Because the systems did not reflect the maximum late fee amounts permitted by their loan agreements, the servicers charged the maximum allowable late fees under the relevant state laws, which frequently exceeded the specific caps in the loan agreements. The servicers caused substantial injury to consumers when they imposed these excessive late fees. Consumers could not reasonably avoid the injury because they do not control how servicers calculate late fees and had no reason to anticipate that servicers would impose excessive late fees. Charging excessive late fees had no benefits to consumers or competition. Examiners concluded that servicers also violated Regulation Z[15] by issuing periodic statements that included inaccurate late payment fee amounts, since they exceeded the

[15] 12 C.F.R. § 1026.41(d)(1)(ii).

amounts allowed by the loan agreements. In response to these findings, servicers waived or refunded late fee overcharges to consumers and corrected the periodic statements.

### 2.3.2 Repeatedly charging consumers for unnecessary property inspections

Mortgage investors generally require servicers to perform property inspection visits for accounts that reach a specified level of delinquency. Generally, servicers must complete these property inspections monthly. To satisfy this requirement, servicers hire a third party that sends an agent to physically locate and view the property. The servicers then pass along the cost of the property inspection to the consumer, with fees ranging from $10 to $50.

Examiners found that in some instances a property inspector would report to servicers that an address was incorrect, and that the inspectors could not locate the property because of this error. Despite knowing that the address was incorrect, the servicers repeatedly hired property inspectors to visit these properties. Examiners found that servicers engaged in an unfair act or practice when they charged consumers for repeat property preservation visits to known bad addresses. Charging consumers for property inspection fees to known bad addresses caused consumers substantial injury. Consumers were unable to anticipate the fees or mitigate them because they have no influence over the servicers' practices, and the servicers did not inform consumers that they had bad addresses. And the injury caused by the practice was not outweighed by countervailing benefits to consumers or competition.

In response to the findings, the servicers revised their policies and procedures and waived or refunded the fees.

### 2.3.3 Misrepresenting that consumers owed PMI premiums

Examiners found that servicers engaged in deceptive acts or practices by sending monthly periodic statements and escrow disclosures that included monthly private mortgage insurance (PMI) premiums that consumers did not owe. These consumers did not have borrower-paid PMI on their accounts; instead, the loans were originated with lender-paid PMI, which should not be billed directly to consumers. After receiving these statements and disclosures some consumers made overpayments that included these amounts.

A representation, omission, act, or practice is deceptive when: (1) The representation, omission, act, or practice misleads or is likely to mislead the consumer; (2) The consumer's interpretation of the representation, omission, act, or practice is reasonable under the circumstances; and

(3) the misleading representation, omission, act, or practice is material.[16] The servicers' statements were likely to mislead consumers by creating the false impression that PMI payments were due. It was reasonable for consumers to rely on the servicers' calculations to determine the appropriate monthly payment amount. Finally, the misrepresentations were material because they led to overpayments. In response to these findings, the servicers refunded any overpayments.

### 2.3.4 Charging consumers fees that should have been waived

The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) directs servicers of federally backed mortgages to grant consumers a forbearance from monthly mortgage payments if the consumer is experiencing a financial hardship as a result of the COVID-19 emergency. During the time a consumer is in forbearance, no fees, penalties, or additional interest beyond scheduled amounts are to be assessed. While the CARES Act prohibits fees, penalties, or additional interest beyond scheduled amounts during a forbearance period, consumers sometimes accrue these amounts during periods when they are not in forbearance. For example, a servicer could appropriately charge a late fee if a consumer was delinquent in May 2020 and then entered a forbearance in June 2020.

When consumers with Federal Housing Administration-insured loans exited CARES Act forbearances and entered certain permanent loss mitigation options, the Department of Housing and Urban Development (HUD) required servicers in certain circumstances to waive late charges, fees, and penalties accrued outside of forbearance periods.

Examiners found that servicers engaged in unfair acts or practices when they failed to waive certain late charges, fees, and penalties accrued outside forbearance periods, where required by HUD, upon a consumer entering a permanent COVID-19 loss mitigation option.[17] Failure to waive the late charges, fees, and penalties constituted substantial injury to consumers. This injury was not reasonably avoidable by consumers because they had no reason to anticipate that their servicer would fail to follow HUD requirements, and consumers lacked reasonable means to avoid the charges. This harm outweighed any benefit to consumers or competition. In response to the finding, the servicers improved their controls, waived all improper charges, and provided refunds to consumers.

[16] 12 U.S.C. §§ 5531 and 5536(a)(1)(B).

[17] The Bureau previously reported a different unfair act or practice of charging fees to consumers during a CARES Act forbearance in Supervisory Highlights, Issue 25, Fall 2021, available at: https://files.consumerfinance.gov/f/documents/cfpb_supervisory-highlights_issue-25_2021-12.pdf.

### 2.3.5 Charging consumers for PMI after it should have been removed

The Homeowners Protection Act (HPA) requires that servicers automatically terminate PMI when the principal balance of the mortgage loan is first scheduled to reach 78 percent of the original value of the property based on the applicable amortization schedule, as long as the borrower is current.[18] Examiners found that servicers violated the HPA when they failed to terminate PMI on the date the principal balance of the mortgage was first scheduled to reach 78 percent loan-to-value on a mortgage loan that was current. As a result, consumers made overpayments for PMI that the servicers should have cancelled. In response to these findings, the servicers refunded excess PMI payments and implemented additional procedures and controls to enhance their PMI handling.[19]

### 2.3.6 Charging late fees after sending periodic statements listing a $0 late fee

Examiners found that servicers sent periodic statements to consumers in their last month of forbearance that incorrectly listed a $0 late fee amount for the subsequent payment, when a late fee was in fact charged if a payment was late. For example, consumers whose loans were in a forbearance period that ended on October 31st received a periodic statement during October billing for the November 1st payment; the periodic statement listed a $0 late fee amount. But because the November 1st payment was due after the forbearance period ended, the servicers then charged these consumers their contractual late fee amount if they missed the November 1st payment, despite sending statements listing a $0 late fee.

Examiners found that this practice was deceptive. Consumers' interpretation that they would incur no late fee was reasonable under the circumstances; consumers reasonably assume that the payment amounts and fees servicers tell them to pay are accurate and truthful. And the misrepresentations were likely to be material because consumers may have elected to make a timely periodic payment if the servicers had accurately advised a late fee would be assessed.

In response to this finding, the servicers updated their periodic statements and waived or refunded late fee charges for the specific payments.

[18] 12 U.S.C. § 4902(b)(1).

[19] The Bureau previously reported similar violations in Supervisory Highlights, Issue 25, Fall 2021, available at: https://files.consumerfinance.gov/f/documents/cfpb_supervisory-highlights_issue-25_2021-12.pdf.

# 2.4 Payday and Small-Dollar Lending

## 2.4.1 Splitting and re-presenting consumer payments without authorization

Examiners found that lenders, in connection with payday, installment, title, and line-of-credit loans, after unsuccessful debit attempts, split missed payments into as many as four sub-payments and simultaneously or near-simultaneously represented them to consumers' banks for payment via debit card.

Examiners found that lenders engaged in unfair acts or practices when they re-presented split payments from consumers' accounts without their authorization to do so simultaneously or near-simultaneously. As a consequence, consumers incurred or were likely to incur injury in the form of multiple overdraft fees, indirect follow-on fees, unauthorized loss of funds, and inability to prioritize payment decisions. Injury was not reasonably avoidable because lenders did not disclose, and consumers had not authorized, same-day, simultaneous or near-simultaneous split debit processing. Substantial injuries were not outweighed by countervailing benefits to consumers or to competition.

In response to these findings, lenders were directed to: (1) provide remediation; (2) stop engaging in split-debit or other payment re-presentment attempts following an initial failed debit attempt, without first obtaining the consumer's authorization as to the manner and timing of the re-presentments; and (3) stop the practice of splitting the single amount owed into several debit attempts, unless the consumer has sufficient time between each debit attempt to learn of any successful debits and to take action to avoid incurring unwanted consequences, such as bank overdraft fees, indirect follow-on fees, unauthorized loss of funds, or inability to prioritize payment decisions.

## 2.4.2 Charging borrowers repossession-related fees not authorized in automobile title loan contracts

Examiners found that lenders engaged in unfair acts or practices when they charged borrowers fees to retrieve personal property from repossessed vehicles and to cover servicer charges, and withheld the personal property and vehicles until borrowers paid the fees. The practices caused or were likely to cause substantial injury when lenders, through their repossession agents, withheld personal property and vehicles until consumers paid unexpected personal property retrieval fees and agent fees for vehicle redemption. In addition to being subject to unexpected fees, borrowers faced being denied access to or destruction of property such as medical equipment and vehicles necessary for basic life functions. Potential countervailing benefits to consumers or to competition did not outweigh the substantial injuries caused.

Lenders were directed to enhance their compliance management systems to prevent these practices and to provide remediation to affected consumers.

### 2.4.3 Failure to timely stop repossessions, charging fees and refinancing despite prior payment arrangements

Examiners found that lenders engaged in unfair acts or practices by failing to stop vehicle repossessions before title loan payments were due as-agreed, and then withholding the vehicles until consumers paid repossession-related fees and refinanced their debts. The practice caused or was likely to cause substantial injury by depriving consumers of their means of transportation and of the contents of their vehicles including medication, by causing them to spend time reclaiming the vehicles, and by imposing repossession fees and refinancing costs. Consumers had no way to stop lenders from disregarding payment agreements specifically designed to prevent repossession. Therefore, they could not reasonably anticipate or avoid the injuries caused. Countervailing benefits of the practice, such as the cost of implementing controls to prevent wrongful repossessions, did not outweigh the substantial injury caused.

Lenders were directed to enhance their compliance management systems to prevent these practices and to provide remediation to affected consumers.

## 2.5 Student Loan Servicing

### 2.5.1 Charging late fees and interest after reversing payments

Examiners found that servicers engaged in unfair acts or practices by initially processing payments but then later reversing those payments, leading to additional late fees and interest for consumers. Although the servicers' policies did not allow student loan payments to be made with a credit card, customer service representatives erroneously accepted credit card payment information from some consumers over the phone and then processed those credit card payments. Subsequently, the servicers manually reversed the payments because they violated their policies. As a result, consumers became delinquent on their accounts and suffered substantial injury in the form of late fees, negative credit reporting, and additional accrued interest. Consumers could not reasonably avoid the injury because they could not anticipate that servicers would reverse payments after initially accepting them, and the servicers did not send notices explaining the reversals in all cases. Moreover, the servicers did not provide consumers with an opportunity to make a payment with another method before reversing the payments. Finally, retroactively reversing credit card payments, as opposed to implementing measures to prevent such payments in the first instance, has no benefits to consumers or to competition.

In response to these findings, the servicers enhanced controls to ensure that payment processing systems will not accept credit card payments and to train customer service representatives to inform consumers at the time of payment that credit cards are not accepted. Additionally, Supervision directed the servicers to reimburse any late fees and correct any negative credit reporting as a result of reversed credit card payments.

# 3. Supervisory Program Developments

## 3.1 Recent Bureau Supervisory Program Developments

Set forth below are CFPB-issued circulars, bulletins, advisory opinions, and proposed rules regarding fees.[20]

### 3.1.1 CFPB proposed a rule to curb excessive credit card late fees

On February 1, 2023, the CFPB proposed a rule to curb excessive credit card late fees that cost American families about $12 billion each year.[21] The CFPB's proposed rule would amend regulations implementing the CARD Act to ensure that late fees meet the Act's requirement to be "reasonable and proportional" to the costs incurred by issuers to handle late payments. Specifically, the proposed rule would lower the immunity provision for late fees to $8 for a missed payment and end the automatic annual inflation adjustment. The proposed rule would also ban late fee amounts above 25% of the consumer's required payment.

### 3.1.2 CFPB issued circular on unanticipated overdraft fee assessment practices

On October 26, 2022, the CFPB issued guidance indicating that overdraft fees may constitute an unfair act or practice under the CFPA, even if the entity complies with the Truth in Lending Act (TILA) and Regulation Z, and the Electronic Fund Transfer Act (EFTA) and Regulation E.[22] As detailed in the circular, when financial institutions charge surprise overdraft fees, sometimes as much as $36, they may be breaking the law. The circular provides some examples of potentially unlawful surprise overdraft fees, including charging fees on purchases made with a positive

[20] Some of these items were also referenced in the last edition of *Supervisory Highlights*.

[21] The proposed rule is available at: https://www.consumerfinance.gov/rules-policy/notice-opportunities-comment/credit-card-penalty-fees-regulation-z/.

[22] Consumer Financial Protection Circular 2022-06, Unanticipated Overdraft Fee Assessment Practices (Oct. 26, 2022), available at: https://files.consumerfinance.gov/f/documents/cfpb_unanticipated-overdraft-fee-assessment-practices_circular_2022-10.pdf.

balance. These overdraft fees occur when a bank displays that a customer has sufficient available funds to complete a debit card purchase at the time of the transaction, but the consumer is later charged an overdraft fee. Often, the financial institution relies on complex back-office practices to justify charging the fee. For instance, after the bank allows one debit card transaction when there is sufficient money in the account, it nonetheless charges a fee on that transaction later because of intervening transactions.

### 3.1.3 CFPB issued bulletin on unfair returned deposited item fee assessment practices

On October 26, 2022, the CFPB issued a bulletin[23] stating that blanket policies of charging returned deposited item fees to consumers for all returned transactions irrespective of the circumstances or patterns of behavior on the account are likely unfair under the CFPA.

### 3.1.4 CFPB issued advisory opinion on debt collectors' collection of pay-to-pay fees

On June 29, 2022, the CFPB issued an advisory opinion[24] affirming that federal law often prohibits debt collectors from charging "pay-to-pay" fees. These charges, commonly described by debt collectors as "convenience fees," are imposed on consumers who want to make a payment in a particular way, such as online or by phone.

[23] Bulletin 2022-06: Unfair Returned Deposited Item Fee Assessment Practices, available at: https://files.consumerfinance.gov/f/documents/cfpb_returned-deposited-item-fee-assessment-practice_compliance-bulletin_2022-10.pdf.

[24] Advisory Opinion on Debt Collectors' Collection of Pay-to-Pay Fees, available at: https://files.consumerfinance.gov/f/documents/cfpb_convenience-fees_advisory-opinion_2022-06.pdf.

# 4. Remedial Actions

## 4.1 Public Enforcement Actions

The Bureau's supervisory activities resulted in and supported the following enforcement actions.

### 4.1.1 Wells Fargo

On December 20, 2022, the CFPB and Wells Fargo entered into a consent order in which Wells Fargo will pay more than $2 billion in redress to consumers and a $1.7 billion civil penalty for legal violations across several of its largest product lines.[25] The bank's illegal conduct led to billions of dollars in financial harm to its customers and, for thousands of customers, the loss of their vehicles and homes. Consumers were illegally assessed fees and interest charges on auto and mortgage loans, had their cars wrongly repossessed, and had payments to auto and mortgage loans misapplied by the bank. Wells Fargo also improperly froze or closed customer deposit accounts, charged consumers unlawful surprise overdraft fees, and did not always waive monthly account service fees consistent with its disclosures. Under the terms of the order, Wells Fargo will pay redress to the over 16 million affected consumer accounts, and pay a $1.7 billion fine, which will go to the CFPB's Civil Penalty Fund, where it will be used to provide relief to victims of consumer financial law violations.

### 4.1.2 Regions Bank

On September 28, 2022, the CFPB ordered Regions Bank to pay $50 million into the CFPB's victims relief fund and to refund at least $141 million to customers harmed by its illegal surprise overdraft fees.[26] Until July 2021, Regions charged customers surprise overdraft fees on certain ATM withdrawals and debit card purchases. The bank charged overdraft fees even after telling consumers they had sufficient funds at the time of the transactions. The CFPB also found that Regions Bank leadership knew about and could have discontinued its surprise overdraft fee practices years earlier, but they chose to wait while Regions pursued changes that would generate new fee revenue to make up for ending the illegal fees.

[25] CFPB Consent Order 2022-CFPB-0011, In the Matter of Wells Fargo Bank (Dec. 20, 2022), available at: https://files.consumerfinance.gov/f/documents/cfpb_wells-fargo-na-2022_consent-order_2022-12.pdf.

[26] CFPB Consent Order 2022-CFPB-0008, In the Matter of Regions Bank (Sept. 28, 2022), available at: https://files.consumerfinance.gov/f/documents/cfpb_Regions_Bank-_Consent-Order_2022-09.pdf.

This is not the first time Regions Bank has been caught engaging in illegal overdraft abuses. In 2015, the CFPB found that Regions had charged $49 million in unlawful overdraft fees and ordered Regions to make sure that the fees had been fully refunded and pay a $7.5 million penalty for charging overdraft fees to consumers who had not opted into overdraft protection and to consumers who had been told they would not be charged overdraft fees.[27]

[27] CFPB Consent Order 2015, In the Matter of Regions Bank, (Apr. 28, 2015), available at: https://files.consumerfinance.gov/f/201504_cfpb_consent-order_regions-bank.pdf.

## PART 1001—FINANCIAL PRODUCTS OR SERVICES

1. The authority citation for part 1001 continues to read as follows:

AUTHORITY: 12 U.S.C. 5481(15)(A)(xi); and 12 U.S.C. 5512(b)(1).

2. Section 1001.2 is amended by revising paragraph (b) and by adding and reserving paragraph (c) to read as follows:

**§ 1001.2 Definitions.*** * * * *

(b) Providing financial data processing products or services by any technological means, including processing, storing, aggregating, or transmitting financial or banking data, alone or in connection with another product or service, where the financial data processing is not offered or provided by a person who, by operation of 12 U.S.C. 5481(15)(A)(vii)(I) or (II), is not a covered person.

(c) [Reserved].

3. Part 1033 is added to read as follows:

## PART 1033—PERSONAL FINANCIAL DATA RIGHTS

### SUBPART A—GENERAL

Sec.
1033.101 Authority, purpose, and organization.
1033.111 Coverage of data providers.
1033.121 Compliance dates.
1033.131 Definitions.
1033.141 Standard setting.

### SUBPART B—OBLIGATION TO MAKE COVERED DATA AVAILABLE

1033.201 Obligation to make covered data available.
1033.211 Covered data.
1033.221 Exceptions.

### SUBPART C—DATA PROVIDER INTERFACES; RESPONDING TO REQUESTS

1033.301 General requirements.

1033.311 Requirements applicable to developer interface.
1033.321 Interface access.
1033.331 Responding to requests for information.
1033.341 Information about the data provider.
1033.351 Policies and procedures.

**SUBPART D—AUTHORIZED THIRD PARTIES**

1033.401 Third party authorization; general.
1033.411 Authorization disclosure.
1033.421 Third party obligations.
1033.431 Use of data aggregator.
1033.441 Policies and procedures for third party record retention.

**AUTHORITY:** 12 U.S.C. 5512; 12 U.S.C. 5514; 12 U.S.C. 5532; 12 U.S.C. 5533.

**SUBPART A—GENERAL**

**§ 1033.101 Authority, purpose, and organization.**

(a) *Authority*. The regulation in this part is issued by the Consumer Financial Protection Bureau (CFPB) pursuant to the Consumer Financial Protection Act of 2010 (CFPA), Pub. L. 111-203, tit. X, 124 Stat. 1955.

(b) *Purpose*. This part implements the provisions of section 1033 of the CFPA by requiring data providers to make available to consumers and authorized third parties, upon request, covered data in the data provider's control or possession concerning a covered consumer financial product or service, in an electronic form usable by consumers and authorized third parties; and by prescribing standards to promote the development and use of standardized formats for covered data, including through industry standards developed by standard-setting bodies recognized by the CFPB. This part also sets forth obligations of third parties that would access covered data on a consumer's behalf, including limitations on their collection, use, and retention of covered data.

(c) *Organization*. This part is divided into subparts as follows:

(1) Subpart A establishes the authority, purpose, organization, coverage of data providers, compliance dates, and definitions applicable to this part.

(2) Subpart B provides the general obligation of data providers to make covered data available upon the request of a consumer or authorized third party, including what types of information must be made available.

(3) Subpart C provides the requirements for data providers to establish and maintain interfaces to receive and respond to requests for covered data.

(4) Subpart D provides the obligations of third parties that would access covered data on behalf of a consumer.

**§ 1033.111 Coverage of data providers.**

(a) *Coverage of data providers.* A data provider has obligations under this part if it controls or possesses covered data concerning a covered consumer financial product or service, subject to the exclusion in paragraph (d) of this section.

(b) *Definition of covered consumer financial product or service. Covered consumer financial product or service* means a consumer financial product or service, as defined in 12 U.S.C. 5481(5), that is:

(1) A *Regulation E account*, which means an account, as defined in Regulation E, 12 CFR 1005.2(b);

(2) A *Regulation Z credit card*, which means a credit card, as defined in Regulation Z, 12 CFR 1026.2(a)(15)(i); and

(3) Facilitation of payments from a Regulation E account or Regulation Z credit card.

(c) *Definition of data provider. Data provider* means a covered person, as defined in 12 U.S.C. 5481(6), that is:

(1) A *financial institution*, as defined in Regulation E, 12 CFR 1005.2(i);

(2) A *card issuer*, as defined in Regulation Z, 12 CFR 1026.2(a)(7); or

(3) Any other person that controls or possesses information concerning a covered consumer financial product or service the consumer obtained from that person.

*Example 1 to paragraph (c):* A digital wallet provider is a data provider.

(d) *Excluded data providers*. The requirements of this part do not apply to data providers that are depository institutions that do not have a consumer interface.

**§ 1033.121 Compliance dates.**

A data provider must comply with §§ 1033.201 and 1033.301 beginning on:

(a) [Approximately six months after the date of publication of the final rule in the *Federal Register*], for depository institution data providers that hold at least $500 billion in total assets and nondepository institution data providers that generated at least $10 billion in revenue in the preceding calendar year or are projected to generate at least $10 billion in revenue in the current calendar year.

(b) [Approximately one year after the date of publication of the final rule in the *Federal Register*], for data providers that are:

(1) Depository institutions that hold at least $50 billion in total assets but less than $500 billion in total assets; or

(2) Nondepository institutions that generated less than $10 billion in revenue in the preceding calendar year and are projected to generate less than $10 billion in revenue in the current calendar year.

(c) [Approximately two and a half years after the date of publication of the final rule in the *Federal Register*], for depository institutions that hold at least $850 million in total assets but less than $50 billion in total assets.

(d) [Approximately four years after the date of publication of the final rule in the *Federal Register*], for depository institutions that hold less than $850 million in total assets.

**§ 1033.131 Definitions.**

For purposes of this part, the following definitions apply:

*Authorized third party* means a third party that has complied with the authorization procedures described in § 1033.401.

*Card issuer* is defined at § 1033.111(c)(2).

*Consumer* means a natural person. Trusts established for tax or estate planning purposes are considered natural persons for purposes of this definition.

*Consumer interface* means an interface through which a data provider receives requests for covered data and makes available covered data in an electronic form usable by consumers in response to the requests.

*Covered consumer financial product or service* is defined at § 1033.111(b).

*Covered data* is defined at § 1033.211.

*Data aggregator* means an entity that is retained by and provides services to the authorized third party to enable access to covered data.

*Data provider* is defined at § 1033.111(c).

*Developer interface* means an interface through which a data provider receives requests for covered data and makes available covered data in an electronic form usable by authorized third parties in response to the requests.

*Financial institution* is defined at § 1033.111(c)(1).

*Qualified industry standard* means a standard issued by a standard-setting body that is fair, open, and inclusive in accordance with § 1033.141(a).

*Regulation E account* is defined at § 1033.111(b)(1).

*Regulation Z credit card* is defined at § 1033.111(b)(2).

*Third party* means any person or entity that is not the consumer about whom the covered data pertains or the data provider that controls or possesses the consumer's covered data.

**§ 1033.141 Standard setting.**

(a) *Fair, open, and inclusive standard-setting body*. A standard-setting body is fair, open, and inclusive and is an issuer of qualified industry standards when it has all of the following attributes:

(1) Openness: The sources, procedures, and processes used are open to all interested parties, including: consumer and other public interest groups with expertise in consumer protection, financial services, community development, fair lending, and civil rights; authorized third parties; data providers; data aggregators and other providers of services to authorized third parties; and relevant trade associations. Parties can meaningfully participate in standards development on a non-discriminatory basis.

(2) Balance: The decision-making power is balanced across all interested parties, including consumer and other public interest groups, at all levels of the standard-setting body. There is meaningful representation for large and small commercial entities within these categories. No single interest or set of interests dominates decision-making. Achieving balance requires recognition that some participants may play multiple roles, such as being both a data provider and an authorized third party. The ownership structure of entities is considered in achieving balance.

(3) Due process: The standard-setting body uses documented and publicly available policies and procedures, and it provides adequate notice of meetings and standards development,

sufficient time to review drafts and prepare views and objections, access to views and objections of other participants, and a fair and impartial process for resolving conflicting views.

(4) Appeals: An appeals process is available for the impartial handling of appeals.

(5) Consensus: Standards development proceeds by consensus, which is defined as general agreement, but not unanimity. During the development of consensus, comments and objections are considered using fair, impartial, open, and transparent processes.

(6) Transparency: Procedures or processes for participating in standards development and for developing standards are transparent to participants and publicly available.

(7) CFPB recognition: The standard-setting body has been recognized by the CFPB within the last three years as an issuer of qualified industry standards.

(b) *CFPB consideration.* A standard-setting body may request that the CFPB recognize it as an issuer of qualified industry standards. The attributes set forth in paragraphs (a)(1) through (6) of this section will inform the CFPB's consideration of the request.

## SUBPART B—OBLIGATION TO MAKE COVERED DATA AVAILABLE

### § 1033.201 Obligation to make covered data available.

(a) *Obligation to make covered data available.* A data provider must make available to a consumer and an authorized third party, upon request, covered data in the data provider's control or possession concerning a covered consumer financial product or service that the consumer obtained from the data provider, in an electronic form usable by consumers and authorized third parties. Compliance with the requirements in §§ 1033.301 and 1033.311 is required in addition to the requirements of this paragraph (a).

(b) *Current data.* In complying with paragraph (a) of this section, a data provider must make available the most recently updated covered data that it has in its control or possession at the time of a request. A data provider must make available information concerning authorized but not yet settled debit card transactions.

**§ 1033.211 Covered data.**

*Covered data* in this part means, as applicable:

(a) Transaction information, including historical transaction information in the control or possession of the data provider. A data provider is deemed to make available sufficient historical transaction information for purposes of § 1033.201(a) if it makes available at least 24 months of such information.

*Example 1 to paragraph (a):* This category includes amount, date, payment type, pending or authorized status, payee or merchant name, rewards credits, and fees or finance charges.

(b) Account balance.

(c) Information to initiate payment to or from a Regulation E account.

*Example 1 to paragraph (c):* This category includes a tokenized account and routing number that can be used to initiate an Automated Clearing House transaction. In complying with its obligation under § 1033.201(a), a data provider is permitted to make available a tokenized account and routing number instead of, or in addition to, a non-tokenized account and routing number.

(d) Terms and conditions.

*Example 1 to paragraph (d):* This category includes the applicable fee schedule, any annual percentage rate or annual percentage yield, rewards program terms, whether a consumer has opted into overdraft coverage, and whether a consumer has entered into an arbitration agreement.

(e) Upcoming bill information.

*Example 1 to paragraph (e):* This category includes information about third party bill payments scheduled through the data provider and any upcoming payments due from the consumer to the data provider.

(f) Basic account verification information, which is limited to the name, address, email address, and phone number associated with the covered consumer financial product or service.

**§ 1033.221 Exceptions.**

A data provider is not required to make available the following covered data to a consumer or authorized third party:

(a) Any confidential commercial information, including an algorithm used to derive credit scores or other risk scores or predictors. Information does not qualify for this exception merely because it is an input to, or an output of, an algorithm, risk score, or predictor. For example, annual percentage rate and other pricing terms are sometimes determined by an internal algorithm or predictor but do not fall within this exception.

(b) Any information collected by the data provider for the sole purpose of preventing fraud or money laundering, or detecting, or making any report regarding other unlawful or potentially unlawful conduct. Information collected for other purposes does not fall within this exception. For example, name and other basic account verification information do not fall within this exception.

(c) Any information required to be kept confidential by any other provision of law. Information does not qualify for this exception merely because the data provider must protect it for the benefit of the consumer. For example, the data provider cannot restrict access to the consumer's own information merely because that information is subject to privacy protections.

(d) Any information that the data provider cannot retrieve in the ordinary course of its business with respect to that information.

**SUBPART C—DATA PROVIDER INTERFACES; RESPONDING TO REQUESTS**

**§ 1033.301 General requirements.**

(a) *Requirement to establish and maintain interfaces*. A data provider subject to the requirements of this part must maintain a consumer interface and must establish and maintain a developer interface. The consumer interface and the developer interface must satisfy the requirements set forth in this section. The developer interface must satisfy the additional requirements set forth in § 1033.311.

(b) *Machine-readable files upon specific request.* Upon specific request, a data provider must make available to a consumer or an authorized third party covered data in a machine-readable file that can be retained by the consumer or authorized third party and transferred for processing into a separate information system that is reasonably available to and in the control of the consumer or authorized third party.

*Example 1 to paragraph (b):* A data provider makes available covered data in a machine-readable file that can be retained if the data can be printed or kept in a separate information system that is in the control of the consumer or authorized third party.

(c) *Fees prohibited.* A data provider must not impose any fees or charges on a consumer or an authorized third party in connection with:

(1) *Interfaces.* Establishing or maintaining the interfaces required by paragraph (a) of this section; or

(2) *Requests.* Receiving requests or making available covered data in response to requests as required by this part.

**§ 1033.311 Requirements applicable to developer interface.**

(a) *General.* A developer interface required by § 1033.301(a) must satisfy the requirements set forth in this section.

(b) *Standardized format.* The developer interface must make available covered data in a standardized format. The interface is deemed to satisfy this requirement if:

(1) The interface makes available covered data in a format that is set forth in a qualified industry standard; or

(2) In the absence of a qualified industry standard, the interface makes available covered data in a format that is widely used by the developer interfaces of other similarly situated data providers with respect to similar data and is readily usable by authorized third parties.

(c) *Performance specifications.* The developer interface must satisfy the following performance specifications:

(1) *Commercially reasonable performance.* The performance of the interface must be commercially reasonable.

(i) *Quantitative minimum performance specification.* The performance of the interface cannot be commercially reasonable if it does not meet the following quantitative minimum performance specification regarding its response rate: The number of proper responses by the interface divided by the total number of queries for covered data to the interface must be equal to or greater than 99.5 percent. For purposes of this paragraph (c)(1)(i), all of the following requirements apply:

(A) Any responses by and queries to the interface during scheduled downtime for the interface must be excluded respectively from the numerator and the denominator of the calculation.

(B) In order for any downtime of the interface to qualify as scheduled downtime, the data provider must have provided reasonable notice of the downtime to all third parties to which the data provider has granted access to the interface. Indicia that the data provider's notice of the downtime may be reasonable include that the notice adheres to a qualified industry standard.

(C) The total amount of scheduled downtime for the interface in the relevant time period, such as a month, must be reasonable. Indicia that the total amount of scheduled downtime may be reasonable include that the amount adheres to a qualified industry standard.

(D) A proper response is a response, other than any message such as an error message provided during unscheduled downtime of the interface, that meets all of the following criteria:

(*1*) The response either fulfills the query or explains why the query was not fulfilled;

(*2*) The response is consistent with the reasonable written policies and procedures that the data provider establishes and maintains pursuant to § 1033.351(a); and

(*3*) The response is provided by the interface within a commercially reasonable amount of time. The amount of time cannot be commercially reasonable if it is more than 3,500 milliseconds.

(ii) *Indicia of compliance*. Indicia that the performance of the interface is commercially reasonable include that it:

(A) Meets the applicable performance specifications set forth in a qualified industry standard; and

(B) Meets the applicable performance specifications achieved by the developer interfaces established and maintained by similarly situated data providers.

(2) *Access cap prohibition*. Except as otherwise permitted by §§ 1033.221, 1033.321, and 1033.331(b) and (c), a data provider must not unreasonably restrict the frequency with which it receives and responds to requests for covered data from an authorized third party through its developer interface. Any frequency restrictions must be applied in a manner that is non-discriminatory and consistent with the reasonable written policies and procedures that the data provider establishes and maintains pursuant to § 1033.351(a). Indicia that any frequency restrictions applied are reasonable include that they adhere to a qualified industry standard.

(d) *Security specifications*—(1) *Access credentials*. A data provider must not allow a third party to access the data provider's developer interface by using any credentials that a consumer uses to access the consumer interface.

(2) *Security program.* (i) A data provider must apply to the developer interface an information security program that satisfies the applicable rules issued pursuant to section 501 of the Gramm-Leach-Bliley Act, 15 U.S.C. 6801; or

(ii) If the data provider is not subject to section 501 of the Gramm-Leach-Bliley Act, the data provider must apply to its developer interface the information security program required by the Federal Trade Commission's Standards for Safeguarding Customer Information, 16 CFR part 314.

**§ 1033.321 Interface access.**

(a) *Denials related to risk management*. A data provider does not violate the general obligation in § 1033.201(a) by reasonably denying a consumer or third party access to an interface described in § 1033.301(a) based on risk management concerns. Subject to paragraph (b) of this section, a denial is not unreasonable if it is necessary to comply with section 39 of the Federal Deposit Insurance Act, 12 U.S.C. 1831p-1 or section 501 of the Gramm-Leach-Bliley Act, 15 U.S.C. 6801.

(b) *Reasonable denials.* To be reasonable pursuant to paragraph (a) of this section, a denial must, at a minimum, be directly related to a specific risk of which the data provider is aware, such as a failure of a third party to maintain adequate data security, and must be applied in a consistent and non-discriminatory manner.

(c) *Indicia of reasonable denials.* Indicia that a denial pursuant to paragraph (a) of this section is reasonable include whether access is denied to adhere to a qualified industry standard related to data security or risk management.

(d) *Denials related to lack of information.* A data provider has a reasonable basis for denying access to a third party under paragraph (a) of this section if:

(1) The third party does not present evidence that its data security practices are adequate to safeguard the covered data, provided that the denial of access is not otherwise unreasonable; or

(2) The third party does not make the following information available in both human-readable and machine-readable formats, and readily identifiable to members of the public, meaning the information must be at least as available as it would be on a public website:

(i) Its legal name and, if applicable, any assumed name it is using while doing business with the consumer;

(ii) A link to its website;

(iii) Its Legal Entity Identifier (LEI) that is issued by:

(A) A utility endorsed by the LEI Regulatory Oversight Committee, or

(B) A utility endorsed or otherwise governed by the Global LEI Foundation (or any successor thereof) after the Global LEI Foundation assumes operational governance of the global LEI system; and

(iv) Contact information a data provider can use to inquire about the third party's data security practices.

**§ 1033.331 Responding to requests for information.**

(a) *Responding to requests—access by consumers*. To comply with the requirement in § 1033.201(a), upon request from a consumer, a data provider must make available covered data when it receives information sufficient to:

(1) Authenticate the consumer's identity; and

(2) Identify the scope of the data requested.

(b) *Responding to requests—access by third parties.* (1) To comply with the requirement in § 1033.201(a), upon request from an authorized third party, a data provider must make available covered data when it receives information sufficient to:

(i) Authenticate the consumer's identity;

(ii) Authenticate the third party's identity;

(iii) Confirm the third party has followed the authorization procedures in § 1033.401; and

(iv) Identify the scope of the data requested.

(2) The data provider is permitted to confirm the scope of a third party's authorization to access the consumer's data by asking the consumer to confirm:

(i) The account(s) to which the third party is seeking access; and

(ii) The categories of covered data the third party is requesting to access, as disclosed by the third party pursuant to § 1033.411(b)(4).

(c) *Response not required.* Notwithstanding the general rules in paragraphs (a) and (b) of this section, a data provider is not required to make covered data available in response to a request when:

(1) The data are withheld because an exception described in § 1033.221 applies;

(2) The data provider has a basis to deny access pursuant to risk management concerns in accordance with § 1033.321(a);

(3) The data provider's interface is not available when the data provider receives a request requiring a response under this section. However, the data provider is subject to the performance specifications in § 1033.311(c);

(4) The request is for access by a third party, and:

(i) The consumer has revoked the third party's authorization pursuant to paragraph (e) of this section;

(ii) The data provider has received notice that the consumer has revoked the third party's authorization pursuant to § 1033.421(h)(2); or

(iii) The consumer has not provided a new authorization to the third party after the maximum duration period, as described in § 1033.421(b)(2).

(d) *Jointly held accounts.* A data provider that receives a request for covered data from a consumer that jointly holds an account or from an authorized third party acting on behalf of such a consumer must make available covered data to that consumer or authorized third party, subject to the other requirements of this section.

(e) *Mechanism to revoke third party authorization to access covered data.* A data provider does not violate the general obligation in § 1033.201(a) by making available to the consumer a reasonable method to revoke any third party's authorization to access all of the consumer's covered data. To be reasonable, the revocation method must, at a minimum, be unlikely to interfere with, prevent, or materially discourage consumers' access to or use of the data, including access to and use of the data by an authorized third party. Indicia that the data provider's revocation method is reasonable include its conformance to a qualified industry standard. A data provider that receives a revocation request from consumers through a revocation method it makes available must notify the authorized third party of the request.

**§ 1033.341 Information about the data provider.**

(a) *Requirement to make information about the data provider readily identifiable.* A data provider must make the information described in paragraphs (b) through (d) of this section:

(1) Readily identifiable to members of the public, meaning the information must be at least as available as it would be on a public website; and

(2) Available in both human-readable and machine-readable formats.

(b) *Identifying information.* A data provider must disclose in the manner required by paragraph (a) of this section:

(1) Its legal name and, if applicable, any assumed name it is using while doing business with the consumer;

(2) A link to its website;

(3) Its LEI that is issued by:

(i) A utility endorsed by the LEI Regulatory Oversight Committee, or

(ii) A utility endorsed or otherwise governed by the Global LEI Foundation (or any successor thereof) after the Global LEI Foundation assumes operational governance of the global LEI system; and

(4) Contact information that enables a consumer or third party to receive answers to questions about accessing covered data under this part.

(c) *Developer interface documentation.* For its developer interface, a data provider must disclose in the manner required by paragraph (a) of this section documentation, including metadata describing all covered data and their corresponding data fields, and other documentation sufficient for a third party to access and use the interface. The documentation must:

(1) Be maintained and updated as the developer interface is updated;

(2) Include how third parties can get technical support and report issues with the interface; and

(3) Be easy to understand and use, similar to data providers' documentation for other commercially available products.

(d) *Performance specification.* On or before the tenth calendar day of each calendar month, a data provider must disclose in the manner required by paragraph (a) of this section the quantitative minimum performance specification described in § 1033.311(c)(1)(i) that the data provider's developer interface achieved in the previous calendar month. The data provider's disclosure must include at least a rolling 13 months of the required monthly figure, except that the disclosure need not include the monthly figure for months prior to the compliance date applicable to the data provider. The data provider must disclose the metric as a percentage rounded to four decimal places, such as "99.9999 percent."

**§ 1033.351 Policies and procedures.**

(a) *Reasonable written policies and procedures.* A data provider must establish and maintain written policies and procedures that are reasonably designed to achieve the objectives set forth in subparts B and C of this part, including paragraphs (b) through (d) of this section. Policies and procedures must be appropriate to the size, nature, and complexity of the data provider's activities. A data provider must periodically review the policies and procedures required by this section and update them as appropriate to ensure their continued effectiveness.

(b) *Policies and procedures for making covered data available.* The policies and procedures required by paragraph (a) of this section must be reasonably designed to ensure that:

(1) *Making available covered data.* A data provider creates a record of the data fields that are covered data in the data provider's control or possession, what covered data are not made available through a consumer or developer interface pursuant to an exception in § 1033.221, and the reasons the exception applies. A data provider is permitted to comply with this requirement by incorporating the data fields defined by a qualified industry standard, provided doing so is appropriate to the size, nature, and complexity of the data provider's activities. Exclusive reliance on data fields defined by a qualified industry standard would not be appropriate if such data fields failed to identify all the covered data in the data provider's control or possession.

(2) *Denials of developer interface access.* When a data provider denies a third party access to a developer interface pursuant to § 1033.321, the data provider:

(i) Creates a record explaining the basis for denial; and

(ii) Communicates to the third party, electronically or in writing, the reason(s) for the denial, and that the communication occurs as quickly as is practicable.

(3) *Denials of information requests.* When a data provider denies a request for information pursuant to § 1033.331, the data provider:

(i) Creates a record explaining the basis for the denial; and

(ii) Communicates to the consumer or third party, electronically or in writing, the type(s) of information denied and the reason(s) for the denial, and that the communication occurs as quickly as is practicable.

(c)(1) *Policies and procedures for ensuring accuracy*. The policies and procedures required by paragraph (a) of this section must be reasonably designed to ensure that covered data are accurately made available through the data provider's developer interface.

(2) *Elements.* In developing its policies and procedures regarding accuracy, a data provider must consider, for example:

(i) Implementing the format requirements of § 1033.311(b); and

(ii) Addressing information provided by a consumer or a third party regarding inaccuracies in the covered data made available through its developer interface.

(3) *Indicia of compliance.* Indicia that a data provider's policies and procedures regarding accuracy are reasonable include whether the policies and procedures conform to a qualified industry standard regarding accuracy.

(d) *Policies and procedures for record retention.* The policies and procedures required by paragraph (a) of this section must be reasonably designed to ensure retention of records that are evidence of compliance with subparts B and C of this part.

(1) *Retention period.* Records related to a data provider's response to a consumer's or third party's request for information or a third party's request to access a developer interface must be retained for at least three years after a data provider has responded to the request. All other records that are evidence of compliance with subparts B and C of this part must be retained for a reasonable period of time.

(2) *Certain records retained pursuant to policies and procedures.* Records retained pursuant to policies and procedures required under paragraph (a) of this section must include, without limitation:

(i) Records of requests for a third party's access to an interface, actions taken in response to such requests, and reasons for denying access, if applicable;

(ii) Records of requests for information, actions taken in response to such requests, and reasons for not making the information available, if applicable;

(iii) Copies of a third party's authorization to access data on behalf of a consumer; and

(iv) Records of actions taken by a consumer and a data provider to revoke a third party's access pursuant to any revocation mechanism made available by a data provider.

## SUBPART D—AUTHORIZED THIRD PARTIES

### § 1033.401 Third party authorization; general.

To become an authorized third party, the third party must seek access to covered data from a data provider on behalf of a consumer to provide a product or service the consumer requested and:

(a) Provide the consumer with an authorization disclosure as described in § 1033.411;

(b) Provide a statement to the consumer in the authorization disclosure, as provided in § 1033.411(b)(5), certifying that the third party agrees to the obligations described in § 1033.421; and

(c) Obtain the consumer's express informed consent to access covered data on behalf of the consumer by obtaining an authorization disclosure that is signed by the consumer electronically or in writing.

### § 1033.411 Authorization disclosure.

(a) *General requirements*. To comply with § 1033.401(a), a third party must provide the consumer with an authorization disclosure electronically or in writing. The authorization disclosure must be clear, conspicuous, and segregated from other material.

(b) *Content.* The authorization disclosure must include:

(1) The name of the third party that will be authorized to access covered data pursuant to the third party authorization procedures in § 1033.401.

(2) The name of the data provider that controls or possesses the covered data that the third party identified in paragraph (b)(1) of this section seeks to access on the consumer's behalf.

(3) A brief description of the product or service that the consumer has requested the third party identified in paragraph (b)(1) of this section provide and a statement that the third party will collect, use, and retain the consumer's data only for the purpose of providing that product or service to the consumer.

(4) The categories of covered data that will be accessed.

(5) The certification statement described in § 1033.401(b).

(6) A description of the revocation mechanism described in § 1033.421(h)(1).

(c) *Language access*—(1) *General language requirements.* The authorization disclosure must be in the same language as the communication in which the third party conveys the authorization disclosure to the consumer. Any translation of the authorization disclosure must be complete and accurate.

(2) *Additional languages.* If the authorization disclosure is in a language other than English, it must include a link to an English-language translation, and it is permitted to include links to translations in other languages. If the authorization disclosure is in English, it is permitted to include links to translations in other languages.

**§ 1033.421 Third party obligations.**

(a) *General limitation on collection, use, and retention of consumer data*—(1) *In general*. The third party will limit its collection, use, and retention of covered data to what is reasonably necessary to provide the consumer's requested product or service.

(2) *Specific activities.* For purposes of paragraph (a)(1) of this section, the following activities are not part of, or reasonably necessary to provide, any other product or service:

(i) Targeted advertising;

(ii) Cross-selling of other products or services; or

(iii) The sale of covered data.

(b) *Collection of covered data*—(1) *In general*. Collection of covered data for purposes of paragraph (a) of this section includes the scope of covered data collected and the duration and frequency of collection of covered data.

(2) *Maximum duration*. In addition to the limitation described in paragraph (a) of this section, the third party will limit the duration of collection of covered data to a maximum period of one year after the consumer's most recent authorization.

(3) *Reauthorization after maximum duration*. To collect covered data beyond the one-year maximum period described in paragraph (b)(2) of this section, the third party will obtain a new authorization from the consumer pursuant to § 1033.401 no later than the anniversary of the most recent authorization from the consumer. The third party is permitted to ask the consumer for a new authorization pursuant to § 1033.401 in a reasonable manner. Indicia that a new authorization request is reasonable include its conformance to a qualified industry standard.

(4) *Effect of maximum duration*. If a consumer does not provide the third party with a new authorization as described in paragraph (b)(3) of this section, the third party will:

(i) No longer collect covered data pursuant to the most recent authorization; and

(ii) No longer use or retain covered data that was previously collected pursuant to the most recent authorization unless use or retention of that covered data remains reasonably necessary to provide the consumer's requested product or service under paragraph (a) of this section.

(c) *Use of covered data*. Use of covered data for purposes of paragraph (a) of this section includes both the third party's own use of covered data and provision of covered data by that third party to other third parties. Examples of uses of covered data that are permitted under paragraph (a) of this section include:

(1) Uses that are specifically required under other provisions of law, including to comply with a properly authorized subpoena or summons or to respond to a judicial process or government regulatory authority;

(2) Uses that are reasonably necessary to protect against or prevent actual or potential fraud, unauthorized transactions, claims, or other liability; and

(3) Servicing or processing the product or service the consumer requested.

(d) *Accuracy*. The third party will establish and maintain written policies and procedures that are reasonably designed to ensure that covered data are accurately received from a data provider and accurately provided to another third party, if applicable.

(1) *Flexibility*. A third party has flexibility to determine its policies and procedures in light of the size, nature, and complexity of its activities.

(2) *Periodic review*. A third party will periodically review its policies and procedures and update them as appropriate to ensure their continued effectiveness.

(3) *Elements*. In developing its policies and procedures regarding accuracy, a third party must consider, for example:

(i) Accepting covered data in a format required by § 1033.311(b); and

(ii) Addressing information provided by a consumer, data provider, or another third party regarding inaccuracies in the covered data.

(4) *Indicia of compliance*. Indicia that a third party's policies and procedures are reasonable include whether the policies and procedures conform to a qualified industry standard regarding accuracy.

(e) *Data security*. (1) A third party will apply to its systems for the collection, use, and retention of covered data an information security program that satisfies the applicable rules issued pursuant to section 501 of the Gramm-Leach-Bliley Act (15 U.S.C. 6801); or

(2) If the third party is not subject to section 501 of the Gramm-Leach-Bliley Act, the third party will apply to its systems for the collection, use, and retention of covered data the information security program required by the Federal Trade Commission's Standards for Safeguarding Customer Information, 16 CFR part 314.

(f) *Provision of covered data to other third parties*. Before providing covered data to another third party, subject to the limitation described in paragraphs (a) and (c) of this section, the third party will require the other third party by contract to comply with the third party obligations in paragraphs (a) through (g) of this section and the condition in paragraph (h)(3) of this section upon receipt of the notice described in paragraph (h)(2) of this section.

(g) *Ensuring consumers are informed*. (1) The third party will provide the consumer with a copy of the authorization disclosure that is signed or otherwise agreed to by the consumer and reflects the date of the consumer's signature or other written or electronic consent. Upon obtaining authorization to access covered data on the consumer's behalf, the third party will deliver a copy to the consumer or make it available in a location that is readily accessible to the consumer, such as the third party's interface. If the third party makes the authorization disclosure available in such a location, the third party will ensure it is accessible to the consumer until the third party's access to the consumer's covered data terminates.

(2) The third party will provide contact information that enables a consumer to receive answers to questions about the third party's access to the consumer's covered data. The contact information must be readily identifiable to the consumer.

(3) The third party will establish and maintain reasonable written policies and procedures designed to ensure that the third party provides to the consumer, upon request, the information listed in this paragraph (g)(3) about the third party's access to the consumer's covered data. The third party has flexibility to determine its policies and procedures in light of the size, nature, and complexity of its activities, and the third party will periodically review its policies and procedures and update them as appropriate to ensure their continued effectiveness.

(i) Categories of covered data collected;

(ii) Reasons for collecting the covered data;

(iii) Names of parties with which the covered data was shared;

(iv) Reasons for sharing the covered data;

(v) Status of the third party's authorization; and

(vi) How the consumer can revoke the third party's authorization to access the consumer's covered data and verification the third party has adhered to requests for revocation.

(h) *Revocation of third party authorization*—(1) *Provision of revocation mechanism*. The third party will provide the consumer with a mechanism to revoke the third party's authorization to access the consumer's covered data that is as easy to access and operate as the initial authorization. The third party will also ensure the consumer is not subject to costs or penalties for revoking the third party's authorization.

(2) *Notice of revocation*. The third party will notify the data provider, any data aggregator, and other third parties to whom it has provided the consumer's covered data when the third party receives a revocation request from the consumer.

(3) *Effect of revocation.* Upon receipt of a consumer's revocation request as described in paragraph (h)(1) of this section or notice of a revocation request from a data provider as described in § 1033.331(e), a third party will:

(i) No longer collect covered data pursuant to the most recent authorization; and

(ii) No longer use or retain covered data that was previously collected pursuant to the most recent authorization unless use or retention of that covered data remains reasonably necessary to provide the consumer's requested product or service under paragraph (a) of this section.

**§ 1033.431 Use of data aggregator.**

(a) *Responsibility for authorization procedures when the third party will use a data aggregator.* A data aggregator is permitted to perform the authorization procedures described in § 1033.401 on behalf of the third party seeking authorization under § 1033.401 to access covered data. However, the third party seeking authorization remains responsible for compliance with the authorization procedures described in § 1033.401, and the data aggregator must comply with paragraph (c) of this section.

(b) *Disclosure of the name of the data aggregator.* The authorization disclosure must include the name of any data aggregator that will assist the third party seeking authorization under § 1033.401 with accessing covered data and a brief description of the services the data aggregator will provide.

(c) *Data aggregator certification.* When the third party seeking authorization under § 1033.401 will use a data aggregator to assist with accessing covered data on behalf of a consumer, the data aggregator must certify to the consumer that it agrees to the conditions on accessing the consumer's data in § 1033.421(a) through (f) and the condition in § 1033.421(h)(3) upon receipt of the notice described in § 1033.421(h)(2) before accessing the consumer's data. Any data aggregator that is retained by the authorized third party after the consumer has completed the authorization procedures must also satisfy this requirement. For this requirement to be satisfied:

(1) The third party seeking authorization under § 1033.401 must include the data aggregator's certification in the authorization disclosure described in § 1033.411; or

(2) The data aggregator must provide its certification to the consumer in a separate communication.

**§ 1033.441 Policies and procedures for third party record retention.**

(a) *General requirement.* A third party that is a covered person or service provider, as defined in 12 U.S.C. 5481(6) and (26), must establish and maintain written policies and procedures that are reasonably designed to ensure retention of records that are evidence of compliance with the requirements of subpart D.

(b) *Retention period.* Records required under paragraph (a) of this section must be retained for a reasonable period of time, not less than three years after a third party obtains the consumer's most recent authorization under § 1033.401(a).

(c) *Flexibility.* A third party covered under paragraph (a) of this section has flexibility to determine its policies and procedures in light of the size, nature, and complexity of its activities.

(d) *Periodic review.* A third party covered under paragraph (a) of this section must periodically review its policies and procedures and update them as appropriate to ensure their continued effectiveness to evidence compliance with the requirements of subpart D.

(e) *Certain records retained pursuant to policies and procedures.* Records retained pursuant to policies and procedures required under this section must include, without limitation:

(1) A copy of the authorization disclosure that is signed or otherwise agreed to by the consumer and reflects the date of the consumer's signature or other written or electronic consent and a record of actions taken by the consumer, including actions taken through a data provider, to revoke the third party's authorization; and

(2) With respect to a data aggregator covered under paragraph (a) of this section, a copy of any data aggregator certification statement provided to the consumer separate from the authorization disclosure pursuant to § 1033.431(c)(2).

Consumer Financial Protection Bureau

1700 G Street NW, Washington, D.C. 20552

**CFPB Bulletin 2020-01**

**Date:** March 6, 2020

**Subject:** Responsible Business Conduct: Self-Assessing, Self-Reporting, Remediating, and Cooperating

In executing its statutory responsibilities, the Bureau of Consumer Financial Protection (Bureau) places primary emphasis on preventing harm to consumers. Preventing harm to consumers is among the most effective and efficient ways of ensuring consumer access to a fair, transparent, and competitive financial market. In 2013, the Bureau issued a Bulletin that identified several activities that individuals or businesses, collectively "entities," could engage in that could prevent and minimize harm to consumers, referring to these activities as "responsible conduct." The Bureau is issuing this updated Bulletin to clarify its approach to responsible conduct and to reiterate the importance of such conduct.

In the first instance, the Bureau's focus is on building a culture of compliance among entities, including covered persons and service providers, in order to minimize the likelihood of a violation of Federal consumer financial law, and thereby prevent harm to consumers. When a violation of law does occur, swift and effective actions taken by an entity to address the violation can minimize resulting harm to consumers. Specifically, an entity may self-assess its compliance with Federal consumer financial law, self-report to the Bureau when it identifies likely violations, remediate the harm resulting from these likely violations, and cooperate above and beyond what is required by law with any Bureau review or investigation.

Such activities are in the public interest. Depending on its form and substance, responsible conduct can improve the Bureau's ability to promptly detect violations of Federal consumer financial law, increase the effectiveness and efficiency of its supervisory and enforcement work, enable the Bureau to focus its finite resources on their best use for the mission, and help more consumers in more matters promptly receive financial redress and additional meaningful remedies for any harm they experienced.

Because responsible conduct is in the public interest, the Bureau seeks to encourage it. Accordingly, if an entity meaningfully engages in responsible conduct, the Bureau intends to favorably consider such conduct, along with other relevant factors, in addressing violations of Federal consumer financial law in supervisory and enforcement matters.[1] Depending on the nature and extent of an entity's actions, the Bureau has a wide range of options available to properly account for responsible conduct. For example, in light of an entity's responsible conduct, the Bureau could exercise its discretion to close an enforcement investigation with no action or decide not to include Matters Requiring Attention in an exam report or supervisory letter. Even if the Bureau does take action, those who engage in responsible conduct may receive other types of credit for engaging in such behavior. For entities within the Bureau's supervisory authority, the Bureau's Division of Supervision, Enforcement, and Fair Lending makes determinations of whether violations should be resolved through non-public supervisory action or a possible public enforcement action through its Action Review Committee (ARC) process. The ARC process includes factors that are closely aligned with the elements of responsible conduct. Thus, for entities under the Bureau's supervisory authority, responsible conduct could result in resolving violations non-publicly through the supervisory process. Responsible conduct also could result in the Bureau's reducing the number of violations pursued or reducing the sanctions or penalties sought by the Bureau in any public enforcement action. The Bureau intends to consider the extent and significance of an entity's responsible conduct, with more extensive and important responsible conduct leading to more substantial consideration.

This guidance, and its description of factors that may warrant favorable consideration, is not adopting any rule or formula to be applied in all matters. The importance of each factor in a given matter, and the way in which the Bureau evaluates each factor, will depend on the circumstances. The Bureau is not in any way limiting its discretion and responsibility to evaluate each matter individually on its own facts and circumstances. In short, the fact that an entity may argue it has satisfied some or even all of the factors set forth in this guidance will not necessarily foreclose the Bureau from bringing any enforcement action or seeking any remedy if it believes such a course is necessary and appropriate.

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[1] Other factors the Bureau considers in determining how to resolve violations of Federal consumer financial law include, without limitation, (1) the nature, extent, and severity of the violations identified and any associated consumer harm; (2) an entity's demonstrated effectiveness and willingness to address the violations; and (3) the importance of deterrence, considering the significance and pervasiveness of the potential consumer harm.

Factors Used to Evaluate and Acknowledge Responsible Conduct

As noted previously, the Bureau principally considers four categories of conduct when evaluating whether some form of credit is warranted in an enforcement investigation or supervisory matter: self-assessing, self-reporting, remediating, and cooperating. However, if an entity engages in another type of activity particular to its situation that is both substantial and meaningful, the Bureau may take that activity into consideration.

Listed below are some of the factors the Bureau intends to consider in determining whether and how much to take into account responsible conduct. This list is not exhaustive, and some of the factors identified may relate to more than one category of responsible conduct.

Self-assessing:

This factor, which can also be described as self-monitoring or self-auditing, reflects a proactive commitment by an entity to use resources for the prevention and early detection of violations of Federal consumer financial law. The Bureau recognizes that a robust compliance management system appropriate for the size and complexity of an entity's business will not prevent all violations, but it will reduce the risk of violations, and it will often facilitate early detection of likely violations, which can limit the size and scope of consumer harm. Questions the Bureau intends to consider in determining whether to provide favorable consideration for self-assessing activity include:

1. What resources does the entity devote to compliance? How robust and effective is its compliance management system? Is it appropriate for the size and complexity of the entity's business?

2. Has the entity taken steps to improve its compliance management system when deficiencies have been identified either by itself or external regulators? Did the entity ignore obvious deficiencies in compliance procedures? Does the entity have a culture of compliance?

3. Considering the nature of the violation, did the entity identify the issue? What is the nature of the violation or likely violation and how did it arise? Was the conduct pervasive or an isolated act? How long did it last? Did senior personnel participate in, or turn a blind eye toward, obvious indicia of misconduct?

4. How was the violation detected and who uncovered it? If identified by the entity, how did the entity identify the issue (*e.g.*, from customer complaints, audits or monitoring

based on routine risk assessments, or whistleblower activity)? Was the identification the result of a robust and effective compliance management system including adequate internal audit, monitoring, and complaint review processes? Was identification prompted by an impending exam or an investigation by a regulator?

5. What self-assessment mechanisms were in place to effectively prevent, identify, or limit the conduct that occurred, elevate it appropriately, and preserve relevant information? In what ways, if any, were the entity's self-assessing mechanisms particularly noteworthy and effective?

Self-reporting:

This factor substantially advances the Bureau's protection of consumers and enhances its mission by reducing the resources it must expend to identify violations and making those resources available for other significant matters. Prompt self-reporting of likely violations also represents concrete evidence of an entity's commitment to responsibly address the conduct at issue. Conversely, efforts to conceal a likely violation from the Bureau represent concrete evidence of the entity's lack of commitment to responsibly address the conduct at issue. For these reasons, the Bureau considers this factor in its evaluation of an entity's overall conduct. Of note, however, an entity's self-reporting of a potential issue does not require it to concede that it has violated the law. Questions the Bureau intends to examine in determining whether to provide favorable consideration for self-reporting of likely violations of Federal consumer financial law include:

1. Did the entity completely and effectively disclose the existence of the conduct to the Bureau, to other regulators, and, if applicable, to self-regulatory organizations? Did the entity report any additional related misconduct likely to have occurred?

2. Did the entity report the conduct to the Bureau without unreasonable delay? If it delayed, what justification, if any, existed for the delay? How did the delay affect the preservation of relevant information, the ability of the Bureau to conduct its review or investigation, or the interests of affected consumers?

3. Did the entity proactively self-report, or wait until discovery or disclosure was likely to happen anyway, for example due to impending supervisory activity, public company reporting requirements, the emergence of a whistleblower, consumer complaints or actions, or the conduct of a Bureau investigation?

Remediating:

When violations of Federal consumer financial law have occurred, the Bureau's remedial priorities include obtaining full redress for those injured by the violations, ensuring that the entity who violated the law implements measures designed to prevent the violations from recurring, and, when appropriate, effectuating changes in the entity's future conduct for the protection and/or benefit of consumers. Questions the Bureau intends to examine in determining whether to provide favorable consideration for remediation activity regarding likely violations of Federal consumer financial law include:

1. What steps did the entity take upon learning of the violation? Did it immediately stop the violation? How long after the violation was uncovered did it take to implement an effective response?

2. What steps did the entity take to discipline the individuals responsible for the violation and to prevent the individuals from repeating the same or similar conduct?

3. Did the entity conduct an analysis to determine the number of affected consumers and the extent to which they were harmed? Were consumers made whole through compensation and other appropriate relief, as applicable? Did affected consumers receive appropriate information related to the violations within a reasonable period of time?

4. What assurances are there that the violation (or a similar violation) is unlikely to recur? Did the entity take measures, such as a root-cause analysis, to ensure that the issues were addressed and resolved in a manner likely to prevent and minimize future violations? Similarly, have the entity's business practices, policies, and procedures changed to remove harmful incentives and encourage proper compliance?

Cooperating:

Unlike self-assessing and remediating, which may occur with or without Bureau involvement, cooperating relates to the quality of an entity's interactions with the Bureau after the Bureau becomes aware of a likely violation of Federal consumer financial law, either through an entity's self-reporting or the Bureau's own efforts. Credit for cooperating in this context depends on the extent to which an entity takes steps above and beyond what the law requires in its interactions with the Bureau. Simply meeting those legal obligations is not a factor that the Bureau intends to give any special consideration in a supervisory review or enforcement investigation. Of note, the Bureau does not consider an entity's good faith assertion of privilege in an enforcement investigation to be a lack of cooperation; an entity asserting privileges in good faith remains eligible for potential favorable consideration for cooperating. Questions the Bureau intends to examine in determining whether to provide favorable consideration for cooperating in a Bureau matter include:

1. Did the entity cooperate promptly and completely with the Bureau and other appropriate regulatory and law enforcement bodies? Was that cooperation present throughout the course of the review and/or investigation?

2. Did the entity take proper steps to develop the facts quickly and completely and to fully share its findings with the Bureau? Did it undertake a thorough review of the nature, extent, origins, and consequences of the violation and related behavior? Who conducted the review and did they have a vested interest or bias in the outcome? Were scope limitations placed on the review? If so, why and what were they?

3. Did the entity promptly make available to the Bureau the results of its review and provide sufficient documentation reflecting its response to the situation? Did it provide evidence with sufficient precision and completeness to facilitate, among other things, appropriate actions against others who violated the law? Did the entity produce a complete and thorough written report detailing the findings of its review? Did it voluntarily disclose material information not directly requested by the Bureau or that otherwise might not have been uncovered? Did the entity provide all relevant, non-privileged information and make assertions of privilege in good faith?

4. Did the entity direct its employees to cooperate with the Bureau and make reasonable efforts to secure such cooperation? Did it make the most appropriate person(s) available for interviews, consultation, and/or sworn statements?

The Bureau intends for this guidance to encourage entities subject to the Bureau's supervisory and enforcement authority to engage in more "responsible conduct," as defined herein. Such an outcome, the Bureau believes, would benefit both consumers and providers of consumer financial products and services, is in the public interest, and supports the Bureau's efforts to prevent consumer harm.

Regulatory Requirements

This Bulletin is a non-binding general statement of policy articulating considerations relevant to the Bureau's exercise of its supervisory and enforcement authority. It is therefore exempt from notice and comment rulemaking requirements under the Administrative Procedure Act pursuant to 5 U.S.C. 553(b). Because no notice of proposed rulemaking is required, the Regulatory Flexibility Act does not require an initial or final regulatory flexibility analysis. 5 U.S.C. 603(a), 604(a). The Bureau has determined that this Bulletin does not impose any new or revise any existing recordkeeping, reporting, or disclosure requirements on covered entities or members of the public that would be collections of information requiring OMB approval under the Paperwork Reduction Act, 44 U.S.C. 3501 *et seq*.

Pursuant to the Congressional Review Act, 5 U.S.C. 801 *et seq*., the Bureau will submit a report containing this policy statement and other required information to the United States Senate, the United States House of Representatives, and the Comptroller General of the United States prior to its applicability date. The Office of Information and Regulatory Affairs has designated this policy statement as not a “major rule” as defined by 5 U.S.C. 804(2).

# Regulatory Roundtable

## Current Legal Issues from the Regulators' Perspectives

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# Federal Deposit Insurance Corporation

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**Supervisory Guidance on Multiple Re-Presentment NSF Fees**

**August 2022**
*(Revised June 2023)*

The Federal Deposit Insurance Corporation (FDIC) is issuing guidance to ensure that supervised institutions are aware of the consumer compliance risks associated with assessing multiple non-sufficient funds (NSF) fees arising from the re-presentment of the same unpaid transaction. Additionally, the FDIC is sharing its supervisory approach where a violation of law is identified and full corrective action is expected.

## Background

Many financial institutions charge NSF fees when checks or Automated Clearinghouse (ACH) transactions are presented for payment, but cannot be covered by the balance in a customer's transaction account. After receiving notice of declination, merchants may subsequently resubmit the transaction for payment. Some financial institutions charge additional NSF fees for the same transaction when a merchant re-presents a check or ACH transaction on more than one occasion after the initial unpaid transaction was declined. In these situations, there is an elevated risk of violations of law and harm to consumers.

During consumer compliance examinations, the FDIC has identified violations of law when financial institutions charged multiple NSF fees for the re-presentment of unpaid transactions. The FDIC found that some disclosures provided to customers did not fully or clearly describe the institution's re-presentment practice, including not explaining that the same unpaid transaction might result in multiple NSF fees if an item was presented more than once.

## Potential Risks Arising from Multiple Re-Presentment NSF Fees

<u>Consumer Compliance Risk</u>: Practices involving the charging of multiple NSF fees arising from the same unpaid transaction results in heightened risks of violations of Section 5 of the Federal Trade Commission (FTC) Act, which prohibits unfair or deceptive acts or practices (UDAP). While specific facts and circumstances ultimately determine whether a practice violates a law or regulation, the failure to disclose material information to customers about re-presentment and fee practices has the potential to mislead reasonable customers, and there are situations that may also present risk of unfairness if the customer is unable to avoid fees related to re-presented transactions.[1]

- <u>Deceptive Practices</u>: In a number of consumer compliance examinations, the FDIC determined that if a financial institution assesses multiple NSF fees arising from the same transaction, but disclosures do not adequately advise customers of this practice, the misrepresentation and omission of this information from the institution's disclosures is

[1] These practices may also violate Section 1036(a)(1)(B) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (12 U.S.C. § 5536(a)(1)(B)), which prohibits any covered person or service provider from engaging in, among other things, abusive acts or practices in connection with a consumer financial product or service.

material. The FDIC found that if this information is not disclosed clearly and conspicuously to customers, the material omission of this information is considered to be deceptive pursuant to Section 5 of the FTC Act.

- Unfair Practices: In certain circumstances, a failure to adequately advise customers of fee practices for re-presentments raises unfairness concerns because the practices may result in substantial injuries to customers; the injury may not be reasonably avoidable; and there may be no countervailing benefits to either customers or competition. In particular, a risk of unfairness may be present if multiple NSF fees are assessed for the same transaction in a short period of time without sufficient notice or opportunity for customers to bring their account to a positive balance in order to avoid the assessment of additional NSF fees. While revising disclosures may address the risk of deception, doing so may not fully address the unfairness risks.

Third-Party Risk: Third parties, including core processors, often play significant roles in processing payments, identifying and tracking re-presented items, and providing systems that determine when NSF fees are assessed. Such third-party arrangements may present risks if not properly managed. Institutions are expected to maintain adequate oversight of third-party activities and appropriate quality control over products and services provided through third-party arrangements.[2] In addition, institutions are responsible for identifying and controlling risks arising from third-party relationships to the same extent as if the third-party activity was handled within the institution. Institutions are encouraged to review and understand the risks presented from their core processing system settings related to multiple NSF fees, as well as understand the capabilities of their core processing system(s), such as identifying and tracking re-presented items and maintaining data on such transactions.

Litigation Risk: Multiple NSF fee practices may result in heightened litigation risk. Numerous financial institutions, including some FDIC-supervised institutions, have faced class action lawsuits alleging breach of contract and other claims because of the failure to adequately disclose re-presentment NSF fee practices in their account disclosures. Some of these cases have resulted in substantial settlements, including customer restitution and legal fees.

**Risk Mitigation Practices**

Institutions are encouraged to review their practices and disclosures regarding the charging of NSF fees for re-presented transactions. The FDIC has observed various risk-mitigating activities that financial institutions have taken to reduce the potential risk of consumer harm and avoid potential violations of law regarding multiple re-presentment NSF fee practices. These include:

- Eliminating NSF fees.

- Declining to charge more than one NSF fee for the same transaction, regardless of whether the item is re-presented.

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[2] FIL-29-2023, "Interagency Guidance on Third-Party Relationships: Risk Management" (June 6, 2023).

- Conducting a comprehensive review of policies, practices, and monitoring activities related to re-presentments and making appropriate changes and clarifications, including providing revised disclosures to all existing and new customers.

- Clearly and conspicuously disclosing the amount of NSF fees to customers and when and how such fees will be imposed, including:
  - Information on whether multiple fees may be assessed in connection with a single transaction when a merchant submits the same transaction multiple times for payment;
  - The frequency with which such fees can be assessed; and
  - The maximum number of fees that can be assessed in connection with a single transaction.

- Reviewing customer notification or alert practices related to NSF transactions and the timing of fees to ensure customers are provided with an ability to effectively avoid multiple fees for re-presented items, including restoring their account balance to a sufficient amount before subsequent NSF fees are assessed.

If institutions self-identify re-presentment NSF fee issues, the FDIC expects supervised financial institutions to:

- Take full corrective action, including providing restitution to harmed customers, consistent with the restitution approach described in this guidance;

- Promptly correct NSF fee disclosures and account agreements for both existing and new customers, including providing revised disclosures and agreements to all customers;

- Consider whether additional risk mitigation practices are needed to reduce potential unfairness risks; and

- Monitor ongoing activities and customer feedback to ensure full and lasting corrective action.

**FDIC's Supervisory Approach**

When exercising supervisory and enforcement responsibilities regarding multiple re-presentment NSF fee practices, the FDIC will take appropriate action to address consumer harm and violations of law. The FDIC's supervisory response will focus on identifying re-presentment related issues and ensuring correction of deficiencies and remediation to harmed customers, when appropriate.

In reviewing compliance management systems, the FDIC recognizes an institution's proactive efforts to self-identify and correct violations. Examiners will generally not cite UDAP violations that have been self-identified and fully corrected prior to the start of a consumer compliance examination.[3] In addition, in determining the scope of any restitution requested, the FDIC will consider the likelihood of substantial consumer harm from the practice as well as an institution's

[3] Page II-6.4 of the FDIC's Consumer Compliance Examination Manual.

record keeping practices and any challenges an institution may have with retrieving, reviewing, and analyzing transaction data or other information about the frequency and timing of re-presentment fees.[4]

If examiners identify violations of law due to re-presentment NSF fee practices that have not been self-identified and fully corrected prior to a consumer compliance examination, the FDIC will evaluate appropriate supervisory or enforcement actions, including civil money penalties and restitution, where appropriate.

[4] The FDIC has generally accepted a two-year lookback period for restitution in instances where institutions have been unable to reasonably access accurate ACH data for re-presented transactions. In addition, based on the on-going and extensive challenges observed in accurately identifying re-presented transactions through core processing systems, the FDIC does not intend to request an institution to conduct a lookback review absent a likelihood of substantial consumer harm.

**Supervisory Guidance on Charging Overdraft Fees for Authorize Positive, Settle Negative Transactions**

The Federal Deposit Insurance Corporation (FDIC) is issuing guidance to ensure that supervised institutions are aware of the consumer compliance risks associated with charging an overdraft fee on a transaction that was authorized against a positive balance but settled against a negative balance, a practice commonly referred to as "Authorize Positive, Settle Negative" (APSN). The FDIC previously identified concerns with this practice in its June 2019 Consumer Compliance Supervisory Highlights.[1] This guidance expands on the 2019 Supervisory Highlights article by discussing the FDIC's concerns with both the available and ledger balance methods used by institutions when assessing overdraft fees. This guidance also clarifies that disclosures describing transaction processing may not mitigate these concerns.

**Background**

Overdraft programs, transaction clearing, and settlement processes are complex. In the case of APSN transactions, which involve consumers being assessed overdraft fees for transactions where they had sufficient account balances at the time the transactions were initiated, it may not be possible for consumers to determine when fees will be assessed and how they may be avoided.

Financial institutions' processing systems generally use either a ledger balance method[2] or an available balance method,[3] including for the purpose of assessing overdraft-related fees. An account's available balance may be impacted by pending debit transactions.[4] Some banks assess overdraft fees on debit card transactions that authorize when a customer's available balance is positive but later post to a customer's account when their balance is negative. In this scenario, a customer's account has a sufficient available balance to cover a debit card transaction when the transaction is authorized but, due to one or more intervening transactions, has an insufficient balance to cover the transaction at the time it settles.[5]

In addition to assessing an overdraft fee on the APSN transaction, some banks also assess overdraft fees on intervening transactions that exceed the customer's account balance. In this

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[1] Consumer Compliance Supervisory Highlights (June 2019).
[2] A ledger balance method calculates the account balance based only on transactions settled during the relevant period and does not take into account authorization holds. This method typically correlates to the balance reflected on a consumer's periodic statement.
[3] An available balance method calculates the account balance based on authorized (but not settled) transactions the financial institution is obligated to pay under contractual or other obligations, as well as settled transactions and pending deposits. The available balance is generally the amount of money/funds the consumer can access because it accounts for any pending debit or credit transactions. This balance typically correlates to the balance accessible to consumers online, through a mobile application, at an ATM, or by phone.
[4] This type of authorization hold is sometimes referred to as a debit hold, a temporary debit authorization hold, or a preauthorization.
[5] Refer to Table 1 in the Consumer Financial Protection Bureau's Consumer Financial Protection Circular 2022-06, "Unanticipated overdraft fee assessment practices" (Oct. 26, 2022) (CFPB Circular 2022-06).

scenario, for example, the bank reduces a customer's balance to account for the initial authorized debit card transaction, and subsequently, an intervening transaction further reduces the customer's available balance so that the account no longer has a sufficient balance. The bank charges an overdraft fee on both the intervening transaction and the initial APSN transaction when posted to the customer's account.[6]

During consumer compliance examinations, the FDIC has determined that certain overdraft practices related to APSN transactions were unfair.

**Potential Risks**

Failure to take steps to avoid assessing overdraft-related fees when transactions are authorized on positive balances but settle on negative balances results in heightened risks of violations of Section 1036(a)(1)(B) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (12 U.S.C. § 5536(a)(1)(B)), which prohibits any covered person or service provider from engaging in any unfair, deceptive, or abusive acts or practices in connection with a consumer financial product or service (Dodd-Frank UDAAP) and Section 5 of the Federal Trade Commission (FTC) Act, which prohibits unfair or deceptive acts or practices (FTC UDAP).[7] The FDIC applies the same standards as the Consumer Financial Protection Bureau (CFPB) and FTC in determining whether an act or practice is unfair under the respective statutes. An act or practice is unfair when it (1) causes or is likely to cause substantial injury to consumers, (2) cannot be reasonably avoided by consumers, and (3) is not outweighed by countervailing benefits to consumers or to competition. Public policy may also be considered in the analysis of whether a particular act or practice is unfair.

Unanticipated and unavoidable overdraft fees can cause substantial injury to consumers. A consumer is likely to suffer injury when charged more overdraft fees than may have been anticipated based on the consumer's actual spending. While not all overdraft fees may be attributable to APSN transactions, the likely presence of intervening transactions may cause additional injury.

The consumer cannot reasonably avoid the injury because the consumer does not have the ability to effectively control payment systems and overdraft processing systems practices. Due to the complicated nature of overdraft processing systems and payment system complexities outside the consumer's control, consumers may be unable to avoid injury. Additionally, in some cases, the institutions' methodology for assessing overdraft fees on APSN transactions resulted in unanticipated and unavoidable overdraft fees that were not outweighed by a countervailing benefit to consumers or competition. Dodd-Frank UDAAP and FTC UDAP risks exist in both available balance and ledger balance methods of assessing overdraft fees, but may be more pronounced in situations where institutions use available balance methods. For example, the use of available balance to assess overdraft fees may exacerbate the injury, as temporary holds may

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[6] Refer to Table 2 in CFPB Circular 2022-06.

[7] For information on how the authorize positive, settle negative practices relate to the Dodd-Frank Act's prohibition on unfair, deceptive, or abusive acts or practices, refer to the CFPB Circular 2022-06. Nothing in this guidance should be read as inconsistent or in conflict with the CFPB Circular in the application of Dodd-Frank UDAAP.

lead to consumers being assessed multiple overdraft fees when they may have reasonably expected only one.

**Risk Mitigation Practices**

Institutions are encouraged to review their practices regarding the charging of overdraft fees on APSN transactions to ensure customers are not charged overdraft fees for transactions consumers may not anticipate or avoid.

Third parties often play significant roles in processing transactions, identifying and tracking balances at the time of authorization, and providing systems that determine when overdraft fees are assessed. Institutions should ensure overdraft programs provided by third parties are compliant with all applicable laws and regulations. Such third-party arrangements may present risks if not properly managed by financial institution management. Institutions are encouraged to review these third party arrangements, as institutions are expected to maintain adequate oversight of third-party activities and appropriate quality control over products and services provided through third-party arrangements.[8] Institutions are also encouraged to review and understand the risks presented from third-party system settings for overdraft-related fees, as well as understand the capabilities of their core processing system(s), such as identifying and tracking transactions authorized on a positive balance but settled on a negative balance and maintaining data on such transactions. Some third parties offer data processing system enhancements aimed at preventing overdraft-related fees from being charged for a transaction when a debit hold authorizes against a positive balance. Note that some third parties may offer these enhancements as optional or require client financial institutions to take action in order to implement them.

In addition, institutions are also generally encouraged to review disclosures and account agreements to ensure the financial institution's practices for charging any fees on deposit accounts are communicated accurately, clearly, and consistently. However, disclosures generally do not fully address Dodd-Frank UDAAP and FTC UDAP risks associated with APSN transactions and related overdraft fees.

[8] FIL-44-2008, "Guidance for Managing Third-Party Risk" (June 6, 2008).

FDIC
**Federal Deposit Insurance Corporation**
550 17th Street NW, Washington, D.C. 20429-9990

Division of Risk Management Supervision
Division of Complex Institution Supervision and Resolution

October 24, 2023

**TO:** Board of Directors

**FROM:** Doreen R. Eberley
Director

Jim McGraw
Acting Director

**SUBJECT:** Proposed Revisions to the FDIC's Section 19 Regulations

## EXECUTIVE SUMMARY

The Divisions of Risk Management Supervision (RMS) and Complex Institution Supervision and Resolution (CISR) recommend that the Board of Directors (Board) revise regulations concerning Section 19 of the Federal Deposit Insurance (FDI) Act to conform to the Fair Hiring in Banking Act (FHBA). (The FHBA is contained within the James M. Inhofe National Defense Authorization Act for Fiscal Year 2023, Pub. L. No. 117-263, § 5705.) The FHBA became effective on December 23, 2022. Among other provisions, the FHBA excluded or exempted categories of otherwise covered offenses from the scope of Section 19, including certain older offenses and "designated lesser offenses." The FHBA also clarified several definitions in Section 19 and provided application-processing procedures. Staff considers most of the proposed revisions to the Section 19 regulations to be required by the FHBA. Other proposed revisions reflect the FDIC's interpretation of Section 19 in light of the FHBA. The proposed revised regulations are attached as Exhibit A. In addition, RMS and CISR recommend that the Board authorize the General Counsel and Executive Secretary to publish the Notice of Proposed Rulemaking in the *Federal Register*, attached as Exhibit B, which describes the proposed changes in detail. Exhibit C is the revised statutory text.

The FDIC will solicit comments on all aspects of its interpretation of the proposed changes to Section 19. In addition, it will request comments as to specific questions regarding the following topics: the appropriate offense date for a covered offense; the definition of the phrase "sentencing occurred"; whether Section 19 encompasses foreign convictions and pretrial diversions; the standard for expungements, sealings, and dismissals; the degree to which Section 19 covers offenses involving controlled substances; and *de minimis* offenses. By seeking public comment, the FDIC can consider the views of the industry and other interested parties about the appropriateness and functionality of the proposed changes to the regulations and help clarify the definitions of key terms contained in the FHBA.

Concur:

____________________________
Harrel M. Pettway

## BACKGROUND

Section 19 of the FDI Act, 12 U.S.C. § 1829 (Section 19), prohibits, without the prior written consent of the FDIC, a person convicted of any criminal offense involving dishonesty, breach of trust, or money laundering, or who has entered into a pretrial diversion or similar program in connection with a prosecution for such an offense (collectively, covered offenses), from becoming or continuing as an institution-affiliated party; owning or controlling, directly or indirectly, an insured institution; or otherwise participating, directly or indirectly, in the conduct of the affairs of an insured institution. Further, the law forbids an insured institution from permitting such a person to engage in any conduct or to continue any relationship prohibited by Section 19.

From 1998 until 2020, the FDIC had a Statement of Policy that was issued under Section 19, occasionally revised, and published in the *Federal Register*. The purpose of the Statement of Policy was to "provide[] the public with guidance relating to section 19 and the FDIC's application of this statute."[1] In 2020, following notice and comment, the FDIC revised and codified the Statement of Policy into the FDIC's Filing Procedures under part 303, subpart L, and Rules of Practice and Procedure under part 308, subpart M.[2]

On December 23, 2022, the President signed into law the FHBA, which significantly revised Section 19 and was effective immediately. The notable changes to Section 19 under the FHBA are discussed below.

## ANALYSIS OF THE PROPOSED AMENDMENTS

The proposed revisions to the FDIC's Section 19 regulations are primarily intended to align the regulations with the FHBA's provisions. The proposed revisions address, among other topics, the types of offenses covered by Section 19, the effect of the completion of sentencing or pretrial-diversion program requirements in the context of Section 19, and the FDIC's procedures for reviewing applications filed under Section 19. The preamble to the *Federal Register* Notice for the proposed rulemaking details these changes. The most significant changes to the Section 19 regulations due to the FHBA, in staff's view, are as follows.

*Certain older offenses*. The FHBA excludes certain offenses from the scope of Section 19 based on the amount of time that has passed since the offense occurred or since the individual was released from incarceration. If an individual has a covered offense and (1) it has been seven years or more since the offense occurred[3] or (2) the individual was incarcerated with respect to the offense and it has been five years or more since the individual was released from incarceration, the Act excludes such an offense from the scope of Section 19.[4] That is, no

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[1] *See* 85 Fed. Reg. 51,312, 51,312 (Aug. 20, 2020) (Final Rule revising and codifying the Statement of Policy into the Code of Federal Regulations).
[2] *See id.*
[3] Legal staff interprets the term "offense occurred" to mean the "last date of the underlying misconduct." In instances with multiple offenses, "offense occurred" means the last date of any of the underlying offenses.
[4] 12 U.S.C. § 1829(c)(1)(A).

consent application is required. Moreover, if an individual (1) committed a covered offense when the individual was 21 years of age or younger and (2) if it has been more than 30 months since the sentencing for that offense occurred, the Act excludes the offense from the scope of Section 19.[5] All of these revisions mark a paradigm shift concerning Section 19. Until the passage of the FHBA, individuals with covered offenses on their records faced potentially a lifetime ban from banking without the FDIC's consent. The revised language means that all state offenses and the vast majority of federal offenses will be removed from the scope of Section 19 after seven years—at the latest.

*Expunged, sealed, and dismissed criminal records*. The Act excludes certain convictions from the scope of Section 19 that have been expunged, sealed, or dismissed.[6] The FDIC's current regulations contain interpretative language concerning such offenses, but the statute has now codified the notion that certain expunged, sealed, or dismissed convictions are excluded from the scope of Section 19. The proposed rule would modestly broaden the statutory language concerning such offenses. The statute addresses expungements, sealings, or dismissals through court order; it is silent as to such actions by operation of law. The proposed rule would include expungements and sealings by operation of law, which would harmonize the FDIC's current regulations concerning expunged and sealed records with the statutory language and provide a more comprehensive framework as to such records.

*Designated lesser offenses*. The FHBA excludes certain "lesser offenses" from the scope of Section 19 including the use of fake identification, shoplifting, trespass, fare evasion, driving with an expired license or tag (and such other low-risk offenses as the FDIC may designate), if one year or more has passed since the applicable conviction or program entry.[7]

*Criminal offenses involving dishonesty.* The FHBA excludes certain offenses from the definition of "criminal offenses involving dishonesty," including (1) misdemeanor criminal offenses committed more than one year before the date on which an individual files an application, excluding any period of incarceration, and (2) "an offense involving the possession of controlled substances."[8] Historically, the FDIC has required an application as to drug-related offenses—aside from simple-possession offenses.[9] The rationale the FDIC has relied on has been that such non-simple-possession offenses (e.g., trafficking and manufacturing) inherently involve dishonesty, breach of trust, or money laundering. In light of the FHBA, however, staff believes that Congress intended to exclude, *at least*, the offenses of simple possession and possession with intent to distribute from the "involving dishonesty" category because of the statute's use of the phrase "involving the possession of controlled substances." Additionally, staff believes that the FDIC should shift from the presumption that other drug-related offenses are necessarily subject to Section 19 as crimes involving dishonesty, breach of trust, or money laundering. It is *possible* that the elements of a drug-related crime could implicate one of those three categories

[5] 12 U.S.C. § 1829(c)(1)(B). The statutory revisions concerning all of these older offenses do not affect the specific federal offenses listed under 12 U.S.C. § 1829(a)(2) (e.g., money laundering).
[6] *See* 12 U.S.C. § 1829(c)(2).
[7] 12 U.S.C. § 1829(c)(3)(D).
[8] 12 U.S.C. § 1829(g)(2)(C).
[9] *See* 85 Fed. Reg. at 51,313 ("The FDIC maintains that an application is required for it to determine the nature of the offense and elements of the crime and therefore it will continue the current requirement that an application be filed, unless the offense is *de minimis*.")

(and if so, an application would be required), but it is not *necessarily* so. Because this proposed rulemaking implements the new statutory language concerning "involving possession," this proposed rulemaking provides an opportunity for the FDIC to treat drug offenses the same as all other types of crimes—which do not automatically trigger the need for an application. Moving away from that presumption of coverage under Section 19 would also align the FDIC with the FRB's treatment of drug-related offenses; the FRB does not presume that drug-related offenses are subject to Section 19 and instead looks at the statutory elements of such crimes like any other form of criminal conduct.

*Standards for FDIC review of Section 19 applications*. The FHBA prescribes standards for the FDIC's review of applications submitted under Section 19.[10]

The proposed rule seeks public comment and would provide for a 60-day comment period. By seeking public comment on the proposed revisions, the Agency may receive input from the banking industry and interested parties about how the FDIC could better apply the requirements of Section 19, areas of confusion for the public and industry, or other feedback that would be useful in the Agency's exercise of its statutory obligations. The FDIC will consider such comments and may make changes to the regulations based upon such feedback.

Lastly, the FHBA requires the FDIC to "consult and coordinate" with the NCUA "as needed to promote consistent implementation [of the Act] where appropriate."[11] Accordingly, throughout this year, staff has worked with staff from the NCUA, as well as staff from the FRB and OCC, in an effort to ensure consistent interpretation and implementation of the FHBA.

**RECOMMENDATION**

In summary, staff considers most of the proposed revisions to the Section 19 regulations to be required by the FHBA. Other proposed revisions reflect staff's interpretation of Section 19 in light of the FHBA. Comments received through the rulemaking process will allow the FDIC to consider the views of the industry and other interested parties about the appropriateness and functionality of the proposed changes to the regulations and the FDIC's application procedures under Section 19. For these reasons, staff recommends approval of the attached Notice of Proposed Rulemaking and its publication in the *Federal Register*.

Staff Contacts

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|---|---|
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[10] *See* 12 U.S.C. § 1829(f).
[11] 12 U.S.C. § 1829(f)(9).

# Regulatory Roundtable

## Current Legal Issues from the Regulators’ Perspectives

Interagency

# Interagency

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level of trust in the financial institution with which they have an account?

*Question 15*: To what extent should trust survey measurements be based on direct and/or indirect measures (as described above)?

*Question 16:* Do the drivers of trust listed above comprehensively identify key factors in measuring and tracking trust in financial institutions over time? If not, what other drivers could be used?

*Question 17*: How important is understanding the drivers of trust in developing a trust measurement for financial institutions?

*Question 18*: What are some of the key factors to consider in developing survey questions that capture how personal characteristics influence trust in financial institutions?

*Question 19*: What are some of the key factors to consider in creating survey questions to capture how trust in bank regulators influence customers' trust in banks?

*Question 20*: What are some of the key factors to consider in creating survey questions to capture how trust in the government influence customers' trust in financial institutions?

*Question 21*: What are the key advantages and disadvantages of having a single banking regulator conducting the survey? To what extent should the OCC consider alternative approaches, such as conducting a joint survey with one or more other federal bank regulators?

(Authority: 12 U.S.C. 1)

**Michael J. Hsu,**

*Acting Comptroller of the Currency.*

[FR Doc. 2023–12301 Filed 6–8–23; 8:45 am]

BILLING CODE 4810–33–P

## FEDERAL RESERVE SYSTEM

**[Docket No. OP–1752]**

## FEDERAL DEPOSIT INSURANCE CORPORATION

**RIN 3064–ZA26**

## DEPARTMENT OF THE TREASURY

### Office of the Comptroller of the Currency

**[Docket ID OCC–2021–0011]**

# Interagency Guidance on Third-Party Relationships: Risk Management

**AGENCY:** The Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC), Treasury.

**ACTION:** Final interagency guidance.

**SUMMARY:** The Board, FDIC, and OCC (collectively, the agencies) are issuing final guidance on managing risks associated with third-party relationships. The final guidance offers the agencies' views on sound risk management principles for banking organizations when developing and implementing risk management practices for all stages in the life cycle of third-party relationships. The final guidance states that sound third-party risk management takes into account the level of risk, complexity, and size of the banking organization and the nature of the third-party relationship. The agencies are issuing this joint guidance to promote consistency in supervisory approaches; it replaces each agency's existing general guidance on this topic and is directed to all banking organizations supervised by the agencies.

**DATES:** The guidance is final as of June 6, 2023.

**FOR FURTHER INFORMATION CONTACT:**

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**SUPPLEMENTARY INFORMATION:**

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## I. Introduction

Banking organizations [1] routinely rely on third parties for a range of products, services, and other activities (collectively, activities). The use of third parties can offer banking organizations significant benefits, such as quicker and more efficient access to technologies, human capital, delivery channels, products, services, and markets. Banking organizations' use of third parties does not remove the need for sound risk management. On the contrary, the use of third parties, especially those using new technologies, may present elevated risks to banking organizations and their customers, including operational, compliance, and strategic risks. Importantly, the use of third parties does not diminish or remove banking organizations'

[1] For a description of the banking organizations supervised by each agency, refer to the definition of "appropriate Federal banking agency" in section 3(q) of the Federal Deposit Insurance Act (12 U.S.C. 1813(q)). This guidance is relevant to all banking organizations supervised by the agencies.

responsibilities to ensure that activities are performed in a safe and sound manner and in compliance with applicable laws and regulations, including but not limited to those designed to protect consumers (such as fair lending laws and prohibitions against unfair, deceptive or abusive acts or practices) and those addressing financial crimes.

The agencies have each previously issued general guidance for their respective supervised banking organizations to address appropriate risk management practices for third-party relationships, each of which is rescinded and replaced by this final guidance: the Board's 2013 guidance,[2] the FDIC's 2008 guidance,[3] and the OCC's 2013 guidance and its 2020 frequently asked questions (herein, OCC FAQs).[4] By issuing this interagency guidance, the agencies aim to promote consistency in their third-party risk management guidance and to clearly articulate risk-based principles for third-party risk management. Further, the agencies have observed an increase in the number and type of banking organizations' third-party relationships. Accordingly, the final guidance is intended to assist banking organizations in identifying and managing risks associated with third-party relationships and in complying with applicable laws and regulations.[5]

## II. Discussion of Comments on the Proposed Guidance

On July 19, 2021, the agencies published for comment proposed guidance on managing risks associated with third-party relationships (proposed guidance).[6] The 60-day comment period initially ended on September 17, 2021. In response to commenters' requests for additional time to analyze and respond to the proposal, the agencies extended the comment period until October 18, 2021.[7]

The agencies invited comment on all aspects of the proposed guidance. To help solicit feedback, the agencies posed 18 questions within the request for comment, organized across the following themes: *General, Scope, Tailored Approach to Third-Party Risk Management, Third-Party Relationships, Due Diligence and Collaborative Arrangements, Subcontractors, Information Security,* and *the OCC's 2020 FAQs.* The agencies collectively received 82 comment letters from banking organizations, financial technology (fintech) companies and other third-party providers, trade associations, consultants, nonprofits, and individuals.[8]

### *A. General Support for the Proposed Guidance*

In general, commenters supported the agencies' efforts to issue joint principles-based guidance on third-party risk management. Commenters agreed with the proposal's overarching message regarding the importance of banking organizations adopting sound risk management practices that are commensurate with the level of risk and complexity of their respective third-party relationships. They agreed that a principles-based approach to third-party risk management can be adapted to a wide range of relationships and scaled for banking organizations of different sizes and complexity.

There were varying views among commenters on the level of detail included in the proposed guidance. While some commenters found the language to be too prescriptive, others noted that it had the right level of detail to enable banking organizations to use the guidance in a risk-based fashion. Other commenters specifically requested that the agencies establish minimum required ''standards'' or incorporate greater specificity on supervisory expectations. Commenters also offered differing perspectives on whether or how to incorporate the concepts from the OCC FAQs.[9]

In response to comments received, the agencies underscore that supervisory guidance does not have the force and effect of law and does not impose any new requirements on banking organizations.[10] The guidance addresses key principles banking organizations can leverage when developing and implementing risk management processes tailored to the risk profile and complexity of their third-party relationships.

### *B. Terminology and Scope*

Commenters offered views on the description of the terms ''business arrangement,'' ''third-party relationship,'' and ''critical activities.''

#### 1. Description of the Terms ''Business Arrangement'' and ''Third-Party Relationship''

Some commenters suggested that the term ''business arrangement'' is overly broad and inconsistent with the risk-based approach of the guidance. For example, some commenters believed that without narrowing the term, banking organizations may face an undue burden when implementing their risk management processes. Several commenters offered suggestions to narrow or modify the term ''business arrangement.'' These suggestions included focusing on material relationships, scoping out low-risk activities, and limiting arrangements to only those that are continuous and/or governed by a written contract.

Similarly, some commenters suggested that the term ''third-party relationship'' was overly broad and may divert banking organizations from focusing sufficiently on those relationships that present higher risk. These commenters suggested applying a materiality standard (for example, those third parties supporting critical activities) or excluding certain categories of third-party relationships (for example, affiliates or bank-to-bank relationships).

A few commenters recommended incorporating some of the more detailed discussions from OCC FAQs 1 and 2 elaborating on and providing examples of ''business arrangements'' and ''third-party relationships.''

With respect to these comments, the agencies believe the scope of the term

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[2] SR Letter 13–19/CA Letter 13–21, ''Guidance on Managing Outsourcing Risk'' (December 5, 2013, updated February 26, 2021).

[3] FIL–44–2008, ''Guidance for Managing Third-Party Risk'' (June 6, 2008).

[4] OCC Bulletin 2013–29, ''Third-Party Relationships: Risk Management Guidance,'' and OCC Bulletin 2020–10, ''Third-Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013–29.'' Additionally, the OCC also issued foreign-based third-party guidance, OCC Bulletin 2002–16, ''Bank Use of Foreign-Based Third-Party Service Providers: Risk Management Guidance,'' which is not being rescinded but instead supplements the final guidance.

[5] These include the ''Interagency Guidelines Establishing Standards for Safety and Soundness,'' and the ''Interagency Guidelines Establishing Information Security Standards,'' which were adopted pursuant to the procedures of section 39 of the Federal Deposit Insurance Act and section 505 of the Graham Leach Bliley Act, respectively. *See* 12 CFR part 30, appendices A and B (OCC); part 208, appendices D–1 and D–2 (Board); and part 364, appendices A and B (FDIC).

[6] ''Proposed Interagency Guidance on Third-Party Relationships: Risk Management,'' 86 FR 38182 (July 19, 2021).

[7] ''Proposed Interagency Guidance on Third-Party Relationships: Risk Management,'' 86 FR 50789 (September 10, 2021).

[8] Comments can be accessed at: *https://www.regulations.gov/document/OCC-2021-0011-0001/comment* (OCC); *https://www.federalreserve.gov/apps/foia/ViewComments.aspx?doc_id=OP-1752&doc_ver=1* (Board); and *https://www.fdic.gov/resources/regulations/federal-register-publications/2021/2021-proposed-interagency-guidance-third-party-rel-rm-3064-za26.html* (FDIC).

[9] The agencies included the OCC's 2020 FAQs as an exhibit when issuing the proposed guidance and sought comment on whether any of the concepts in the OCC FAQs should be incorporated into the interagency guidance. *See* 86 FR 38196.

[10] *See* 12 CFR part 4, appendix A to subpart F (OCC); 12 CFR part 262, appendix A (Board); and 12 CFR part 302, appendix A (FDIC).

"business arrangement" in the proposed guidance captures the full range of third-party relationships that may pose risk to banking organizations, and the final guidance does not change that scope. These relationships have evolved, and may continue to evolve, over time to encompass a large range of activities, justifying the use of broad terminology. The agencies have incorporated concepts from OCC FAQs 1 and 2. Although the terms "business arrangement" and "third-party relationship" are broad, the guidance does not suggest that all relationships require the same level or type of oversight or risk management, since different relationships present varying levels of risk. The guidance states that, as part of sound risk management, a banking organization analyzes the risks associated with each third-party relationship and adjusts its risk management practices, commensurate with the banking organization's size, complexity, and risk profile and with the nature of its third-party relationships. The agencies have removed from the final guidance the proposed text, which stated that the term "business arrangement" generally excludes customer relationships. Since some business relationships may incorporate elements or features of a customer relationship, the removal of the proposed text is intended to reduce ambiguity.

2. Description of the Term "Critical Activities"

Commenters expressed views on the term "critical activities," suggesting that the agencies provide banking organizations flexibility in determining which activities are higher risk and critical in nature or requested clarification on or limitation of the scope and application of the term. Some commenters requested the agencies provide further examples of critical activities or clarify whether banking organizations could employ risk-tiering processes to identify critical activities.

Commenters provided other suggestions that they thought would improve the description of "critical activities," such as:

- Merging the concepts of "critical activities" and "significant bank functions;"
- Reconsidering whether certain factors articulated within the proposed guidance should be determinative of criticality;
- Clarifying whether a certain monetary threshold would determine whether an activity requires a "significant investment in resources to implement the third-party relationship and manage the risk;" [11]
- Incorporating the concept from OCC FAQ 8 that not every relationship involving critical activities is necessarily a critical third-party relationship; and
- Aligning the concept of criticality in the proposed guidance with similar concepts in existing, related guidance (for example, the definitions for "critical operations" and "core business line" used in the Interagency Paper on Sound Practices to Strengthen Operational Resilience [12] (Sound Practices Paper)) to facilitate banking organizations' adoption of comprehensive risk management strategies.

The agencies considered the range of comments on the term "critical activities" and have made certain revisions to improve clarity and emphasize flexibility. The revised term eliminates imprecise concepts like "significant investment" and "significant bank function," instead focusing on illustrative, risk-based characteristics, such as activities that could cause significant risk to the banking organization if the third party fails to meet expectations or that have significant impacts on customers or the banking organization's financial condition or operation. The agencies have incorporated concepts from OCC FAQs 7, 8, and 9, recognizing that an activity that is critical for one banking organization may not be critical for another. Some banking organizations may assign a criticality or risk level to each third-party relationship, while others may identify critical activities and those third parties associated with such activities. Regardless of a banking organization's approach, applying a sound methodology to designate which activities and third-party relationships receive more comprehensive oversight is key for effective risk management.

In response to the comments requesting alignment with other issuances, the agencies note that this guidance is intended to provide examples of considerations that may be helpful to all banking organizations, regardless of size. It is important for each banking organization to assess risks presented by each of its third-party relationships and tailor its risk management processes accordingly. To the extent that specific laws and regulations may be applicable, for example, recovery or resolution planning to large banking organizations,[13] those banking organizations may desire to leverage definitions and approaches in those laws and regulations when developing and implementing third-party risk management, such as identifying third-party relationships that that support higher-risk activities, including critical activities. Moreover, to the extent that other guidance may be relevant to certain banking organizations, such as the Sound Practices Paper, which is intended for the largest and most complex banking organizations,[14] such organizations may choose to reference relevant terms and concepts contained in those other issuances when implementing their third-party risk management processes.

*C. Tailored Approach to Third-Party Risk Management*

Commenters offered views on appropriately tailoring the risk management principles discussed in the guidance to meet the different needs of individual banking organizations, and particularly community banking organizations. For example, some commenters asserted that smaller, less complex banking organizations do not need to adopt the same risk management approaches adopted by larger, more complex banking organizations. As such, they asked that the guidance include language either to clarify the flexibility of the guidance with respect to the size of banking organizations or to the risk presented by certain third-party relationships. Some commenters suggested that the guidance make allowances for banking organizations to explicitly accept the risk of the relationship, in lieu of establishing full due diligence practices, based on the banking organization's risk profile and individual circumstances of the relationship.

Commenters also suggested that the agencies could provide examples of appropriate practices specific to smaller banking organizations or of the specific risks that certain categories of third parties or critical activities may pose to smaller banking organizations. Several commenters requested some form of acknowledgment that smaller banking organizations may lack the necessary

[11] "Proposed Interagency Guidance on Third-Party Relationships: Risk Management", 86 FR 38182, at 38187 (July 19, 2021); *https://www.federalregister.gov/documents/2021/07/19/2021-15308/proposed-interagency-guidance-on-third-party-relationships-risk-management.*

[12] "Interagency Paper on Sound Practices to Strengthen Operational Resilience," Federal Reserve SR 20–24 (November 2, 2020); OCC Bulletin 2020–94 (October 30, 2020); and FDIC FIL–103–2020 (November 2, 2020).

[13] *See* 12 CFR part 243 (Regulation QQ); 12 CFR part 30, appendix E.

[14] The practices are addressed to domestic banks with more than $250 billion in total consolidated assets or banks with more than $100 billion in total assets and other risk characteristics. *See* note 12.

resources to thoroughly vet third parties, and thus should be afforded some form of ‘‘safe harbor'' relating to third-party risk management to allow them to compete in the digital era.

In addition, commenters suggested incorporating concepts from OCC FAQs 5, 6, and 7 to help reinforce flexibility for community banking organizations (acknowledging, for example, that banking organizations may have limited negotiating power, that there is no one way for banks to structure their third-party risk management processes, and that not all relationships warrant the same level of oversight or risk management).

In response to these comments, the agencies reiterate that the guidance is relevant to all banking organizations. The agencies have incorporated concepts from OCC FAQ 9, clarifying language in the guidance about tailoring third-party risk management processes based on risk. The guidance notes that not all third-party relationships present the same level or type of risk and therefore not all relationships require the same extent of oversight or risk management. It also states that as part of sound risk management, it is the responsibility of each banking organization to analyze the risks associated with each third-party relationship and to calibrate its risk management processes, commensurate with the banking organization's size, complexity, and risk profile and with the nature of its third-party relationships.

Banking organizations have flexibility in their approach to assessing the risk posed by each third-party relationship and deciding the relevance of the considerations discussed in the guidance. To reinforce this flexibility and provide clarity on third-party risk management implementation, especially for community banking organizations, the agencies have streamlined and simplified certain sections of the guidance. The agencies have also incorporated into the final guidance concepts from OCC FAQs 5, 6, and 7 discussed above.

*D. Specific Types of Third-Party Relationships*

Commenters pointed to types of third-party relationships that may pose heightened or novel risk management considerations. A number of commenters discussed a banking organization's use of third parties for technological advances and innovations, including relationships with fintech companies. Some commenters raised particular risks presented by data aggregators and suggested a range of approaches to address these risks. Suggestions included interagency coordination on a Consumer Financial Protection Bureau (CFPB) rulemaking on consumer access to financial records.[15] In addition, some commenters expressed concern that the discussion in OCC FAQ 4 on third-party risk management expectations related to data aggregators may unintentionally result in outsized burdens on banking organizations. Other commenters asked for additional flexibility for banking organizations to manage relationships with third parties in relatively concentrated industries, mentioning cloud computing as an example.

Some commenters also noted that third-party risk management processes may be applied differently, based on the specific type of relationship. For example, several commenters stated that arrangements with affiliates may present different or lower risks than those with unaffiliated third parties, and suggested that, as a result, a banking organization's third-party risk management may differ for affiliates and non-affiliates. Certain commenters also suggested that third parties that are already supervised or regulated (including some foreign-regulated entities) present less risk to banking organizations such that a banking organization's risk management could be tailored accordingly (for example, through reduced due diligence).

Commenters also suggested the agencies enhance discussion in the proposed guidance on foreign-based third parties, including clearly explaining this term, describing typical risks and accompanying risk management strategies, and addressing the possibility of incompatible legal obligations between jurisdictions. In the final guidance, the agencies have included a footnote to address questions surrounding the term ‘‘foreign-based third party'' and have retained applicable considerations for foreign-based third parties within relevant sections of the risk management life cycle.

With respect to comments about technological advances and innovation, the agencies recognize that some banking organizations are forming relationships with fintech companies, including under new or novel structures and arrangements. Depending on the specific circumstances, including the activities performed, such relationships may introduce new or increase existing risks to a banking organization, such as those risks identified by some commenters. For example, in some third-party relationships, the respective roles and responsibilities of a banking organization and a third party may differ from those in other third-party relationships. Additionally, depending on how the business arrangement is structured, the banking organization and the third party each may have varying degrees of interaction with customers. Longstanding principles of third-party risk management set forth in this guidance are applicable to all third-party relationships, including those with fintech companies. Therefore, it is important for a banking organization to understand how the arrangement with a third party, including a fintech company, is structured so that the banking organization may assess the types and levels of risks posed and determine how to manage those third-party relationships accordingly. The agencies did not incorporate concepts from OCC FAQ 4, opting to provide broad risk management guidance.

The agencies considered other comments in relation to specific types of third-party relationships but decided not to exclude any specific third-party relationships from the scope of the guidance; rather, the guidance is relevant to managing all third-party relationships. Because third-party relationships present varying levels and types of risk, the guidance notes that not all relationships require the same level or type of oversight or risk management.

This principles-based guidance provides a flexible, risk-based approach to third-party risk management that can be adjusted to the unique circumstances of each third-party relationship. The agencies do not believe it would be appropriate to prescribe alternative approaches or to broadly assume lower levels of risk based solely on the type of a third party. For example, while a third-party relationship with an affiliate may have different characteristics and risks as compared to those with non-affiliated third parties, affiliate relationships may not always present lower risks. The same is true for third parties that are subject to some form of regulation.

The agencies also incorporated concepts from OCC FAQs 7 and 9, reiterating that as part of sound risk management, it is the responsibility of each banking organization to analyze the risks associated with each third-party relationship and to calibrate its risk management practices, commensurate with the banking organization's size, complexity, and risk

[15] *See* 12 U.S.C. 5533. As required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the agencies are participating in consultations with the CFPB related to the rulemaking.

profile and with the nature of its third-party relationships.

*E. Risk Management Life Cycle*

Commenters made a wide range of suggestions in the risk management life cycle section of the proposed guidance. Commenters expressed mixed views on the level of detail provided with respect to the various aspects of the risk management life cycle as well as the meaning of certain concepts. Some commenters raised concerns that the level of detail made the guidance overly burdensome on smaller banks. Other commenters recommended that the agencies expand the discussion to include additional stages within the risk management life cycle; a risk management matrix; or practical, illustrative examples throughout all stages of the life cycle.

In response to these comments, the agencies have clarified and streamlined the guidance and removed details that were duplicative, not useful, or that could be interpreted as prescriptive. The agencies also reiterate that the guidance is principles-based. Examples of considerations are merely illustrative, not requirements, and may not be applicable or material to each banking organization or each third-party relationship. The examples are not intended to be interpreted as exhaustive or to be used as a checklist. The agencies support a risk-based approach for banking organizations to assess the risk posed by a third-party relationship and tailor their third-party risk management processes accordingly.

In addition to these general comments, commenters provided thoughts on specific stages of the risk management life cycle, which are addressed below:

1. Due Diligence and Collaborative Arrangements

The due diligence and third-party selection stage of the risk management life cycle drew particular attention from commenters. Some raised concerns with the feasibility of banking organizations performing the full range of due diligence outlined in the proposal, noting that third parties or their related subcontractors may be unable or unwilling to disclose certain information. These commenters stated that the extent of due diligence described may be beyond certain banking organizations' expertise or not be fully applicable for most relationships. Other commenters suggested that banking organizations could engage in less stringent due diligence for certain types of third parties. Suggestions to address these concerns included revising the guidance to scale due diligence to the risk posed by the third party, limiting the burden of certain due diligence practices, and acknowledging shortcomings in accessing certain information.

Other commenters focused on steps to reduce the burdens of due diligence, by facilitating collaboration among banking organizations and reliance on certifications. For example, many commenters expressed support for proposed language on shared due diligence or collaboration between banking organizations.

In some cases, commenters noted challenges with shared due diligence or collaboration among banking organizations, such as antitrust or privacy considerations and the ability to meet due diligence needs in a shared framework. Some commenters recommended solutions, such as joint data collections and assessments across banking organizations and third parties. Other commenters asked the agencies to incorporate and expand upon the discussions in OCC FAQs 14 and 24 that banking organizations may rely on industry-accepted certifications and/or other reports.

Commenters also suggested that the guidance address due diligence options when banking organizations have difficulty gaining access to information necessary to perform due diligence and audits. Several commenters recommended that the guidance be tailored for or scope out certain third parties that may be resistant to due diligence efforts. Banking organizations may not be able to seek out alternatives to these third parties, especially where the industry is particularly concentrated. Another commenter noted that the use of on-site audits or visits has declined over time and could be inefficient and costly, especially for third parties with operations in several physical locations (such as cloud computing service providers).

With respect to commenters focused on specific third-party relationships, the agencies reiterate that relationships present varying levels of risk and not all relationships require the same level or type of oversight or risk management. However, the agencies do not believe it would be appropriate for banking organizations to conduct reduced due diligence based solely on a third party's entity type.

With respect to commenters focused on steps to limit the burdens of due diligence, including collaboration with other banking organizations and engaging with third parties that specialize in conducting due diligence, the agencies note that such collaborative efforts could be beneficial and reduce burden, especially for community banking organizations, and have made certain clarifying revisions to the guidance in that regard. However, use of any collaborative efforts does not abrogate the responsibility of banking organizations to manage third-party relationships in a safe and sound manner and consistent with applicable laws and regulations (including antitrust laws). It is important for the banking organization to evaluate the conclusions from such collaborative efforts based on the banking organization's own specific circumstances and performance criteria for the activity. A banking organization engaging an external party to supplement risk management, including due diligence, constitutes establishing a business arrangement; such a relationship would typically be covered by the banking organization's third-party risk management processes. The agencies have incorporated into the final guidance concepts from OCC FAQs 12, 13, and 25.

With respect to those commenters focused on circumstances in which banking organizations may have difficulty gaining access to information, the agencies acknowledge challenges in some circumstances. Consistent with the concepts from OCC FAQs 1, 5, and 17, the guidance provides that in such circumstances, banking organizations should consider taking steps to mitigate the risks or, if the risks cannot be mitigated, to determine whether the residual risks are acceptable. The guidance also states that when assessing the risk of a third-party relationship, banking organizations may consider information available from various sources. For example, the agencies incorporated concepts from OCC FAQs 14 and 24, recognizing that banking organizations may consider public regulatory disclosures when considering the risks presented by the specific third party. If the banking organization has concerns that the relationship falls outside of its risk appetite, it should consider making alternative choices.

As the guidance emphasizes, it is the responsibility of the banking organization to identify and evaluate the risks associated with each third-party relationship and to tailor its risk management practices, commensurate with the banking organization's size, complexity, and risk profile, as well as with the nature of its third-party relationships. As such, the agencies have not excluded any specific third-party relationships from the scope of the guidance.

2. Contract Negotiation

Commenters identified a range of suggestions on how the guidance approaches contract negotiations. Several commenters expressed concern that the section was overly detailed, that many contracts may not contain all of the contractual considerations discussed in the proposed guidance, and that such considerations might be treated as a mandatory checklist. Other commenters found the nature and extent of contractual language in the proposed guidance helpful in practice for informing a banking organization's contract negotiations.

Several commenters stated that the guidance should acknowledge the need for greater flexibility in certain contract negotiations. For example, some commenters requested that the guidance recognize that banking organizations may lack sufficient leverage in negotiations with larger third parties and may struggle to get certain ''typical'' provisions into the contract.

Further, several commenters recommended that the agencies provide additional support to smaller institutions to increase their collective negotiating power with respect to third parties, such as by creating a tool or supporting a collective group to facilitate negotiations. Some commenters proposed that the guidance include language from several of the OCC FAQs to clarify additional considerations regarding limited negotiating power and use of collaborative efforts when negotiating contracts.

In response to these comments, the agencies have incorporated concepts from OCC FAQs 5 and 13, acknowledging that a banking organization may have limited negotiating power in certain instances and should understand any resulting limitations. As the guidance states, many of the same considerations for collaborative arrangements apply throughout the risk management life cycle.

The agencies have streamlined some of the considerations in this section but believe that the overall scope of the discussion would be useful to banking organizations in understanding and preparing for contract negotiations.

3. Ongoing Monitoring

Several commenters recommended that the agencies revise the proposed guidance to encourage banks to adopt active, continuous, real-time monitoring, arguing that this approach is preferable to engaging in periodic assessments. Others requested the guidance provide additional information on alternative monitoring arrangements (such as certifications), collaborative monitoring arrangements, and reliance on external parties to supplement ongoing monitoring.

The agencies are not encouraging any specific approach to ongoing monitoring. Rather, the guidance continues to state that a banking organization's ongoing monitoring, like other third-party risk management processes, should be appropriate for the risks associated with each third-party relationship, commensurate with the banking organization's size, complexity, and risk profile and with the nature of its third-party relationships. Additionally, the guidance states that banking organizations may consider collaborative arrangements or the use of external parties to supplement ongoing monitoring.

*F. Subcontractors*

Commenters expressed a variety of views on banking organizations' relationships with subcontractors. These comments largely focused on whether the guidance could be clarified to promote additional flexibility in how banking organizations manage the risks associated with subcontractors, which pose challenges not necessarily present in a direct third-party relationship.

Various commenters emphasized the importance of managing risks posed by subcontractors, especially those that are material to a service being provided to a banking organization; those with access to sensitive, nonpublic information; those that perform higher-risk activities, including critical activities; those with access to the banking organization's infrastructure; and those within extended chains of subcontractors. However, many of these commenters expressed concern regarding the potential challenges in overseeing and conducting effective due diligence on subcontractors, such as a banking organization's lack of a relationship with (contractually or otherwise), and leverage over, subcontractors. These commenters suggested either narrowing the guidance's discussion on subcontractors (for example, excluding relationships beyond third parties) or refocusing a banking organization's oversight to a third party's ability to manage its subcontractors. Commenters also suggested that, in line with OCC FAQ 11, a banking organization could require a third party to bind its subcontractors to any obligations and standards of the third party.

With respect to these comments, the agencies acknowledge the risks and added complexity that may be involved with respect to a third party's use of subcontractors. The agencies also recognize concerns by commenters interpreting the guidance to mean banking organizations are expected to assess or oversee all subcontractors of a third party. Accordingly, consistent with the concepts in OCC FAQ 11, the agencies have revised the guidance, focusing on a banking organization's approach to evaluating its third party's own processes for overseeing subcontractors and managing risks. As the guidance clarifies, relationships with a third party, including a third party's use of subcontractors, should be evaluated based on the risk the relationship poses to the banking organization, which may include assessing whether a third party's use of subcontractors may heighten or raise additional risk to the banking organization and applying mitigating factors, as appropriate. The agencies have also made streamlining changes to improve clarity and promote flexibility, including by removing use of the term ''critical subcontractor.''

*G. Oversight and Accountability*

Commenters provided suggestions as to the proper role of a banking organization's board of directors and management with respect to effective third-party risk management. Some commenters, for example, stated that the proposed guidance implied excessive board involvement in day-to-day management activity. Others suggested that the guidance could further clarify the role of the board of directors in risk management activities, specifically those aspects of third-party risk management that could appropriately be executed and overseen by senior management. Some commenters similarly suggested the guidance clarify the authority of management to establish policies governing third-party relationships. A few commenters requested the guidance provide granularity on the types, depth, and frequency of information necessary for board review, including for ongoing monitoring. Additionally, several commenters suggested incorporating into the guidance and elaborating upon OCC FAQs 6 and 26, which discuss the board's responsibility for overseeing the development of an effective third-party risk management process, and its role in contract approval. Some commenters also requested ''Oversight and Accountability'' and its related subsections in the proposed guidance be better differentiated from the phases of the risk management life cycle, as the concepts and related activities occur throughout the risk management life cycle.

The agencies have incorporated concepts from OCC FAQs 6 and 26, reorganizing the guidance to make clear that oversight and accountability happens throughout the risk management life cycle and is not a specific stage. Further, the agencies have made changes to clarify and distinguish the board's responsibilities from management's responsibilities and to avoid the appearance of a prescriptive approach to the board's role in the risk management life cycle, while still emphasizing that the board has ultimate oversight responsibility to ensure that the banking organization operates in a safe and sound manner and in compliance with applicable laws and regulations.

*H. Other Matters Raised*

Commenters also offered other thoughts and suggestions relating to the guidance. Commenters noted that it would be helpful to have a period prior to the guidance taking effect to permit banking organizations to adapt processes accordingly. Several commenters also recommended that the agencies leverage, refer to, or combine recent, relevant regulations and policy issuances (such as the ''Computer-Security Incident Notification rule,'' [16] ''Third-Party Due Diligence Guide for Community Banks,'' [17] and the ''Model Risk Management'' booklet of the *Comptroller's Handbook* [18]) as part of any final third-party risk management guidance. A few commenters made reference to the FDIC's 2016 proposed examination guidance for third-party lending,[19] stating that, although not finalized, the 2016 proposed guidance set forth meaningful concepts about third-party lending relationships that could be useful in developing the final guidance.

Several commenters shared considerations regarding, and requested insight into, the agencies' examinations of banking organizations' third-party risk management processes. Some commenters suggested that any final guidance include a separate section outlining specific examination procedures to set clear and consistent expectations regarding the examination process.

Commenters provided thoughts on incorporating any or all of the OCC's FAQs. Several commenters suggested including relevant FAQs as an appendix or separate section rather than incorporating them throughout any final guidance, complementing principle-based guidance with more issue-specific FAQs to provide practical context. Others thought that the existence of a separate set of FAQs would create unnecessary confusion for examiners and the industry. In response, the agencies have not incorporated issue-specific FAQs where it was determined the matters are adequately reflected in other issuances published since the OCC FAQs were last updated.

Several commenters requested greater coordination among federal, state, and foreign regulators with respect to this guidance. Specifically, a few commenters suggested that other federal government agencies, such as the National Credit Union Administration, join the agencies in issuing this guidance. Another commenter urged the agencies to support federal legislative proposals that would clarify the authority of state regulators to examine third-party service providers together with the agencies.

Some commenters suggested that the agencies develop additional guidance and educational resources on a wide array of separate topics that a banking organization's third-party risk management processes could touch upon, such as consumer protection issues, artificial intelligence, alternative data uses, and other novel developments, citing the agencies' crypto-asset ''policy sprints'' as an example. For example, as to consumer protection issues, some commenters expressed concern with certain third-party relationships, such as so-called ''rent-a-charter'' arrangements that they believe are improperly used by non-bank third parties to preempt state usury laws. Multiple commenters requested that the agencies update the guidance to warn or discourage banking organizations about certain risks, such as high-interest loans or conflicts with state laws. Several commenters also suggested that the agencies use their existing authorities (such as under the Bank Service Company Act [20]) to address the risks of what those commenters perceived as ''systemically important'' third-party service providers, or to otherwise assist banking organizations' third-party risk management efforts. Other commenters suggested the agencies and the CFPB provide for automatic sharing of service provider reports of examination with service providers' client banking organizations or provide certifications relevant to a banking organization's due diligence.

In response to these comments, given the broad, principles-based approach of this guidance, the agencies have not revised the guidance to address specific topics or types of relationships. Separate guidance on certain topics or relationships already exists; these types of specific guidance issuances, unless expressly rescinded, would remain unaffected by this guidance. While certain topics (including those raised by commenters) are not explicitly discussed in the final guidance, the broad-based scope of the guidance captures the full range of third-party relationships. With respect to requests that would require statutory or regulatory changes, or may be outside the authority of the agencies, such requests cannot be addressed by this guidance.

The agencies actively monitor trends and developments in the financial services industry and will consider issuing additional guidance or educational resources as necessary and appropriate to convey the agencies' views. The agencies plan to develop additional resources to assist smaller, non-complex community banking organizations in managing relevant third-party risks. The agencies will continue to coordinate closely about risk management matters, including third-party risk management, to help promote consistency across banking organizations and across the agencies.

Regarding questions about each agency's approach to examining third-party risk management, each agency has its own processes and procedures for conducting supervisory activities, including examination work. The final guidance includes a brief discussion of the agencies' supervisory reviews, the scope of which is tailored to evaluate the risks inherent in a banking organization's third-party relationships and the effectiveness of a banking organization's third-party risk management processes.

**III. Paperwork Reduction Act**

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3521) (PRA) states that no agency may conduct or sponsor, nor is the respondent required to respond to, an information collection unless it displays a currently valid Office of

[16] 12 CFR part 53 (OCC); 12 CFR 225, subpart N (Board); 12 CFR 304, subpart C (FDIC).

[17] ''Conducting Due Diligence on Financial Technology Companies A Guide for Community Banks,'' Board, FDIC, OCC (August 2021), available at: *https://www.occ.gov/news-issuances/news-releases/2021/nr-ia-2021-85a.pdf.*

[18] ''Comptroller's Handbook: Model Risk Management,'' OCC (August 2021), available at: *https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/model-risk-management/pub-ch-model-risk.pdf.*

[19] FDIC FIL–50–2016, ''Examination Guidance for Third-Party Lending'' (July 29, 2016). This proposed examination guidance was not finalized.

[20] 12 U.S.C. 1861 *et seq.*

Management and Budget (OMB) control number.

The guidance does not revise any existing, or create any new, information collections pursuant to the PRA. Rather, any reporting, recordkeeping, or disclosure activities mentioned in the guidance are usual and customary and should occur in the normal course of business as defined in the PRA.[21] Consequently, no submissions will be made to the OMB for review.

## IV. Text of Final Interagency Guidance on Third-Party Relationships

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### *A. Overview*

The Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) (collectively, the agencies) have issued this guidance to provide sound risk management principles supervised banking organizations[1] can leverage when developing and implementing risk management practices to assess and manage risks associated with third-party relationships.[2]

Whether activities are performed internally or via a third party, banking organizations are required to operate in a safe and sound manner[3] and in compliance with applicable laws and regulations.[4] A banking organization's use of third parties does not diminish its responsibility to meet these requirements to the same extent as if its activities were performed by the banking organization in-house. To operate in a safe and sound manner, a banking organization establishes risk management practices to effectively manage the risks arising from its activities, including from third-party relationships.[5]

This guidance addresses any business arrangement[6] between a banking organization and another entity, by contract or otherwise. A third-party relationship may exist despite a lack of a contract or remuneration. Third-party relationships can include, but are not limited to, outsourced services, use of independent consultants, referral arrangements, merchant payment processing services, services provided by affiliates and subsidiaries, and joint ventures. Some banking organizations may form third-party relationships with new or novel structures and features—such as those observed in relationships with some financial technology (fintech) companies. The respective roles and responsibilities of a banking organization and a third party may differ, based on the specific circumstances of the relationship. Where the third-party relationship involves the provision of products or services to, or other interaction with, customers, the banking organization and the third party may have varying degrees of interaction with those customers.

The use of third parties can offer banking organizations significant benefits, such as access to new technologies, human capital, delivery channels, products, services, and markets. However, the use of third parties can reduce a banking organization's direct control over activities and may introduce new risks or increase existing risks, such as operational, compliance, and strategic risks. Increased risk often arises from greater operational or technological complexity, newer or different types of relationships, or potential inferior performance by the third party. A banking organization can be exposed to adverse impacts, including substantial financial loss and operational disruption, if it fails to appropriately manage the risks associated with third-party relationships. Therefore, it is important for a banking organization to identify, assess, monitor, and control risks related to third-party relationships.

The principles set forth in this guidance can support effective third-party risk management for all types of third-party relationships, regardless of how they may be structured. It is important for a banking organization to understand how the arrangement with a particular third party is structured so that the banking organization may assess the types and levels of risks posed and determine how to manage the third-party relationship accordingly.

### *B. Risk Management*

Not all relationships present the same level of risk, and therefore not all relationships require the same level or type of oversight or risk management. As part of sound risk management, a banking organization analyzes the risks associated with each third-party relationship and tailors risk management practices, commensurate with the banking organization's size, complexity, and risk profile and with the nature of the third-party relationship. Maintaining a complete inventory of its third-party relationships and periodically conducting risk assessments for each third-party relationship supports a banking organization's determination of whether risks have changed over time and to update risk management practices accordingly.

As part of sound risk management, banking organizations engage in more comprehensive and rigorous oversight and management of third-party relationships that support higher-risk activities, including critical activities. Characteristics of critical activities may include those activities that could:

- Cause a banking organization to face significant risk if the third party fails to meet expectations;
- Have significant customer impacts; or
- Have a significant impact on a banking organization's financial condition or operations.

It is up to each banking organization to identify its critical activities and third-party relationships that support these critical activities. Notably, an activity that is critical for one banking organization may not be critical for another. Some banking organizations may assign a criticality or risk level to each third-party relationship, whereas others identify critical activities and those third parties that support such activities. Regardless of a banking organization's approach, a key element

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[21] 5 CFR 1320.3(b)(2).

[1] For a description of the banking organizations supervised by each agency, refer to the definition of "appropriate Federal banking agency" in section 3(q) of the Federal Deposit Insurance Act (12 U.S.C. 1813(q)). This guidance is relevant to all banking organizations supervised by the agencies.

[2] Supervisory guidance does not have the force and effect of law and does not impose any new requirements on banking organizations. See 12 CFR 4, subpart F, appendix A (OCC); 12 CFR 262, appendix A (FRB) 12 CFR 302, appendix A (FDIC).

[3] *See* 12 U.S.C. 1831p–1. The agencies implemented section 1831p–1 by regulation through the "Interagency Guidelines Establishing Standards for Safety and Soundness." *See* 12 CFR part 30, appendix A (OCC), 12 CFR part 208, appendix D–1 (Board); and 12 CFR part 364, appendix A (FDIC).

[4] References to applicable laws and regulations throughout this guidance include but are not limited to those designed to protect consumers (such as fair lending laws and prohibitions against unfair, deceptive or abusive acts or practices) and those addressing financial crimes.

[5] This guidance is relevant for all third-party relationships, including situations in which a supervised banking organization provides services to another supervised banking organization.

[6] The term "business arrangement" is meant to be interpreted broadly and is synonymous with the term "third-party relationship."

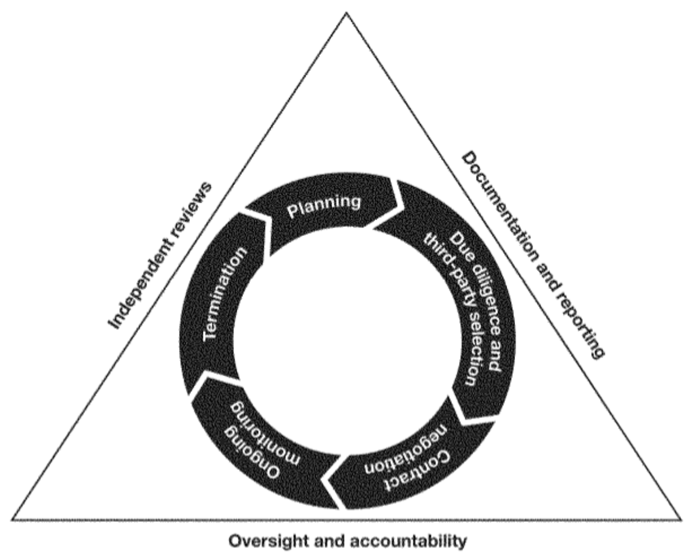
of effective risk management is applying a sound methodology to designate which activities and third-party relationships receive more comprehensive oversight.

*C. Third-Party Relationship Life Cycle*

Effective third-party risk management generally follows a continuous life cycle for third-party relationships. The stages of the risk management life cycle of third-party relationships are shown in Figure 1 and detailed below. The degree to which the examples of considerations discussed in this guidance are relevant to each banking organization is based on specific facts and circumstances and these examples may not apply to all of a banking organization's third-party relationships.

It is important to involve staff with the requisite knowledge and skills in each stage of the risk management life cycle. A banking organization may involve experts across disciplines, such as compliance, risk, or technology, as well as legal counsel, and may engage external support when helpful to supplement the qualifications and technical expertise of in-house staff.[7]

**Figure 1: Stages of the Risk Management Life Cycle**




Source: Board, FDIC, and OCC

1. Planning

As part of sound risk management, effective planning allows a banking organization to evaluate and consider how to manage risks before entering into a third-party relationship. Certain third parties, such as those that support a banking organization's higher-risk activities, including critical activities, typically warrant a greater degree of planning and consideration. For example, when critical activities are involved, plans may be presented to and approved by a banking organization's board of directors (or a designated board committee).

Depending on the degree of risk and complexity of the third-party relationship, a banking organization typically considers the following factors, among others, in planning:

- Understanding the strategic purpose of the business arrangement and how the arrangement aligns with a banking organization's overall strategic goals, objectives, risk appetite, risk profile, and broader corporate policies;
- Identifying and assessing the benefits and the risks associated with the business arrangement and determining how to appropriately manage the identified risks;
- Considering the nature of the business arrangement, such as volume of activity, use of subcontractor(s), technology needed, interaction with customers, and use of foreign-based third parties;[8]
- Evaluating the estimated costs, including estimated direct contractual costs and indirect costs expended to augment or alter banking organization staffing, systems, processes, and technology;
- Evaluating how the third-party relationship could affect banking organization employees, including dual

[7] When a banking organization uses a third-party assessment service or utility, it has a business arrangement with that entity. Therefore, the arrangement should be incorporated into the banking organization's third-party risk management processes.

[8] The term "foreign-based third-party" refers to third parties whose servicing operations are located in a foreign country and subject to the law and jurisdiction of that country. Accordingly, this term does not include a U.S.-based subsidiary of a foreign firm because its servicing operations are subject to U.S. laws. This term does include U.S. third parties to the extent that their actual servicing operations are located in or subcontracted to entities domiciled in a foreign country and subject to the law and jurisdiction of that country.

employees,[9] and what transition steps are needed for the banking organization to manage the impacts when activities currently conducted internally are outsourced;

- Assessing a potential third party's impact on customers, including access to or use of those customers' information, third-party interaction with customers, potential for consumer harm, and handling of customer complaints and inquiries;
- Understanding potential information security implications, including access to the banking organization's systems and to its confidential information;
- Understanding potential physical security implications, including access to the banking organization's facilities;
- Determining how the banking organization will select, assess, and oversee the third party, including monitoring the third party's compliance with applicable laws, regulations, and contractual provisions, and requiring remediation of compliance issues that may arise;
- Determining the banking organization's ability to provide adequate oversight and management of the proposed third-party relationship on an ongoing basis (including whether staffing levels and expertise, risk management and compliance management systems, organizational structure, policies and procedures, or internal control systems need to be adapted over time for the banking organization to effectively address the business arrangement); and
- Outlining the banking organization's contingency plans in the event the banking organization needs to transition the activity to another third party or bring it in-house.

2. Due Diligence and Third-Party Selection

Conducting due diligence on third parties before selecting and entering into third-party relationships is an important part of sound risk management. It provides management with the information needed about potential third parties to determine if a relationship would help achieve a banking organization's strategic and financial goals. The due diligence process also provides the banking organization with the information needed to evaluate whether it can appropriately identify, monitor, and control risks associated with the particular third-party relationship. Due diligence includes assessing the third party's ability to: perform the activity as expected, adhere to a banking organization's policies related to the activity, comply with all applicable laws and regulations, and conduct the activity in a safe and sound manner. Relying solely on experience with or prior knowledge of a third party is not an adequate proxy for performing appropriate due diligence, as due diligence should be tailored to the specific activity to be performed by the third party.

The scope and degree of due diligence should be commensurate with the level of risk and complexity of the third-party relationship. More comprehensive due diligence is particularly important when a third party supports higher-risk activities, including critical activities. If a banking organization uncovers information that warrants additional scrutiny, the banking organization should consider broadening the scope or assessment methods of the due diligence.

In some instances, a banking organization may not be able to obtain the desired due diligence information from a third party. For example, the third party may not have a long operational history, may not allow on-site visits, or may not share (or be permitted to share) information that a banking organization requests. While the methods and scope of due diligence may differ, it is important for the banking organization to identify and document any limitations of its due diligence, understand the risks from such limitations, and consider alternatives as to how to mitigate the risks. In such situations, a banking organization may, for example, obtain alternative information to assess the third party, implement additional controls on or monitoring of the third party to address the information limitation, or consider using a different third party.

A banking organization may use the services of industry utilities or consortiums, consult with other organizations,[10] or engage in joint efforts to supplement its due diligence. As the activity to be performed by the third party may present a different level of risk to each banking organization, it is important to evaluate the conclusions from such supplemental efforts based on the banking organization's own specific circumstances and performance criteria for the activity. Effective risk management processes include evaluating the capabilities of any external party conducting the supplemental efforts, understanding how such supplemental efforts relate to the banking organization's planned use of the third party, and assessing the risks of relying on the supplemental efforts. Use of such external parties to conduct supplemental due diligence does not abrogate the responsibility of the banking organization to manage third-party relationships in a safe and sound manner and consistent with applicable laws and regulations.

Depending on the degree of risk and complexity of the third-party relationship, a banking organization typically considers the following factors, among others, as part of due diligence:

a. Strategies and Goals

A review of the third party's overall business strategy and goals helps the banking organization to understand: (1) how the third party's current and proposed strategic business arrangements (such as mergers, acquisitions, and partnerships) may affect the activity; and (2) the third party's service philosophies, quality initiatives, and employment policies and practices (including its diversity policies and practices). Such information may assist a banking organization to determine whether the third party can perform the activity in a manner that is consistent with the banking organization's broader corporate policies and practices.

b. Legal and Regulatory Compliance

A review of any legal and regulatory compliance considerations associated with engaging a third party allows a banking organization to evaluate whether it can appropriately mitigate risks associated with the third-party relationship. This may include (1) evaluating the third party's ownership structure (including identifying any beneficial ownership, whether public or private, foreign, or domestic ownership) and whether the third party has the necessary legal authority to perform the activity, such as any necessary licenses or corporate powers; (2) determining whether the third party itself or any owners are subject to sanctions by the Office of Foreign Assets Control; (3) determining whether the third party has the expertise, processes, and controls to enable the banking organization to remain in compliance with applicable domestic and international laws and

[9] Dual employees are employed by both the banking organization and the third party.

[10] Any collaborative activities among banks must comply with antitrust laws. Refer to the Federal Trade Commission and U.S. Department of Justice's "Antitrust Guidelines for Collaborations Among Competitors" (April 2000), available at *https://www.ftc.gov/sites/default/files/documents/public_events/joint-venture-hearings-antitrust-guidelines-collaboration-among-competitors/ftcdojguidelines-2.pdf.*

regulations; (4) considering the third party's responsiveness to any compliance issues (including violations of law or regulatory actions) with applicable supervisory agencies and self-regulatory organizations, as appropriate; and (5) considering whether the third party has identified, and articulated a process to mitigate, areas of potential consumer harm.

c. Financial Condition

An assessment of a third party's financial condition through review of available financial information, including audited financial statements, annual reports, and filings with the U.S. Securities and Exchange Commission (SEC), among others, helps a banking organization evaluate whether the third party has the financial capability and stability to perform the activity. Where relevant and available, a banking organization may consider other types of information such as access to funds, expected growth, earnings, pending litigation, unfunded liabilities, reports from debt rating agencies, and other factors that may affect the third party's overall financial condition.

d. Business Experience

An evaluation of a third party's: (1) depth of resources (including staffing); (2) previous experience in performing the activity; and (3) history of addressing customer complaints or litigation and subsequent outcomes, helps to inform a banking organization's assessment of the third party's ability to perform the activity effectively. Another consideration may include whether there have been significant changes in the activities offered or in its business model. Likewise, a review of the third party's websites, marketing materials, and other information related to banking products or services may help determine if statements and assertions accurately represent the activities and capabilities of the third party.

e. Qualifications and Backgrounds of Key Personnel and Other Human Resources Considerations

An evaluation of the qualifications and experience of a third party's principals and other key personnel related to the activity to be performed provides insight into the capabilities of the third party to successfully perform the activities. An important consideration is whether the third party and the banking organization, as appropriate, periodically conduct background checks on the third party's key personnel and contractors who may have access to information technology systems or confidential information. Another important consideration is whether there are procedures in place for identifying and removing the third party's employees who do not meet minimum suitability requirements or are otherwise barred from working in the financial services sector. Another consideration is whether the third party has training to ensure that its employees understand their duties and responsibilities and are knowledgeable about applicable laws and regulations as well as other factors that could affect performance or pose risk to the banking organization. Finally, an evaluation of the third party's succession and redundancy planning for key personnel, and of the third party's processes for holding employees accountable for compliance with policies and procedures, provides valuable information to the banking organization.

f. Risk Management

Appropriate due diligence includes an evaluation of the effectiveness of a third party's overall risk management, including policies, processes, and internal controls, and alignment with applicable policies and expectations of the banking organization surrounding the activity. This would include an assessment of the third party's governance processes, such as the establishment of clear roles, responsibilities, and segregation of duties pertaining to the activity. It is also important to consider whether the third party's controls and operations are subject to effective audit assessments, including independent testing and objective reporting of results and findings. Banking organizations also gain important insight by evaluating processes for escalating, remediating, and holding management accountable for concerns identified during audits, internal compliance reviews, or other independent tests, if available. When relevant and available, a banking organization may consider reviewing System and Organization Control (SOC) reports and any conformity assessment or certification by independent third parties related to relevant domestic or international standards.[11] In such cases, the banking organization may also consider whether the scope and the results of the SOC reports, certifications, or assessments are relevant to the activity to be performed or suggest that additional scrutiny of the third party or any of its contractors may be appropriate.

[11] For example, those of the National Institute of Standards and Technology, Accredited Standards Committee X9, and the International Standards Organization.

g. Information Security

Understanding potential information security implications, including access to a banking organization's systems and information, can help a banking organization decide whether or not to engage with a third party. Due diligence in this area typically involves assessing the third party's information security program, including its consistency with the banking organization's information security program, such as its approach to protecting the confidentiality, integrity, and availability of the banking organization's data. It may also involve determining whether there are any gaps that present risk to the banking organization or its customers and considering the extent to which the third party applies controls to limit access to the banking organization's data and transactions, such as multifactor authentication, end-to-end encryption, and secure source code management. It also aids a banking organization when determining whether the third party keeps informed of, and has sufficient experience in identifying, assessing, and mitigating, known and emerging threats and vulnerabilities. As applicable, assessing the third party's data, infrastructure, and application security programs, including the software development life cycle and results of vulnerability and penetration tests, can provide valuable information regarding information technology system vulnerabilities. Finally, due diligence can help a banking organization evaluate the third party's implementation of effective and sustainable corrective actions to address any deficiencies discovered during testing.

h. Management of Information Systems

It is important to review and understand the third party's business processes and information systems that will be used to support the activity. When technology is a major component of the third-party relationship, an effective practice is to review both the banking organization's and the third party's information systems to identify gaps in service-level expectations, business process and management, and interoperability issues. It is also important to review the third party's processes for maintaining timely and accurate inventories of its technology and its contractor(s). A banking organization also benefits from understanding the third party's measures for assessing the performance of its information systems.

i. Operational Resilience

An assessment of a third party's operational resilience practices supports a banking organization's evaluation of a third party's ability to effectively operate through and recover from any disruption or incidents, both internal and external.[12] Such an assessment is particularly important where the impact of such disruption could have an adverse effect on the banking organization or its customers, including when the third party interacts with customers. It is important to assess options to employ if the third party's ability to perform the activity is impaired and to determine whether the third party maintains appropriate operational resilience and cybersecurity practices, including disaster recovery and business continuity plans that specify the time frame to resume activities and recover data. To gain additional insight into a third party's resilience capabilities, a banking organization may review (1) the results of operational resilience and business continuity testing and performance during actual disruptions; (2) the third party's telecommunications redundancy and resilience plans; and (3) preparations for known and emerging threats and vulnerabilities, such as wide-scale natural disasters, pandemics, distributed denial of service attacks, or other intentional or unintentional events. Other considerations related to operational resilience include (1) dependency on a single provider for multiple activities; and (2) interoperability or potential end of life issues with the software programming language, computer platform, or data storage technologies used by the third party.

j. Incident Reporting and Management Processes

Review and consideration of a third party's incident reporting and management processes is helpful to determine whether there are clearly documented processes, timelines, and accountability for identifying, reporting, investigating, and escalating incidents. Such review assists in confirming that the third party's escalation and notification processes meet the banking organization's expectations and regulatory requirements.[13]

k. Physical Security

It is important to evaluate whether the third party has sufficient physical and environmental controls to protect the safety and security of people (such as employees and customers), its facilities, technology systems, and data, as applicable. This would typically include a review of the third party's employee on- and off-boarding procedures to ensure that physical access rights are managed appropriately.

l. Reliance on Subcontractors[14]

An evaluation of the volume and types of subcontracted activities and the degree to which the third party relies on subcontractors helps inform whether such subcontracting arrangements pose additional or heightened risk to a banking organization. This typically includes an assessment of the third party's ability to identify, manage, and mitigate risks associated with subcontracting, including how the third party selects and oversees its subcontractors and ensures that its subcontractors implement effective controls. Other important considerations include whether additional risk is presented by the geographic location of a subcontractor or dependency on a single provider for multiple activities.

m. Insurance Coverage

An evaluation of whether the third party has existing insurance coverage helps a banking organization determine the extent to which potential losses are mitigated, including losses posed by the third party to the banking organization or that might prevent the third party from fulfilling its obligations to the banking organization. Such losses may be attributable to dishonest or negligent acts; fire, floods, or other natural disasters; loss of data; and other matters. Examples of insurance coverage may include fidelity bond; liability; property hazard and casualty; and areas that may not be covered under a general commercial policy, such as cybersecurity or intellectual property.

n. Contractual Arrangements With Other Parties

A third party's commitments to other parties may introduce potential legal, financial, or operational implications to the banking organization. Therefore, it is important to obtain and evaluate information regarding the third party's legally binding arrangements with subcontractors or other parties to determine whether such arrangements may create or transfer risks to the banking organization or its customers.

3. Contract Negotiation

When evaluating whether to enter into a relationship with a third party, a banking organization typically determines whether a written contract is needed, and if the proposed contract can meet the banking organization's business goals and risk management needs. After such determination, a banking organization typically negotiates contract provisions that will facilitate effective risk management and oversight and that specify the expectations and obligations of both the banking organization and the third party. A banking organization may tailor the level of detail and comprehensiveness of such contract provisions based on the risk and complexity posed by the particular third-party relationship.

While third parties may initially offer a standard contract, a banking organization may seek to request modifications, additional contract provisions, or addendums to satisfy its needs. In difficult contract negotiations, including when a banking organization has limited negotiating power, it is important for the banking organization to understand any resulting limitations and consequent risks. Possible actions that a banking organization might take in such circumstances include determining whether the contract can still meet the banking organization's needs, whether the contract would result in increased risk to the banking organization, and whether residual risks are acceptable. If the contract is unacceptable for the banking organization, it may consider other approaches, such as employing other third parties or conducting the activity in-house. In certain circumstances, banking organizations may gain an advantage by negotiating contracts as a group with other organizations.

It is important that a banking organization understand the benefits and risks associated with engaging third parties and particularly before executing contracts involving higher-risk activities, including critical activities. As part of its oversight responsibilities, the board of directors should be aware of and, as appropriate, may approve or delegate approval of contracts involving higher-risk activities. Legal counsel review may also be warranted prior to finalization.

Periodic reviews of executed contracts allow a banking organization to confirm that existing provisions continue to address pertinent risk controls and legal

[12] Disruptive events could include technology-based failures, human error, cyber incidents, pandemic outbreaks, and natural disasters.

[13] For example, regulatory requirements regarding incident notification include the FBAs' "Computer Security Incident Notification Rule." *See* 12 CFR 53 (OCC); 12 CFR 225, subpart N (Board); 12 CFR 304, subpart C (FDIC).

[14] Third parties may enlist the help of suppliers, service providers, or other organizations, which this guidance collectively refers to as subcontractors.

protections. If new risks are identified, a banking organization may consider renegotiating a contract.

Depending on the degree of risk and complexity of the third-party relationship, a banking organization typically considers the following factors, among others, during contract negotiations:

a. Nature and Scope of Arrangement

In negotiating a contract, it is helpful for a banking organization to clearly identify the rights and responsibilities of each party. This typically includes specifying the nature and scope of the business arrangement. Additional considerations may also include, as applicable, a description of (1) ancillary services such as software or other technology support, maintenance, and customer service; (2) the activities the third party will perform; and (3) the terms governing the use of the banking organization's information, facilities, personnel, systems, intellectual property, and equipment, as well as access to and use of the banking organization's or customers' information. If dual employees will be used, it may also be helpful to specify their responsibilities and reporting lines. It is also important for a banking organization to understand how changes in business and other circumstances may give rise to the third party's rights to terminate or renegotiate the contract.

b. Performance Measures or Benchmarks

For certain relationships, clearly defined performance measures can assist a banking organization in evaluating the performance of a third party. In particular, a service-level agreement between the banking organization and the third party can help specify the measures surrounding the expectations and responsibilities for both parties, including conformance with policies and procedures and compliance with applicable laws and regulations. Such measures can be used to monitor performance, penalize poor performance, or reward outstanding performance. It is important to negotiate performance measures that do not incentivize imprudent performance or behavior, such as encouraging processing volume or speed without regard for accuracy, compliance requirements, or adverse effects on the banking organization or customers.

c. Responsibilities for Providing, Receiving, and Retaining Information

It is important to consider contract provisions that specify the third party's obligation for retention and provision of timely, accurate, and comprehensive information to allow the banking organization to monitor risks and performance and to comply with applicable laws and regulations. Such provisions typically address:

- The banking organization's ability to access its data in an appropriate and timely manner;
- The banking organization's access to, or use of, the third-party's data and any supporting documentation, in connection with the business arrangement;
- The banking organization's access to, or use of, its own or the third-party's data and how such data and supporting documentation may be shared with regulators in a timely manner as part of the supervisory process;
- Whether the third party is permitted to resell, assign, or permit access to customer data, or the banking organization's data, metadata, and systems, to other entities;
- Notification to the banking organization whenever compliance lapses, enforcement actions, regulatory proceedings, or other events pose a significant risk to the banking organization or customers;
- Notification to the banking organization of significant strategic or operational changes, such as mergers, acquisitions, divestitures, use of subcontractors, key personnel changes, or other business initiatives that could affect the activities involved; and
- Specification of the type and frequency of reports to be received from the third party, as appropriate. This may include performance reports, financial reports, security reports, and control assessments.

d. The Right To Audit and Require Remediation

To help ensure that a banking organization has the ability to monitor the performance of a third party, a contract often establishes the banking organization's right to audit and provides for remediation when issues are identified. Generally, a contract includes provisions for periodic, independent audits of the third party and its relevant subcontractors, consistent with the risk and complexity of the third-party relationship. Therefore, it would be appropriate to consider whether contract provisions describe the types and frequency of audit reports the banking organization is entitled to receive from the third party (for example, SOC reports, Payment Card Industry (PCI) compliance reports, or other financial and operational reviews). Such contract provisions may also reserve the banking organization's right to conduct its own audits of the third party's activities or to engage an independent party to perform such audits.

e. Responsibility for Compliance With Applicable Laws and Regulations

A banking organization is responsible for conducting its activities in compliance with applicable laws and regulations, including those activities involving third parties. The use of third parties does not abrogate these responsibilities. Therefore, it is important for a contract to specify the obligations of the third party and the banking organization to comply with applicable laws and regulations. It is also important for the contract to provide the banking organization with the right to monitor and be informed about the third party's compliance with applicable laws and regulations, and to require timely remediation if issues arise. Contracts may also reflect considerations of relevant guidance and self-regulatory standards, where applicable.

f. Costs and Compensation

Contracts that clearly describe all costs and compensation arrangements help reduce misunderstandings and disputes over billing and help ensure that all compensation arrangements are consistent with sound banking practices and applicable laws and regulations. Contracts commonly describe compensation and fees, including cost schedules, calculations for base services, and any fees based on volume of activity and for special requests. Contracts also may specify the conditions under which the cost structure may be changed, including limits on any cost increases. During negotiations, a banking organization should confirm that a contract does not include incentives that promote inappropriate risk taking by the banking organization or the third party. A banking organization should also consider whether the contract includes burdensome upfront or termination fees, or provisions that may require the banking organization to reimburse the third party. Appropriate provisions indicate which party is responsible for payment of legal, audit, and examination fees associated with the activities involved. Another consideration is outlining cost and responsibility for purchasing and maintaining hardware and software, where applicable.

g. Ownership and License

In order to prevent disputes between the parties regarding the ownership and licensing of a banking organization's property, it is common for a contract to state the extent to which the third party has the right to use the banking organization's information, technology, and intellectual property, such as the banking organization's name, logo, trademark, and copyrighted material. Provisions that indicate whether any data generated by the third party become the banking organization's property help avert misunderstandings. It is also important to include appropriate warranties on the part of the third party related to its acquisition of licenses or subscriptions for use of any intellectual property developed by other third parties. When the banking organization purchases software, it is important to consider a provision to establish escrow agreements to provide for the banking organization's access to source code and programs under certain conditions (for example, insolvency of the third party).

h. Confidentiality and Integrity

With respect to contracts with third parties, there may be increased risks related to the sensitivity of non-public information or access to infrastructure. Effective contracts typically prohibit the use and disclosure of banking organization and customer information by a third party and its subcontractors, except as necessary to provide the contracted activities or comply with legal requirements. If the third party receives personally identifiable information, contract provisions are important to ensure that the third party implements and maintains appropriate security measures to comply with applicable laws and regulations.

Another important provision is one that specifies when and how the third party will disclose, in a timely manner, information security breaches or unauthorized intrusions. Considerations may include the types of data stored by the third party, legal obligations for the banking organization to disclose the breach to its regulators or customers, the potential for consumer harm, or other factors. Such provisions typically stipulate that the data intrusion notification to the banking organization include estimates of the effects on the banking organization and its customers and specify corrective action to be taken by the third party. They also address the powers of each party to change security and risk management procedures and requirements and resolve any confidentiality and integrity issues arising out of shared use of facilities owned by the third party. Typically, such provisions stipulate whether and how often the banking organization and the third party will jointly practice incident management exercises involving unauthorized intrusions or other breaches of confidentiality and integrity.

i. Operational Resilience and Business Continuity

Both internal and external factors or incidents (for example, natural disasters or cyber incidents) may affect a banking organization or a third party and thereby disrupt the third party's performance of the activity. Consequently, an effective contract provides for continuation of the activity in the event of problems affecting the third party's operations, including degradations or interruptions in delivery. As such, it is important for the contract to address the third party's responsibility for appropriate controls to support operational resilience of the services, such as protecting and storing programs, backing up datasets, addressing cybersecurity issues, and maintaining current and sound business resumption and business continuity plans.

To help ensure maintenance of operations, contracts often require the third party to provide the banking organization with operating procedures to be carried out in the event business continuity plans are implemented, including specific recovery time and recovery point objectives. Contracts may also stipulate whether and how often the banking organization and the third party will jointly test business continuity plans. Another consideration is whether the contract provides for the transfer of the banking organization's accounts, data, or activities to another third party without penalty in the event of the third party's bankruptcy, business failure, or business interruption.

j. Indemnification and Limits on Liability

Incorporating indemnification provisions into a contract may reduce the potential for a banking organization to be held liable for claims and be reimbursed for damages arising from a third party's misconduct, including negligence and violations of laws and regulations. As such, it is important to consider whether indemnification clauses specify the extent to which the banking organization will be held liable for claims or be reimbursed for damages based on the failure of the third party or its subcontractor to perform, including failure of the third party to obtain any necessary intellectual property licenses. Such consideration typically includes an assessment of whether any limits on liability are in proportion to the amount of loss the banking organization might experience as a result of third-party failures, or whether indemnification clauses require the banking organization to hold the third party harmless from liability.

k. Insurance

One way in which a banking organization can protect itself against losses caused by or related to a third party and the products and services provided through third-party relationships is by including insurance requirements in a contract. These provisions typically require the third party to (1) maintain specified types and amounts of insurance (including, if appropriate, naming the banking organization as insured or additional insured); (2) notify the banking organization of material changes to coverage; and (3) provide evidence of coverage, as appropriate. The type and amount of insurance coverage should be commensurate with the risk of possible losses, including those caused by the third party to the banking organization or that might prevent the third party from fulfilling its obligations to the banking organization, and the activities performed.

l. Dispute Resolution

Disputes regarding a contract can delay or otherwise have an adverse impact upon the activities performed by a third party, which may negatively affect the banking organization. Therefore, a banking organization may want to consider whether the contract should establish a dispute resolution process to resolve problems between the banking organization and the third party in an expeditious manner, and whether the third party should continue to provide activities to the banking organization during the dispute resolution period. It is important to also understand whether the contract contains provisions that may impact the banking organization's ability to resolve disputes in a satisfactory manner, such as provisions addressing arbitration or forum selection.

m. Customer Complaints

Where customer interaction is an important aspect of the third-party relationship, a banking organization may find it useful to include a contract provision to ensure that customer complaints and inquiries are handled properly. Effective contracts typically specify whether the banking organization or the third party is responsible for responding to customer complaints or inquiries. If it is the third party's responsibility, it is important to include provisions for the third party to receive and respond to customer complaints and inquiries in a timely manner and to provide the banking organization with sufficient, timely, and usable information to analyze customer complaint and inquiry activity and associated trends. If it is the banking organization's responsibility, it is important to include provisions for the banking organization to receive prompt notification from the third party of any complaints or inquiries received by the third party.

n. Subcontracting

Third-party relationships may involve subcontracting arrangements, which can result in risk due to the absence of a direct relationship between the banking organization and the subcontractor, further lessening the banking organization's direct control of activities. The impact on a banking organization's ability to assess and control risks may be especially important if the banking organization uses third parties for higher-risk activities, including critical activities. For this reason, a banking organization may want to address when and how the third party should notify the banking organization of its use or intent to use a subcontractor and whether specific subcontractors are prohibited by the banking organization. Another important consideration is whether the contract should prohibit assignment, transfer, or subcontracting of the third party's obligations to another entity without the banking organization's consent. Where subcontracting is integral to the activity being performed for the banking organization, it is important to consider more detailed contractual obligations, such as reporting on the subcontractor's conformance with performance measures, periodic audit results, and compliance with laws and regulations. Where appropriate, a banking organization may consider including a provision that states the third party's liability for activities or actions by its subcontractors and which party is responsible for the costs and resources required for any additional monitoring and management of the subcontractors. It may also be appropriate to reserve the right to terminate the contract without penalty if the third party's subcontracting arrangements do not comply with contractual obligations.

o. Foreign-Based Third Parties

In contracts with foreign-based third parties, it is important to consider choice-of-law and jurisdictional provisions that provide dispute adjudication under the laws of a single jurisdiction, whether in the United States or elsewhere. When engaging with foreign-based third parties, or where contracts include a choice-of-law provision that includes a jurisdiction other than the United States, it is important to understand that such contracts and covenants may be subject to the interpretation of foreign courts relying on laws in those jurisdictions. It may be warranted to seek legal advice on the enforceability of the proposed contract with a foreign-based third party and other legal ramifications, including privacy laws and cross-border flow of information.

p. Default and Termination

Contracts can protect the ability of the banking organization to change third parties when appropriate without undue restrictions, limitations, or cost. An effective contract stipulates what constitutes default, identifies remedies, allows opportunities to cure defaults, and establishes the circumstances and responsibilities for termination. Therefore, it is important to consider including contractual provisions that:

• Provide termination and notification requirements with reasonable time frames to allow for the orderly transition of the activity, when desired or necessary, without prohibitive expense;
• Provide for the timely return or destruction of the banking organization's data, information, and other resources;
• Assign all costs and obligations associated with transition and termination; and
• Enable the banking organization to terminate the relationship with reasonable notice and without penalty, if formally directed by the banking organization's primary federal banking regulator.

q. Regulatory Supervision

For relevant third-party relationships, it is important for contracts to stipulate that the performance of activities by third parties for the banking organization is subject to regulatory examination and oversight, including appropriate retention of, and access to, all relevant documentation and other materials.[15] This can help ensure that a third party is aware of its role and potential liability in its relationship with a banking organization.

4. Ongoing Monitoring

Ongoing monitoring enables a banking organization to: (1) confirm the quality and sustainability of a third party's controls and ability to meet contractual obligations; (2) escalate significant issues or concerns, such as material or repeat audit findings, deterioration in financial condition, security breaches, data loss, service interruptions, compliance lapses, or other indicators of increased risk; and (3) respond to such significant issues or concerns when identified.

Effective third-party risk management includes ongoing monitoring throughout the duration of a third-party relationship, commensurate with the level of risk and complexity of the relationship and the activity performed by the third party. Ongoing monitoring may be conducted on a periodic or continuous basis, and more comprehensive or frequent monitoring is appropriate when a third-party relationship supports higher-risk activities, including critical activities. Because both the level and types of risks may change over the lifetime of third-party relationships, banking organizations may adapt their ongoing monitoring practices accordingly, including changes to the frequency or type of information used in monitoring.

Typical monitoring activities include: (1) review of reports regarding the third party's performance and the effectiveness of its controls; (2) periodic visits and meetings with third-party representatives to discuss performance and operational issues; and (3) regular testing of the banking organization's controls that manage risks from its third-party relationships, particularly when supporting higher-risk activities, including critical activities. In certain circumstances, based on risk, a banking organization may also perform direct testing of the third party's own controls. To gain efficiencies or leverage specialized expertise, banking organizations may engage external resources, refer to conformity assessments or certifications, or collaborate when performing ongoing monitoring.[16] To support effective monitoring, a banking organization dedicates sufficient staffing with the necessary expertise, authority, and accountability to perform a range of ongoing monitoring activities, such as those described above.

Depending on the degree of risk and complexity of the third-party relationship, a banking organization typically considers the following factors, among others, as part of ongoing monitoring:

[15] *See* 12 U.S.C. 1464(d)(7)(D) and 1867(c)(1).

[16] Refer to important considerations discussed in "Due Diligence and Third-Party Selection" of this guidance when a banking organization chooses to engage external resources to supplement its third-party risk management.

- The overall effectiveness of the third-party relationship, including its consistency with the banking organization's strategic goals, business objectives, risk appetite, risk profile, and broader corporate policies;
- Changes to the third party's business strategy and its agreements with other entities that may pose new or increased risks or impact the third party's ability to meet contractual obligations;
- Changes in the third party's financial condition, including its financial obligations to others;
- Changes to, or lapses in, the third party's insurance coverage;
- Relevant audits, testing results, and other reports that address whether the third party remains capable of managing risks and meeting contractual obligations and regulatory requirements;
- The third party's ongoing compliance with applicable laws and regulations and its performance as measured against contractual obligations;
- Changes in the third party's key personnel involved in the activity;
- The third party's reliance on, exposure to, and use of subcontractors, the location of subcontractors (and any related data), and the third party's own risk management processes for monitoring subcontractors;
- Training provided to employees of the banking organization and the third party;
- The third party's response to changing threats, new vulnerabilities, and incidents impacting the activity, including any resulting adjustments to the third party's operations or controls;
- The third party's ability to maintain the confidentiality, availability, and integrity of the banking organization's systems, information, and data, as well as customer data, where applicable;
- The third party's response to incidents, business continuity and resumption plans, and testing results to evaluate the third party's ability to respond to and recover from service disruptions or degradations;
- Factors and conditions external to the third party that could affect its performance and financial and operational standing, such as changing laws, regulations, and economic conditions; and
- The volume, nature, and trends of customer inquiries and complaints, the adequacy of the third party's responses (if responsible for handling customer inquiries or complaints), and any resulting remediation.

5. Termination

A banking organization may terminate a relationship for various reasons, such as expiration or breach of the contract, the third party's failure to comply with applicable laws or regulations, or a desire to seek an alternate third party, bring the activity in-house, or discontinue the activity. When this occurs, it is important for management to terminate relationships in an efficient manner, whether the activities are transitioned to another third party, brought in-house, or discontinued. Depending on the degree of risk and complexity of the third-party relationship, a banking organization typically considers the following factors, among others, to facilitate termination:

- Options for an effective transition of services, such as potential alternate third parties to perform the activity;
- Relevant capabilities, resources, and the time frame required to transition the activity to another third party or bring in-house while still managing legal, regulatory, customer, and other impacts that might arise;
- Costs and fees associated with termination;
- Managing risks associated with data retention and destruction, information system connections and access control, or other control concerns that require additional risk management and monitoring after the end of the third-party relationship;
- Handling of joint intellectual property; and
- Managing risks to the banking organization, including any impact on customers, if the termination happens as a result of the third party's inability to meet expectations.

*D. Governance*

There are a variety of ways for banking organizations to structure their third-party risk management processes. Some banking organizations disperse accountability for their third-party risk management processes among their business lines.[17] Other banking organizations may centralize the processes under their compliance, information security, procurement, or risk management functions. Regardless of how a banking organization structures its process, the following practices are typically considered throughout the third-party risk management life cycle,[18] commensurate with risk and complexity.

1. Oversight and Accountability

Proper oversight and accountability are important aspects of third-party risk management because they help enable a banking organization to minimize adverse financial, operational, or other consequences. A banking organization's board of directors has ultimate responsibility for providing oversight for third-party risk management and holding management accountable. The board also provides clear guidance regarding acceptable risk appetite, approves appropriate policies, and ensures that appropriate procedures and practices have been established. A banking organization's management is responsible for developing and implementing third-party risk management policies, procedures, and practices, commensurate with the banking organization's risk appetite and the level of risk and complexity of its third-party relationships.

In carrying out its responsibilities, the board of directors (or a designated board committee) typically considers the following factors, among others:

- Whether third-party relationships are managed in a manner consistent with the banking organization's strategic goals and risk appetite and in compliance with applicable laws and regulations;
- Whether there is appropriate periodic reporting on the banking organization's third-party relationships, such as the results of management's planning, due diligence, contract negotiation, and ongoing monitoring activities; and
- Whether management has taken appropriate actions to remedy significant deterioration in performance or address changing risks or material issues identified, including through ongoing monitoring and independent reviews.

When carrying out its responsibilities, management typically performs the following activities, among others:

- Integrating third-party risk management with the banking organization's overall risk management processes;
- Directing planning, due diligence, and ongoing monitoring activities;
- Reporting periodically to the board (or designated committee), as appropriate, on third-party risk management activities;
- Providing that contracts with third parties are appropriately reviewed, approved, and executed;

[17] Each applicable business line can provide valuable input into the third-party risk management process, for example, by completing risk assessments, reviewing due diligence information, and evaluating the controls over the third-party relationship.

[18] Refer to Figure 1: Stages of the Risk Management Life Cycle.

• Establishing appropriate organizational structures and staffing (level and expertise) to support the banking organization's third-party risk management processes;

• Implementing and maintaining an appropriate system of internal controls to manage risks associated with third-party relationships;

• Assessing whether the banking organization's compliance management system is appropriate to the nature, size, complexity, and scope of its third-party relationships;

• Determining whether the banking organization has appropriate access to data and information from its third parties;

• Escalating significant issues to the board and monitoring any resulting remediation, including actions taken by the third party; and

• Terminating business arrangements with third parties when they do not meet expectations or no longer align with the banking organization's strategic goals, objectives, or risk appetite.

2. Independent Reviews

It is important for a banking organization to conduct periodic independent reviews to assess the adequacy of its third-party risk management processes. Such reviews typically consider the following factors, among others:

• Whether the third-party relationships align with the banking organization's business strategy, and with internal policies, procedures, and standards;

• Whether risks of third-party relationships are identified, measured, monitored, and controlled;

• Whether the banking organization's processes and controls are designed and operating adequately;

• Whether appropriate staffing and expertise are engaged to perform risk management activities throughout the third-party risk management life cycle, including involving multiple disciplines across the banking organization, as appropriate; and

• Whether conflicts of interest or appearances of conflicts of interest are avoided or eliminated when selecting or overseeing third parties.

A banking organization may use the results of independent reviews to determine whether and how to adjust its third-party risk management process, including its policies, reporting, resources, expertise, and controls. It is important that management respond promptly and thoroughly to issues or concerns identified and escalate them to the board, as appropriate.

3. Documentation and Reporting

It is important that a banking organization properly document and report on its third-party risk management process and specific third-party relationships throughout their life cycle. Documentation and reporting, key elements that assist those within or outside the banking organization who conduct control activities, will vary among banking organizations depending on the risk and complexity of their third-party relationships. Examples of processes that support effective documentation and internal reporting that the agencies have observed include, but are not limited to:

• A current inventory of all third-party relationships (and, as appropriate to the risk presented, related subcontractors) that clearly identifies those relationships associated with higher-risk activities, including critical activities;

• Planning and risk assessments related to the use of third parties;

• Due diligence results and recommendations;

• Executed contracts;

• Remediation plans and related reports addressing the quality and sustainability of the third party's controls;

• Risk and performance reports required and received from the third party as part of ongoing monitoring;

• If applicable, reports related to customer complaint and inquiry monitoring, and any subsequent remediation reports;

• Reports from third parties of service disruptions, security breaches, or other events that pose, or may pose, a material risk to the banking organization;

• Results of independent reviews; and

• Periodic reporting to the board (including, as applicable, dependency on a single provider for multiple activities).

*E. Supervisory Reviews of Third-Party Relationships*

The concepts discussed in this guidance are relevant for all third-party relationships and are provided to banking organizations to assist in the tailoring and implementation of risk management practices commensurate to each banking organization's size, complexity, risk profile, and the nature of its third-party relationships. Each agency will review its supervised banking organizations' risk management of third-party relationships as part of its standard supervisory processes. Supervisory reviews will evaluate risks and the effectiveness of risk management to determine whether activities are conducted in a safe and sound manner and in compliance with applicable laws and regulations.

In their evaluations of a banking organization's third-party risk management, examiners consider that banking organizations engage in a diverse set of third-party relationships, that not all third-party risk relationships present the same risks, and that banking organizations accordingly tailor their practices to the risks presented. Thus, the scope of the supervisory review depends on the degree of risk and the complexity associated with the banking organization's activities and third-party relationships. When reviewing third-party risk management processes, examiners typically conduct the following activities, among others:

• Assess the ability of the banking organization's management to oversee and manage the banking organization's third-party relationships;

• Assess the impact of third-party relationships on the banking organization's risk profile and key aspects of financial and operational performance, including compliance with applicable laws and regulations;

• Perform transaction testing or review results of testing to evaluate the activities performed by the third party and assess compliance with applicable laws and regulations;

• Highlight and discuss any material risks and deficiencies in the banking organization's risk management process with senior management and the board of directors as appropriate;

• Review the banking organization's plans for appropriate and sustainable remediation of any deficiencies, particularly those associated with the oversight of third parties that involve critical activities; and

• Consider supervisory findings when assigning the components of the applicable rating system and highlight any material risks and deficiencies in the Report of Examination.

When circumstances warrant, an agency may use its legal authority to examine functions or operations that a third party performs on a banking organization's behalf. Such examinations may evaluate the third party's ability to fulfill its obligations in a safe and sound manner and comply with applicable laws and regulations, including those designed to protect customers and to provide fair access to financial services. The agencies may pursue corrective measures, including enforcement actions, when necessary to address violations of laws and regulations or unsafe or unsound banking practices by the banking organization or its third party.

**Michael J. Hsu,**

*Acting Comptroller of the Currency.*

By order of the Board of Governors of the Federal Reserve System.

**Ann E. Misback,**

*Secretary of the Board.*

Federal Deposit Insurance Corporation.

Dated at Washington, DC, on June 1, 2023.

**James P. Sheesley,**

*Assistant Executive Secretary.*

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BILLING CODE 4810–33–P; 6210–01–P; 6714–01–P

## DEPARTMENT OF THE TREASURY

### Office of Foreign Assets Control

### Notice of OFAC Sanctions Action

**AGENCY:** Office of Foreign Assets Control, Treasury.

**ACTION:** Notice.

**SUMMARY:** The U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) is publishing the names of one or more persons that have been placed on OFAC's Specially Designated Nationals and Blocked Persons List (SDN List) based on OFAC's determination that one or more applicable legal criteria were satisfied. All property and interests in property subject to U.S. jurisdiction of these persons are blocked, and U.S. persons are generally prohibited from engaging in transactions with them.

**DATES:** See **SUPPLEMENTARY INFORMATION** section for applicable date(s).

**FOR FURTHER INFORMATION CONTACT:** OFAC: Andrea Gacki, Director, tel.: 202–622–2490; Associate Director for Global Targeting, tel.: 202–622–2420; Assistant Director for Licensing, tel.: 202–622–2480; Assistant Director for Regulatory Affairs, tel.: 202–622–4855; or Assistant Director for Enforcement, Compliance & Analysis, tel.: 202–622–2490.

**SUPPLEMENTARY INFORMATION:**

#### Electronic Availability

The Specially Designated Nationals and Blocked Persons List and additional information concerning OFAC sanctions programs are available on OFAC's website (*https://ofac.treasury.gov/*).

#### Notice of OFAC Action(s)

On June 6, 2023, OFAC determined that the property and interests in property subject to U.S. jurisdiction of the following persons are blocked under the relevant sanctions authority listed below.

#### Individuals

1. DAMGHANI, Davoud (a.k.a. DAMGHANI, Davood; a.k.a. DAMGHANI, Davud; a.k.a. DAMQANI, Davood; a.k.a. DAMQANI, Davoud), Beijing, China; DOB 14 Mar 1971; POB Tehran, Iran; nationality Iran; Additional Sanctions Information—Subject to Secondary Sanctions; Gender Male; Passport D10003642 (Iran) issued 30 Jun 2018 expires 30 Jun 2023; National ID No. 0053758110 (Iran) (individual) [NPWMD] [IFSR] (Linked To: MINISTRY OF DEFENSE AND ARMED FORCES LOGISTICS).

Designated pursuant to section 1(a)(iv) of Executive Order 13382 of June 28, 2005, ''Blocking Property of Weapons of Mass Destruction Proliferators and Their Supporters'' (''E.O. 13382''), 70 FR 38567, 3 CFR, 2005 Comp., p. 170, for acting or purporting to act for or on behalf of, directly or indirectly, MINISTRY OF DEFENSE AND ARMED FORCES LOGISTICS, a person whose property and interests in property are blocked pursuant to E.O. 13382.

2. GONG, Jiao, China; DOB 17 Feb 1995; POB Heibei, China; nationality China; Additional Sanctions Information—Subject to Secondary Sanctions; Gender Female; National ID No. 130321199502170121 (China) (individual) [NPWMD] [IFSR] (Linked To: WEI, Zunyi).

Designated pursuant to section 1(a)(iii) of E.O. 13382 for having provided, or attempted to provide, financial, material, technological or other support for, or goods or services in support of, WEI, Zunyi, a person whose property and interests in property are blocked pursuant to E.O. 13382.

3. HAGHIGHAT, Ghasem (a.k.a. ''GAO, Shan''), China; Iran; DOB 19 Jun 1961; nationality Iran; Additional Sanctions Information—Subject to Secondary Sanctions; Gender Male; Passport G9302650 (Iran) expires 04 Dec 2012; alt. Passport A0026483 (Iran) expires 25 Nov 2004 (individual) [NPWMD] [IFSR] (Linked To: BEIJING SHINY NIGHTS TECHNOLOGY DEVELOPMENT CO., LTD).

Designated pursuant to section 1(a)(iv) of E.O. 13382 for acting or purporting to act for or on behalf of, directly or indirectly, BEIJING SHINY NIGHTS TECHNOLOGY DEVELOPMENT CO., LTD, a person whose property and interests in property are blocked pursuant to E.O. 13382.

4. LI, Zeming, Zhejiang, China; DOB 22 May 1985; POB Zhejiang, China; nationality China; Additional Sanctions Information—Subject to Secondary Sanctions; Gender Male; Passport EE2360309 (China) issued 24 Aug 2018 expires 23 Aug 2028 (individual) [NPWMD] [IFSR] (Linked To: ZHEJIANG QINGJI IND. CO., LTD).

Designated pursuant to section 1(a)(iv) of E.O. 13382 for acting or purporting to act for or on behalf of, directly or indirectly, ZHEJIANG QINGJI IND. CO., LTD, a person whose property and interests in property are blocked pursuant to E.O. 13382.

5. QIN, Xutong, Ji Lin, China; DOB 29 Apr 1994; POB Ji Lin, China; nationality China; Additional Sanctions Information—Subject to Secondary Sanctions; Gender Female; Passport E77862399 (China) issued 19 Apr 2016 expires 18 Apr 2026 (individual) [NPWMD] [IFSR] (Linked To: HONG KONG KE.DO INTERNATIONAL TRADE CO., LIMITED).

Designated pursuant to section 1(a)(iv) of E.O. 13382 for acting or purporting to act for or on behalf of, directly or indirectly, HONG KONG KE.DO INTERNATIONAL TRADE CO., LIMITED, a person whose property and interests in property are blocked pursuant to E.O. 13382.

6. SHEN, Weisheng, Zhejiang, China; DOB 01 Nov 1957; POB Haimen, China; nationality China; Additional Sanctions Information—Subject to Secondary Sanctions; Gender Male; Passport G23381737 (China) issued 13 Jun 2007 expires 12 Jun 2017; National ID No. 330103195711011317 (China) (individual) [NPWMD] [IFSR] (Linked To: ZHEJIANG QINGJI IND. CO., LTD).

Designated pursuant to section 1(a)(iv) of E.O. 13382 for acting or purporting to act for or on behalf of, directly or indirectly, ZHEJIANG QINGJI IND. CO., LTD, a person whose property and interests in property are blocked pursuant to E.O. 13382.

7. WEI, Zunyi (a.k.a. WEI, Zun Yi; a.k.a. ''WEI, David''), Beijing, China; DOB 20 Dec 1975; POB Shandong, China; nationality China; Additional Sanctions Information—Subject to Secondary Sanctions; Gender Male; Passport EE1650028 (China) issued 28 Aug 2018 expires 27 Aug 2028; National ID No. 370922197512201811 (China) (individual) [NPWMD] [IFSR] (Linked To: HONG KONG KE.DO INTERNATIONAL TRADE CO., LIMITED).

Designated pursuant to section 1(a)(iv) of E.O. 13382 for acting or purporting to act for or on behalf of, directly or indirectly, HONG KONG KE.DO INTERNATIONAL TRADE CO., LIMITED, a person whose property and interests in property are blocked pursuant to E.O. 13382.

FDIC Federal Deposit Insurance Corporation

## FACT SHEET

**For Release**
Thursday, November 16, 2023

**Final Rule on Special Assessment Pursuant to Systemic Risk Determination**

The Federal Deposit Insurance Corporation (FDIC) Board of Directors approved a final rule to implement a special assessment to recover the loss to the Deposit Insurance Fund (DIF) associated with protecting uninsured depositors following the closures of Silicon Valley Bank and Signature Bank. The Federal Deposit Insurance Act (FDI Act) requires the FDIC to take this action in connection with the systemic risk determination announced on March 12, 2023.

- Under the final rule, the banks that benefited most from the assistance provided under the systemic risk determination will be charged a special assessment to recover losses to the DIF resulting from the protection of uninsured depositors. In general, large banks and regional banks, and particularly those with large amounts of uninsured deposits, were the banks most vulnerable to uninsured deposit runs and benefited most from the stability provided under the systemic risk determination.

- The FDIC estimates that 114 banking organizations will be subject to the special assessment, including 48 banking organizations with total assets over $50 billion and 66 banking organizations with total assets between $5 and $50 billion. **No banking organizations with total assets under $5 billion will pay a special assessment**, based on data for the December 31, 2022 reporting period.

- Currently, the FDIC estimates that of the total cost of the failures of Silicon Valley Bank and Signature Bank, **approximately $16.3 billion was attributable to the protection of uninsured depositors.** These loss estimates will be periodically adjusted as assets are sold, liabilities are satisfied, and receivership expenses are incurred.

- The special assessment will be collected at an **annual rate of approximately 13.4 basis points for an anticipated total of eight quarterly assessment periods**. Because the estimated loss pursuant to the systemic risk determination will be periodically adjusted, the FDIC retains the ability to cease collection early, impose an extended special assessment collection period after the initial eight-quarter collection period to collect the difference between losses and the amounts collected, and impose a one-time final shortfall special assessment after both receiverships terminate.

- The special assessment will be collected beginning with the **first quarterly assessment period of 2024** (i.e., January 1 through March 31, 2024) with an invoice payment date of June 28, 2024.

# Community Reinvestment Act Final Rule Fact Sheet

October 2023

The Community Reinvestment Act (CRA) became law in 1977 and remains one of the seminal pieces of legislation to address systemic inequities in access to credit. The CRA encourages banks to help meet the credit needs of their entire communities in which they do business, with a focus on low- and moderate-income (LMI) communities, consistent with safe and sound operations. The last comprehensive interagency revision to the CRA regulations occurred in 1995.

The final rule issued by the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency updates the CRA regulations to achieve the following key goals:

- **Encourage banks to expand access to credit, investment, and banking services in LMI communities.**

  Under the final rule, the agencies will evaluate bank performance across the varied activities they conduct and communities in which they operate so that the CRA continues to be a strong and effective tool to address inequities in access to credit and financial services. It promotes financial inclusion by supporting bank activities with Minority Depository Institutions and Community Development Financial Institutions and in Native Land Areas, persistent poverty areas, and other high-need areas.

- **Adapt to changes in the banking industry, including mobile and online banking.**

  The final rule will update the CRA regulations to evaluate lending outside traditional assessment areas generated by the growth of non-branch delivery systems, such as online and mobile banking, branchless banking, and hybrid models. It is calibrated to recognize the continued importance of bank branches, while establishing a framework to evaluate the digital delivery of banking products and services for certain banks.

- **Provide greater clarity and consistency in the application of the CRA regulations.**

  The final rule adopts a new metrics-based approach to evaluating bank retail lending and community development financing, using benchmarks based on peer and demographic data. The agencies will develop data tools using reported loan data that give banks and the public additional insight into performance standards. The final rule also clarifies eligible CRA activities, such as affordable housing, that are focused on LMI, underserved, native, and rural communities.

- **Tailor CRA evaluations and data collection to bank size and type.**

  The final rule recognizes differences in bank size and business models. For example, small banks will continue to be evaluated under the existing framework with the option to be evaluated under the new framework. The rule also exempts small and intermediate banks from new data requirements that apply to banks with assets of at least $2 billion and limits certain new data requirements to large banks with assets greater than $10 billion.

**Board of Governors of the Federal Reserve System**
**Federal Deposit Insurance Corporation**
**Office of the Comptroller of the Currency**

**January 3, 2023**

**Joint Statement on Crypto-Asset Risks to Banking Organizations**

The Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) (collectively, the agencies) are issuing the following statement on crypto-asset[1] risks to banking organizations.

The events of the past year have been marked by significant volatility and the exposure of vulnerabilities in the crypto-asset sector. These events highlight a number of key risks associated with crypto-assets and crypto-asset sector participants that banking organizations should be aware of, including:

- Risk of fraud and scams among crypto-asset sector participants.
- Legal uncertainties related to custody practices, redemptions, and ownership rights, some of which are currently the subject of legal processes and proceedings.
- Inaccurate or misleading representations and disclosures by crypto-asset companies, including misrepresentations regarding federal deposit insurance, and other practices that may be unfair, deceptive, or abusive, contributing to significant harm to retail and institutional investors, customers, and counterparties.
- Significant volatility in crypto-asset markets, the effects of which include potential impacts on deposit flows associated with crypto-asset companies.
- Susceptibility of stablecoins to run risk, creating potential deposit outflows for banking organizations that hold stablecoin reserves.
- Contagion risk within the crypto-asset sector resulting from interconnections among certain crypto-asset participants, including through opaque lending, investing, funding, service, and operational arrangements. These interconnections may also present concentration risks for banking organizations with exposures to the crypto-asset sector.
- Risk management and governance practices in the crypto-asset sector exhibiting a lack of maturity and robustness.
- Heightened risks associated with open, public, and/or decentralized networks, or similar systems, including, but not limited to, the lack of governance mechanisms establishing oversight of the system; the absence of contracts or standards to clearly establish roles, responsibilities, and liabilities; and vulnerabilities related to cyber-attacks, outages, lost or trapped assets, and illicit finance.

It is important that risks related to the crypto-asset sector that cannot be mitigated or controlled do not migrate to the banking system. The agencies are supervising banking organizations that may be exposed to risks stemming from the crypto-asset sector and carefully reviewing any

[1] By "crypto-asset," the agencies refer generally to any digital asset implemented using cryptographic techniques.

proposals from banking organizations to engage in activities that involve crypto-assets. Through the agencies' case-by-case approaches to date, the agencies continue to build knowledge, expertise, and understanding of the risks crypto-assets may pose to banking organizations, their customers, and the broader U.S. financial system. Given the significant risks highlighted by recent failures of several large crypto-asset companies, the agencies continue to take a careful and cautious approach related to current or proposed crypto-asset-related activities and exposures at each banking organization.

Banking organizations are neither prohibited nor discouraged from providing banking services to customers of any specific class or type, as permitted by law or regulation. The agencies are continuing to assess whether or how current and proposed crypto-asset-related activities by banking organizations can be conducted in a manner that adequately addresses safety and soundness, consumer protection, legal permissibility, and compliance with applicable laws and regulations, including anti-money laundering and illicit finance statutes and rules. Based on the agencies' current understanding and experience to date, the agencies believe that issuing or holding as principal crypto-assets that are issued, stored, or transferred on an open, public, and/or decentralized network, or similar system is highly likely to be inconsistent with safe and sound banking practices. Further, the agencies have significant safety and soundness concerns with business models that are concentrated in crypto-asset-related activities or have concentrated exposures to the crypto-asset sector.

The agencies will continue to closely monitor crypto-asset-related exposures of banking organizations. As warranted, the agencies will issue additional statements related to engagement by banking organizations in crypto-asset-related activities. The agencies also will continue to engage and collaborate with other relevant authorities, as appropriate, on issues arising from activities involving crypto-assets.

Each agency has developed processes[2] whereby banking organizations engage in robust supervisory discussions regarding proposed and existing crypto-asset-related activities.[3] Banking organizations should ensure that crypto-asset-related activities can be performed in a safe and sound manner, are legally permissible, and comply with applicable laws and regulations, including those designed to protect consumers (such as fair lending laws and prohibitions against unfair, deceptive, or abusive acts or practices). Banking organizations should ensure appropriate

---

[2] *See* OCC Interpretive Letter 1179 "Chief Counsel's Interpretation Clarifying: (1) Authority of a Bank to Engage in Certain Cryptocurrency Activities; and (2) Authority of the OCC to Charter a National Trust Bank," (November 18, 2021); Federal Reserve SR 22-6 / CA 22-6: "Engagement in Crypto-Asset-Related Activities by Federal Reserve-Supervised Banking Organizations," (August 16, 2022); and FDIC FIL-16-2022 "Notification and Supervisory Feedback Procedures for FDIC-Supervised Institutions Engaging in Crypto-Related Activities," (April 7, 2022).

[3] Entities seeking to become regulated banking organizations will also be expected to adopt and demonstrate appropriate risk management processes and controls to mitigate risks associated with planned activities, which would include any crypto-asset-related activities, before receiving a charter or otherwise being authorized to commence business. The entities should discuss all planned activities with the appropriate regulator prior to filing an application.

risk management, including board oversight, policies, procedures, risk assessments, controls, gates and guardrails, and monitoring, to effectively identify and manage risks.[4]

[4] *See* Interagency Guidelines Establishing Standards for Safety and Soundness 12 CFR 30, Appendix A (OCC); 12 CFR 208, Appendix D-1 (Federal Reserve) and 12 CFR 364, Appendix A (FDIC). *See also* OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches, 12 CFR 30, Appendix D (OCC).

**Summary of Principles**

**Federal Reserve Board**
**Federal Deposit Insurance Corporation**
**Office of the Comptroller of the Currency**

October 24, 2023

**Summary of Final Principles for Climate-Related Financial Risk Management for Large Financial Institutions**

*Background*

Climate-related financial risks, including physical and transition risks, can manifest within traditional risk areas, including credit, market, liquidity, operational, and legal risks.

In December 2021, April 2022, and December 2022, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Board, respectively, proposed substantively similar guidance on risk management principles to support the effective management of climate-related financial risks for the financial institutions they supervise with over $100 billion in total consolidated assets.

*Final Guidance*

- The final guidance is substantively similar to the guidance previously proposed by the agencies, with targeted modifications in response to commenter feedback. These modifications include clarification on the applicability to large foreign banking organizations, clarification on the role of boards of directors and management, and removal of a reference in the Board's proposal to compensation practices.

- The final guidance contains high-level principles covering six areas: governance; policies, procedures, and limits; strategic planning; risk management; data, risk measurement, and reporting; and scenario analysis. Additionally, the final principles describe how climate-related financial risks can be addressed in the management of traditional risk areas.

- The final principles neither prohibit nor discourage large financial institutions from providing banking services to customers of any specific class or type, as permitted by law or regulation. The decision regarding whether to make a loan or to open, close, or maintain an account rests with the financial institution, so long as the financial institution complies with applicable laws and regulations.

- The agencies are providing guidance to large financial institutions through these principles on the management of climate-related financial risks just as the agencies provide guidance to financial institutions in identifying and managing other risks.

- The final principles are intended to promote a consistent understanding of the effective management of climate-related financial risks.

###

# The Unique Ethical and Legal Challenges in Advising Regulated Institutions

John Geiringer, Partner
Barack Ferrazzano Financial Institutions Group

Scott Alvarez, Retired General Counsel
Federal Reserve Board

# The Unique Ethical and Legal Challenges in Advising Regulated Institutions

## IBA Bank Counsel Conference

**December 1, 2023**

**Presented By:**
**John M. Geiringer** | T. 312.984.3217 | john.geiringer@bfkn.com
with special guest
**Scott G. Alvarez** | T. 301.502.1308 | scott.alvarez.1600@gmail.com
Former General Counsel, FRB

200 West Madison Street, Suite 3900 | Chicago, Illinois 60606 | T. 312.984.3100 | bfkn.com

# Regulatory Relations

# Regulatory Engagement

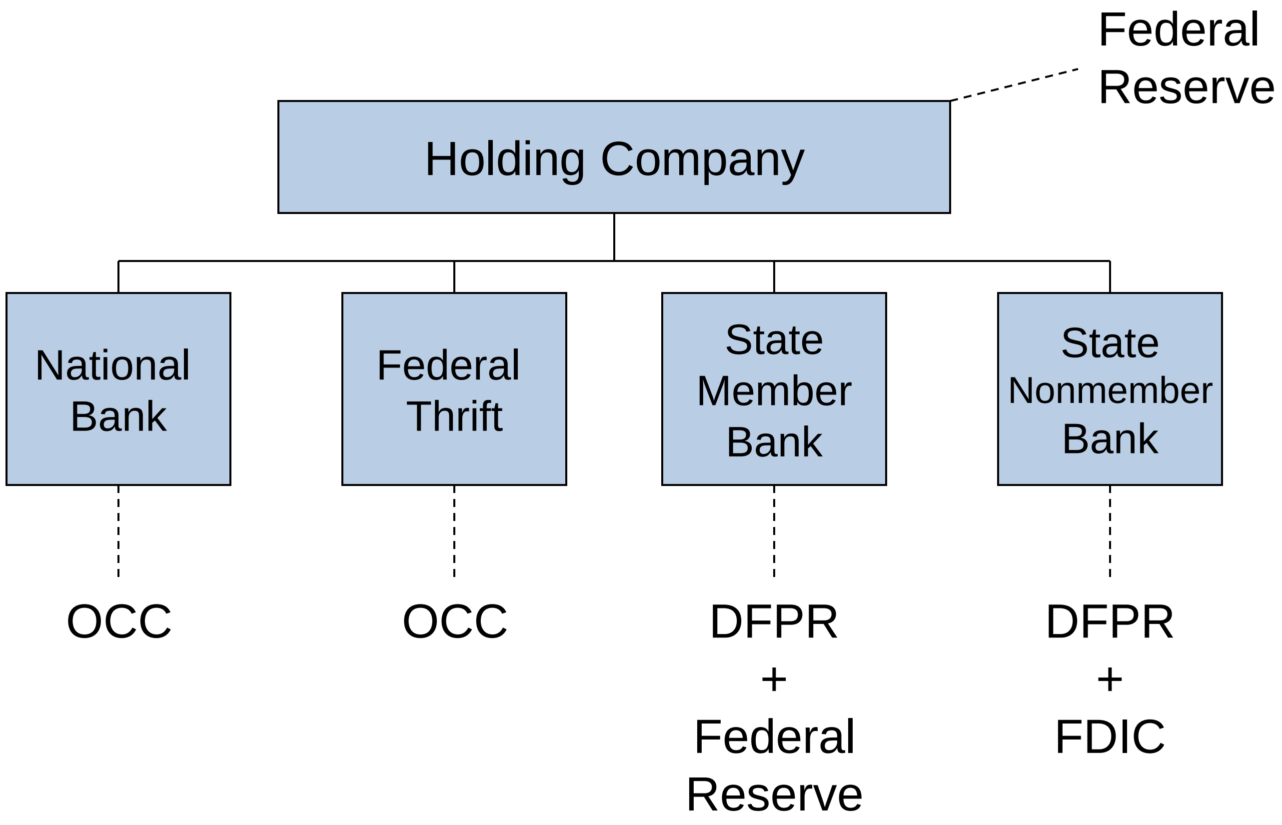
- Supervision vs. litigation
- Preserving your client's relationship
- Obtaining good feedback and outcomes
- Examiner treatment

# Understanding the Client

# Institution Information

- FDIC/ BankFind Suite
- Federal Reserve/ National Information Center (NIC)
- FDIC/ Call Reports
- FFIEC/ Uniform Bank Performance Report (UBPR)
- Reports of Examination and regulatory correspondence
- Enforcement actions
- Governance documents
- Others

# Organizational Structure and Regulators



# Understanding the Sources

# Legal and Regulatory

- Statutes
- Regulations/ Federal Register
- Supervisory guidance
- Examination handbooks
- Reports of Examination and regulatory correspondence
- Enforcement actions
- Failed bank reports
- Speeches and Congressional testimony
- Others

# Asset Threshold Issues

| Asset Threshold(s) | Provision(s) |
|---|---|
| $48 million | Home Mortgage Disclosure Act reporting requirements |
| $50 million | Management interlock restrictions , Insurance activities |
| $150 million | Streamlined SEC reporting requirements |
| $300 million | Expedited acquisition eligibility and/or streamlined acquisition reporting requirements |
| $330 million | Community Reinvestment Act requirements |
| $500 million | BHC risk-based capital requirements, Corporate governance requirements |
| $1 billion | Corporate governance requirements, Flood insurance escrow requirements |
| $1.322 billion | Community Reinvestment Act requirements |
| $2.23 billion | High-priced mortgage threshold |
| $3 billion | Expedited acquisition eligibility and/or streamlined acquisition reporting requirements, Corporate governance requirements, Small BHC Policy Statement, Collins Amendment exemption, 18-month examination cycle, Streamlined stock buyback and redemption reporting requirements |
| $5 billion | Tailored call reports |
| $7.5 billion | Expedited acquisition eligibility and/or streamlined acquisition reporting requirements |
| $10 billion | CFPB primary regulator for consumer compliance, Interchange fee cap (“Durbin Amendment”), Volcker Rule, Portfolio QM, Mortgage escrow requirements, CBLR eligibility, Swap margin and capital requirements |
| $20 billion | Thrift charter opt out |

Source: Congressional Research Service (2021)

# "Secret Law"

[M]any of the control doctrines . . . have been unwritten, or have been written but not well publicized, or in some cases even disseminated. And as a result, the practical determinants of when the Board will deem one company to control another, can in some cases not be discovered except through supplication to a small handful of people who have spent a long apprenticeship in the subtle hermeneutics of Federal Reserve lore, receiving the wisdom of their elders through oral tradition in the way that gnostic secrets are transmitted from shaman to novice in the culture of some tribes of the Orinoco.

Randal Quarles (FRB Vice Chair for Supervision)
April 23, 2019

# Case Study

## Control Definitions

- Bank Holding Company Act/ Regulation Y
- Change in Control Act/ Regulation Y
- 23A/B of the Federal Reserve Act/ Regulation W
- Regulation O
- Illinois Banking Act

# Case Study

Dividends for Illinois State Member Banks

- Illinois Banking Act
- Federal Reserve/ Regulation H
- Federal Reserve/ SR 09-4
- Examination findings
- Enforcement actions

# Case Study

## Affiliate Transactions

- Dodd-Frank Act revises 23A/23B of the FRA
- Changes to covered transactions, collateral requirements, credit exposure, investment funds, exemptions
- Regulation W not yet revised accordingly

# Understanding the Mission

# Legal vs. Business/Policy Advice

- “What may I do?” vs. “What should I do?”
- Identify pros and cons
- Outside counsel vs. in-house role

# Regulatory Opinion Types

Options

- Confidential vs. disclosed
- Informal vs. formal interpretations

Factors

- Engagement considerations
- Certainty
- Timing

# Attorney-Client Privilege

# Examination and Visitation Authority

| | |
|---|---|
| DFPR | 205 ILCS 5/48 |
| FDIC | 12 U.S.C. 1820 |
| FRB | 12 U.S.C. 248 |
| OCC | 12 U.S.C. 481 |

# Unfettered Access?

The Federal Reserve examines, on a regular basis, institutions for which we have been granted supervisory authority by Congress and, through that authority, has complete and unfettered access to an institution's most sensitive financial information and processes, including information that would otherwise be privileged and not subject to public disclosure.

# Statutory Exception

The submission by any person of any information to [banking agencies] for any purpose in the course of any supervisory or regulatory process of such [agency] shall not be construed as waiving, destroying, or otherwise affecting any privilege such person may claim with respect to such information under Federal or State law as to any person or entity other than such [agency].

12 U.S.C. 1828(x)

# Common Issues

- Legal advice
- Examinations
- Proactive disclosures
- Internal investigations
- Enforcement

# Conflicts of Interest

# Potential Clients

- Bank
- Employees
- Board of directors
  - Inside vs. outside
  - Board factions
- Holding Company
- Shareholders

# Potential Conflict Situations

- Dominant management/ significant shareholder
- Mergers and acquisitions
- Enforcement actions
- Troubled banks
- Others

# Regulatory Confidentiality Issues

# Confidential Supervisory Information

- Scope of definition
  - Examination reports and ratings
  - Regulatory correspondence
  - Other information

# Confidential Supervisory Information (cont.)

- Disclosure situations
  - Insurance companies
  - Securities disclosures
  - M&A
  - Others

# Suspicious Activity Reports

- SARs (and existence) confidential, except for BSA responsibilities
- Existence/ non-existence of SARs confidential, including SAR information if reveals SAR existence
- If impermissibly asked to disclose SAR (or SAR information), decline to produce and notify FinCEN/federal banking agency

# SEC Issues

# SEC "Up-the-Ladder Rule"

- Report material violations to CLO / CEO
- If futile, report to Audit Committee, Independent Committee, or Board
- If inappropriate response, report reasons to CLO, CEO, and directors
- Disclose to SEC if:
  - prevents substantial injury
  - prevents perjury/fraud
  - rectifies consequences of material violation that caused substantial injury

# Speech by SEC Commissioner Allison Herren Lee (March 4, 2022)

- Revisiting “Up-the-Ladder Rule”
- Legal advice should reflect interests of corporation/shareholders
- Independent/rigorous analysis of materiality issues
- Minimum standards for attorney competence/experience
- Continuing legal education requirements
- Obligation to investigate red flags
- Law firm oversight

# Potential Liability

# IAP Liability

<u>Institution-Affiliated Party</u>

- any director, officer, employee, or controlling shareholder (other than a BHC/SLHC) of, or agent for, a bank;
- any other person who has filed or is required to file a change-in-control notice;
- any shareholder (other than a BHC/SLHC), consultant, joint venture partner; or any other person who participates in the conduct of the affairs of a bank; or
- <u>any independent contractor (including any attorney</u>, appraiser, or accountant) who knowingly or recklessly participates in violations, breaches of fiduciary duty, or unsafe or unsound practices, which caused or are likely to cause more than a minimal financial loss to, or a significant adverse effect on, the bank

# FDIC Professional Liability Recoveries and Expenses

| Type of Claim | Total Recoveries – 2007-2022 | |
|---|---|---|
| Securities | | |
| RMBS | $2,043,643,910 | (45.5%) |
| Other | $65,002,496 | (1.4%) |
| D&O Liability | $1,326,494,017 | (29.5%) |
| Accountant Malpractice | $461,635,367 | (10.3%) |
| MMF | $241,442,946 | (5.4%) |
| Bond | $204,239,458 | (4.6%) |
| Appraiser Malpractice | $45,738,132 | (1.0%) |
| Attorney Malpractice | $44,424,157 | (1.0%) |
| Other Professional Claims | $34,413,216 | (0.8%) |
| Insurance Issuer | $22,478,837 | (0.5%) |
| Financial Instruments – LIBOR | $767,300 | (0.0%) |
| **Total** | **$4,490,279,836** | **(100.0%)** |

# Other Issues

# Hot Spots

- State law issues
- Dealing with the media
- Deposit insurance
- Troubled bank situations
  - Advance retainers
  - Document retention
- Others

# Questions?

# John M. Geiringer

**John M. Geiringer**
Partner | Financial Institutions Group
T. 312.984.3217 | john.geiringer@bfkn.com

As the Regulatory Section Leader of BFKN's Financial Institutions Group, John advises a wide variety of financial institutions around the country about the full spectrum of legal, regulatory, and supervisory issues that they face. He is a frequent speaker and author in the financial institutions area on issues surrounding banking regulations, examinations, and enforcement actions, as well as on cybersecurity.

John devotes significant time to anti-money laundering, counter-terrorist financing, and related national security issues. In this regard, he lectures and advises institutions around the country, engages with relevant organizations, and has published on the subject.

Prior to joining BFKN in 1999, John worked as a bank regulator and also as a compliance consultant. He served as legal counsel for the Illinois bank regulatory agency, now the Illinois Department of Financial and Professional Regulation. John also obtained practical experience with respect to bank operations and compliance issues as a regulatory consultant with a regional accounting firm, performing compliance reviews and training for a variety of financial institutions.

# Special Guest -- Scott G. Alvarez

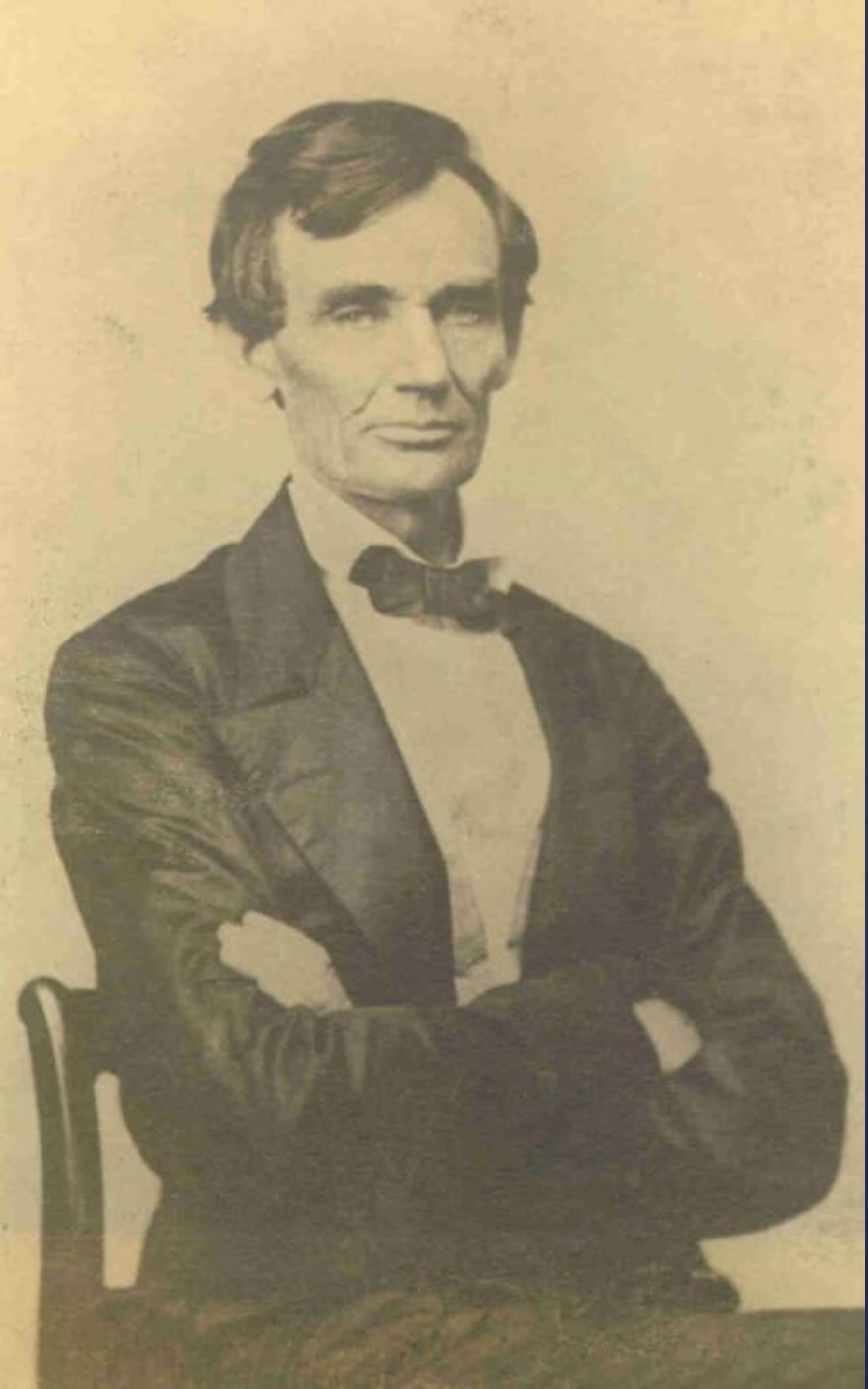
Scott G. Alvarez served as General Counsel to the Board of Governors of the Federal Reserve System and the Federal Open Market Committee for 13 years, retiring in September 2017 after serving a total of 36 years as an attorney for the Board of Governors. As the chief legal officer for the Board. he provided legal and policy advice on a wide range of regulatory, administrative, organizational, legislative and other issues related to the duties and operations of the Federal Reserve Board, Federal Reserve System, and FOMC.

Currently, Scott is an Adjunct Professor at Georgetown University Law Center. He was an Adjunct Professor at the Boston University Law School and has been a guest lecturer at the Yale School of Management, Columbia University Law School, New York University Law School, Duke Law School and the UNC Law School.

He was also a contributor to First Responders: Inside the US Strategy for Fighting the 2007-2009 Global Financial Crisis, Edited by B. Bernanke, T. Geithner, and H Paulson. Scott received his JD from Georgetown University Law Center and an A.B. in Economics from Princeton University.

# Lincoln the Lawyer: Professionalism, Ethics, and Civility

John Lupton, Executive Director
Illinois Supreme Court Historic
Preservation Commission



# Abraham Lincoln's Law Practice and Professionalism

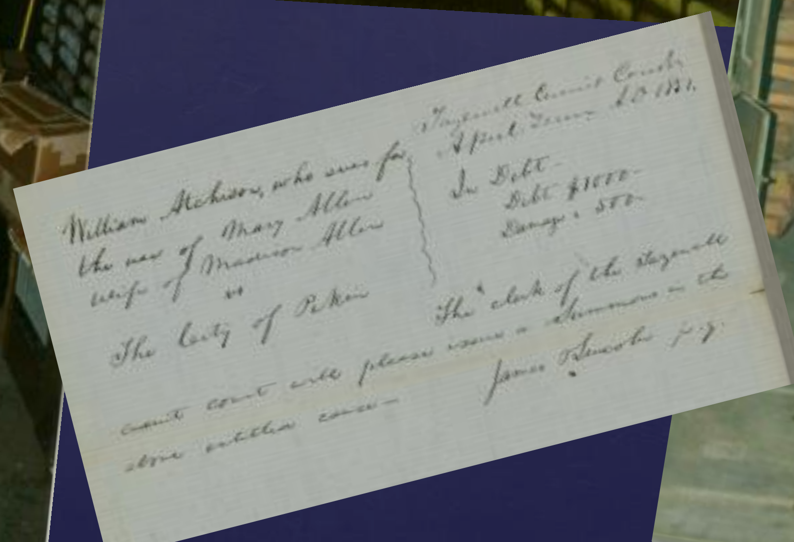
# Lincoln’s Legal Career

1. Lincoln Legal Papers Project
2. General Overview on Lincoln’s Law Practice
3. Lincoln and Banking
4. Notes for a Law Lecture

# 1. Lincoln Legal Papers Project



Clerk will issue process in the above en
in assumpsit
cause— Damage $1500.00
Lincoln & Herndon p.q.

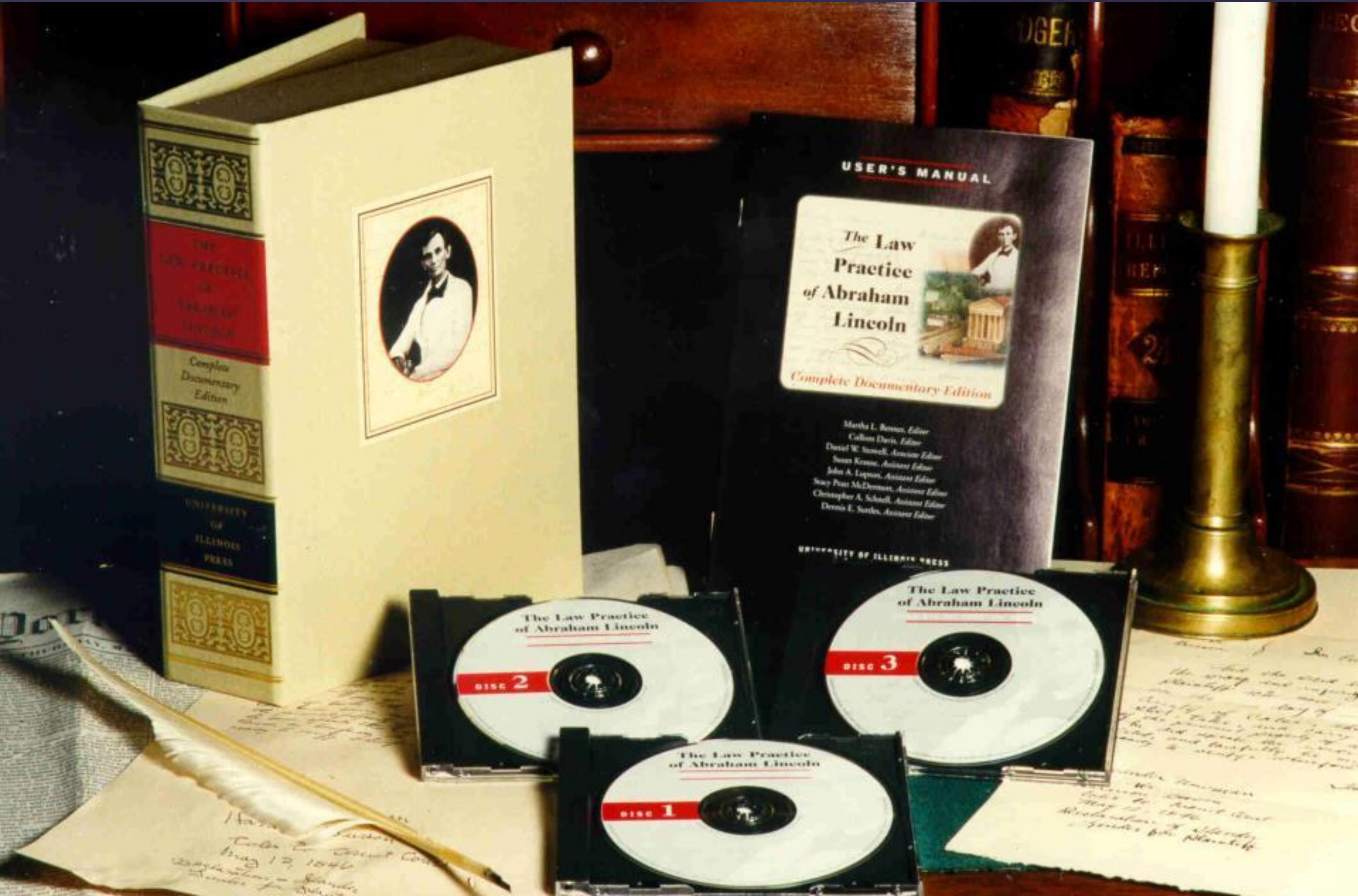

William Atchison, who sues for the use of Mary Allen wife of Madison Allen
vs
The City of Pekin

Tazewell Circuit Court
April Term AD 1851.

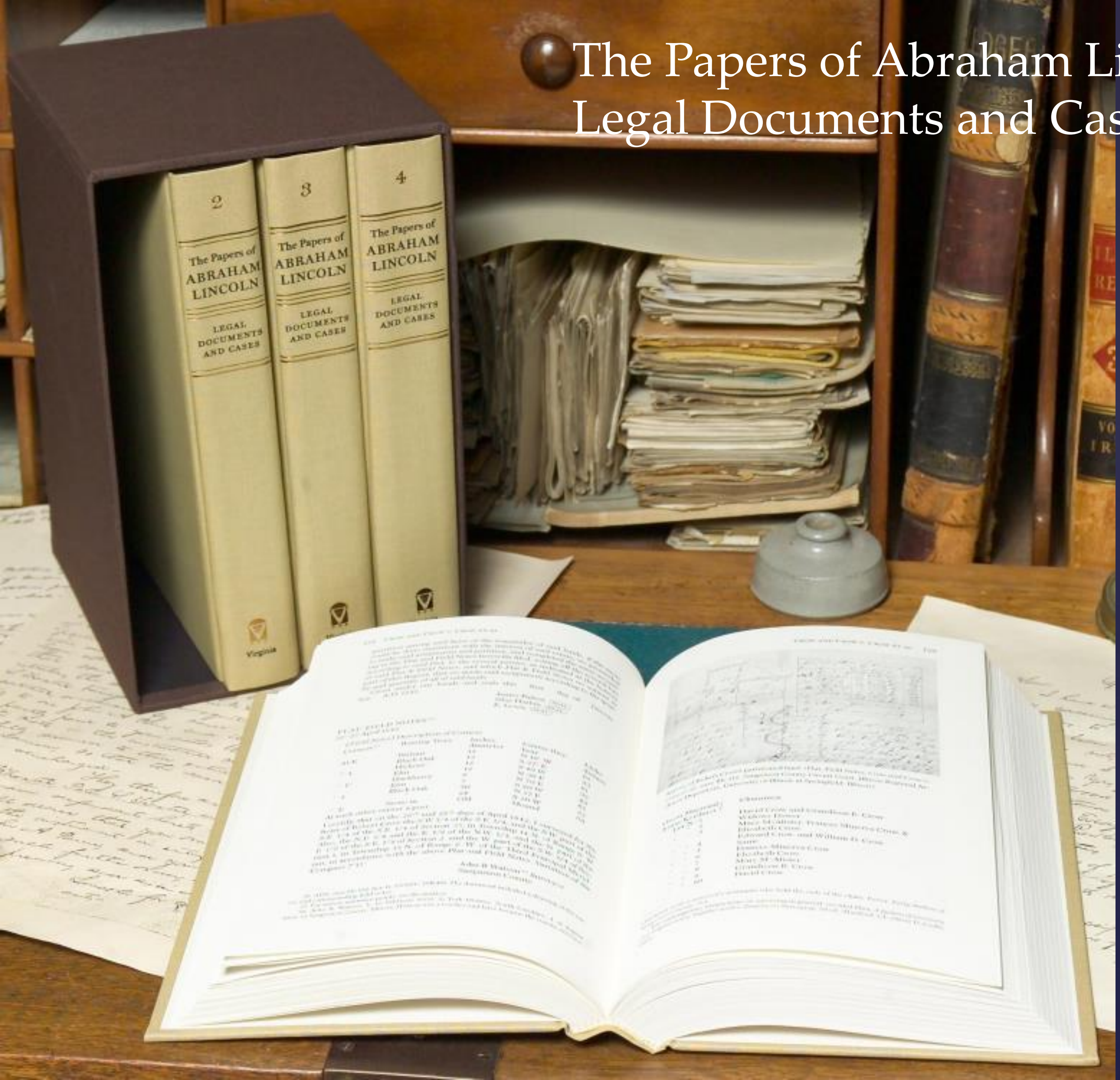
In Debt—
Debt $1000—
Damage $500—

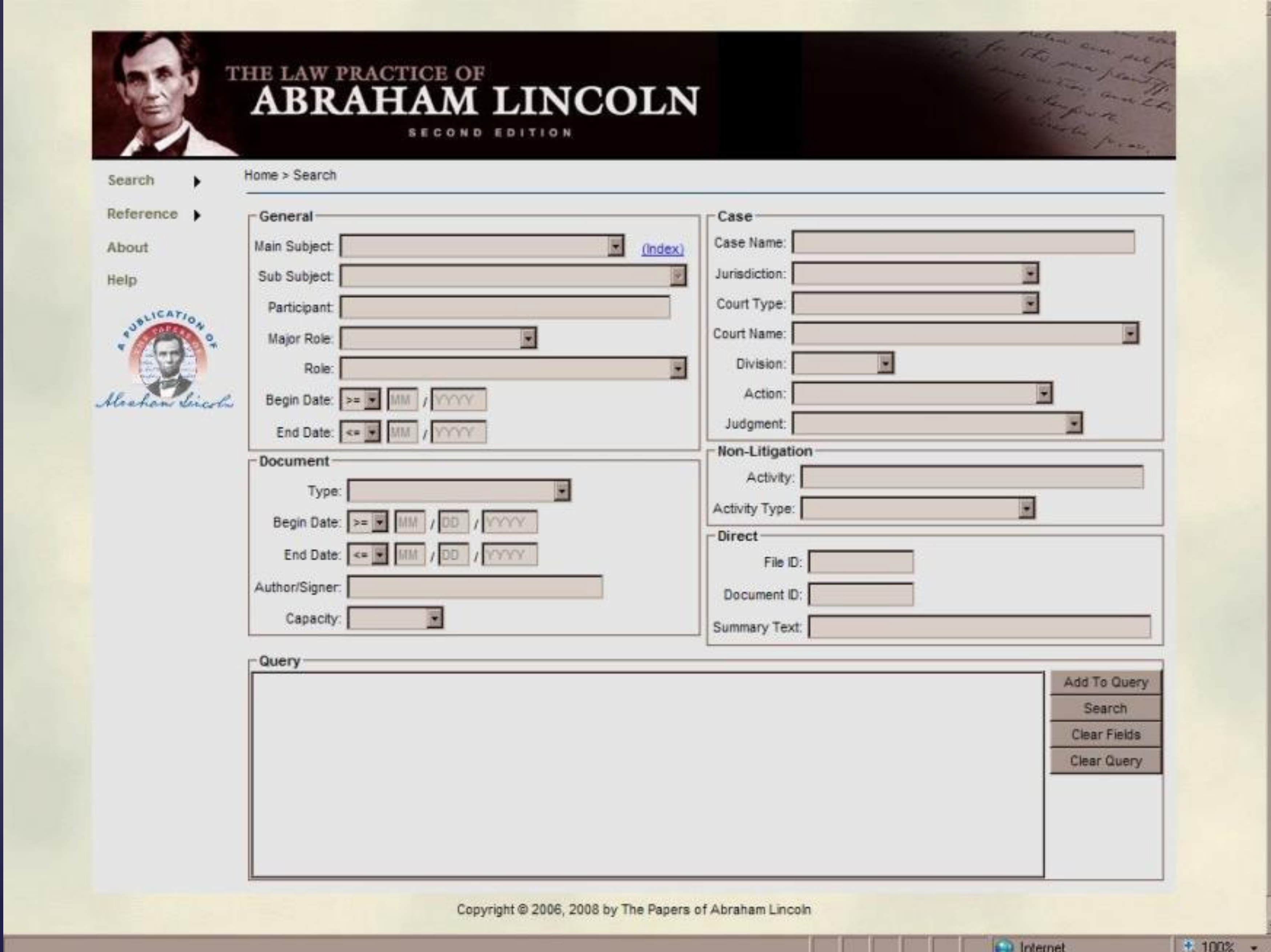
The clerk of the Tazewell circuit court will please issue a summons in the above entitled cause—
James Lincoln p.q.

# The Law Practice of Abraham Lincoln: Complete Documentary Edition



# The Papers of Abraham Lincoln: Legal Documents and Cases






www.lawpracticeofabrahamlincoln.org

In Tender Consideration
Women, Families, and the Law in Abraham Lincoln's Illinois
A. LINCOLN
Lincoln's Ladder to the Presidency
The Eighth
THE CASE of ABRAHAM LINCOLN
A. Lincoln
ATTORNEY AT LAW
A CALLAN FILMS PRODUCTION
THE LEGAL CAREER OF AMERICA'S GREATEST PRESIDENT
Abraham Lincoln, Esq.
Edited by Roger Billings and Frank J. Williams
Lincoln: Prelude to the Presidency
A WILL-TV documentary premiering in February 2009
DAN ABRAMS AND DAVID FISHER
LINCOLN'S LAST TRIAL
THE MURDER CASE THAT PROPELLED HIM TO THE PRESIDENCY
MARK E. STEINER
THE RIVER, THE BRIDGE, AND THE MAKING OF AMERICA
BRIAN McGINTY
Lawyer
"A sophisticated, thoughtful treatment of Lincoln and 19th century law practice." —Publishers Weekly
Brian Dirck
The Murder Trials of Abraham Lincoln
GEORGE R. DEKLE, SR.

# 2. General Observations on Lincoln's Law Practice

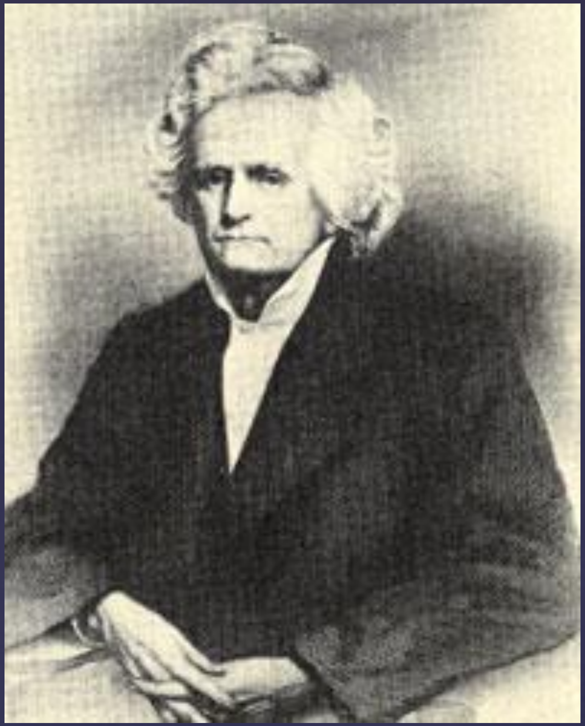
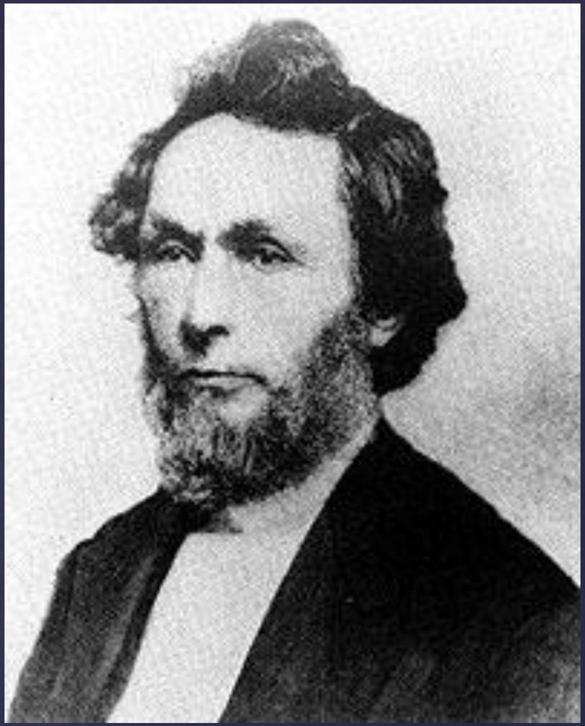
# Lincoln the Lawyer Mythology

- Country Bumpkin Lawyer
- Super Lawyer

- Cause Lawyer
- Corporate Lawyer

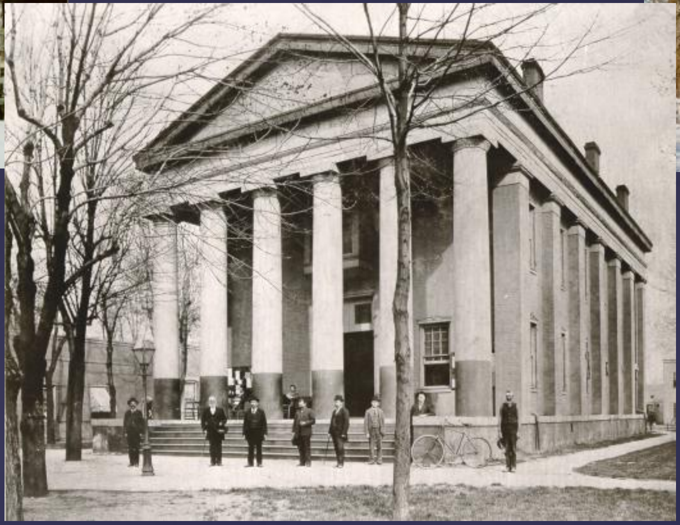
# Lincoln's Legal Education:

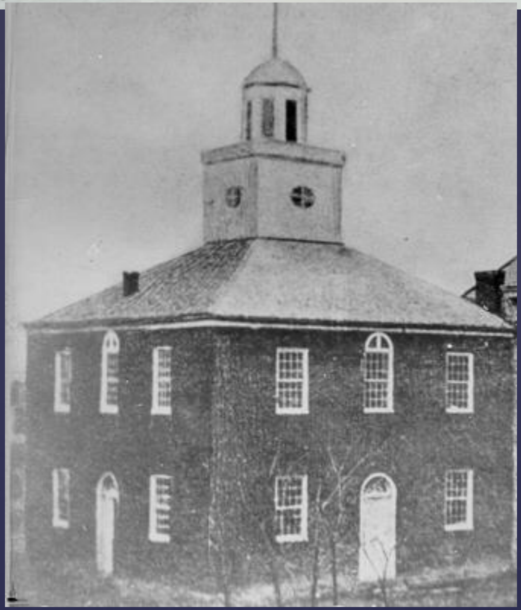
Atypical

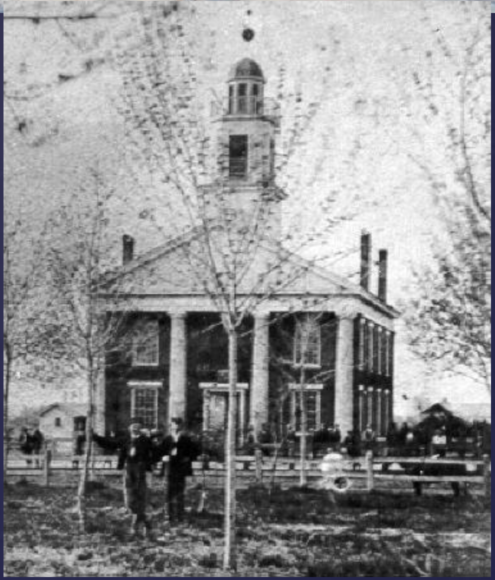
  

Lincoln’s Legal Partnerships

1. John T. Stuart, 1837-1841
2. Stephen T. Logan, 1841-1844
3. William H. Herndon, 1844-1861







Large Law Practice:

- More than 5,100 cases over 25-year period
- More than 2,500 cases in Sangamon County
- More than 400 cases in Illinois Supreme Court
- More than 300 cases in federal court

Consummate General Practice Attorney:

- No specialization
- Debt
- Divorce, Slander, Foreclose Mortgage, Replevin, Larceny, Selling Liquor, Murder, Mechanic's Lien, Assumpsit, Assault, Bastardy, Trespass Quare Clausum Fregit, Ejectment,, Mandamus, Injunction, Partition, Specific Performance, Quo Warranto, etc.

# Lincoln and Banking

93 cases involving Banks

33 involved State Bank of Illinois




*Bank of Missouri v. Ryan et al.*

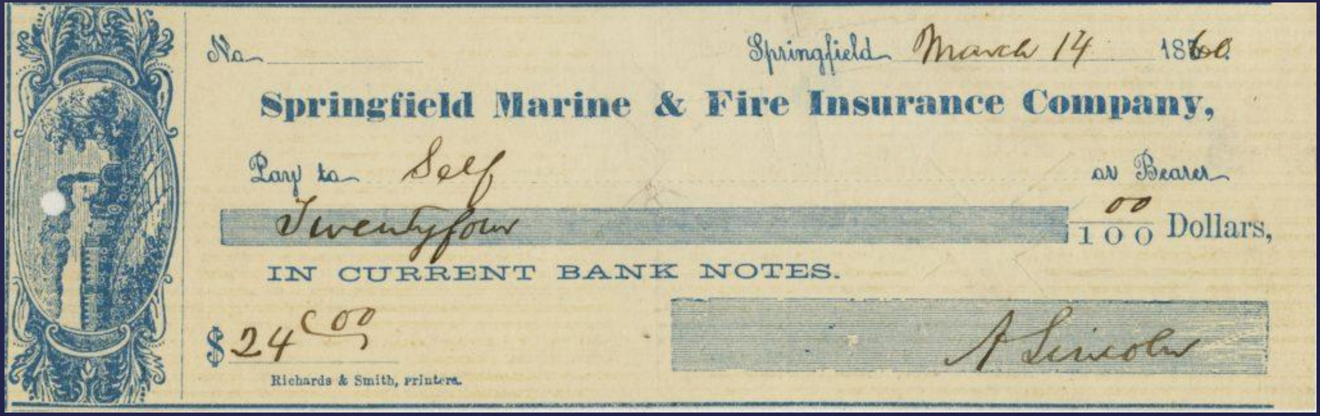
U.S. District Court, Northern District of Illinois (1856)

*Dormody v. State Bank of Illinois*

Illinois Supreme Court
3 Ill. 237 (1840)

Abraham Lincoln's Bank:

Marine Bank in Springfield


No.

Springfield March 14 1860

Springfield Marine & Fire Insurance Company,

Pay to Self or Bearer

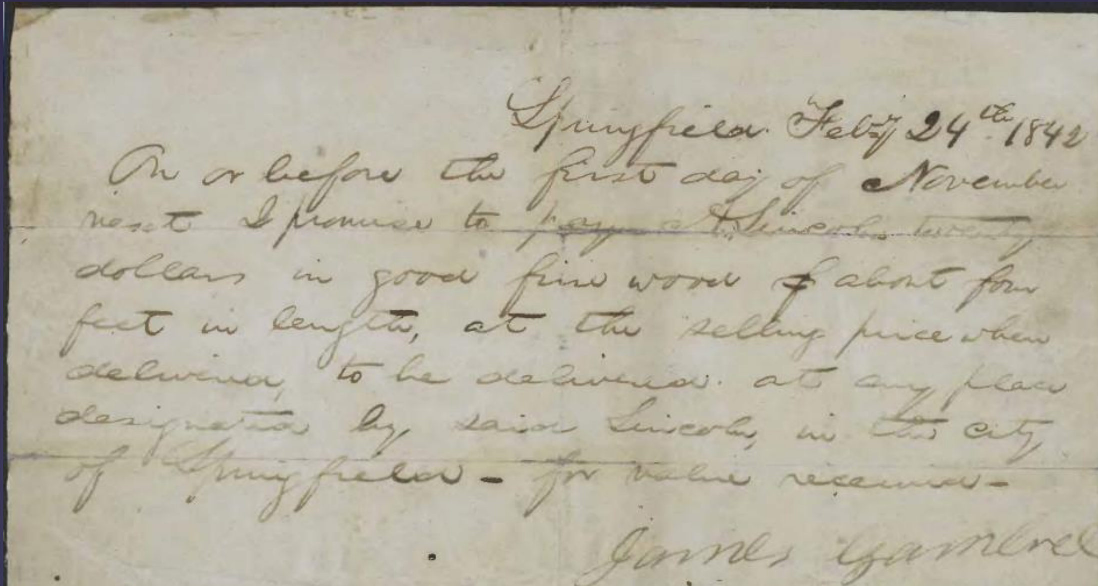
Twentyfour 00/100 Dollars,

IN CURRENT BANK NOTES.

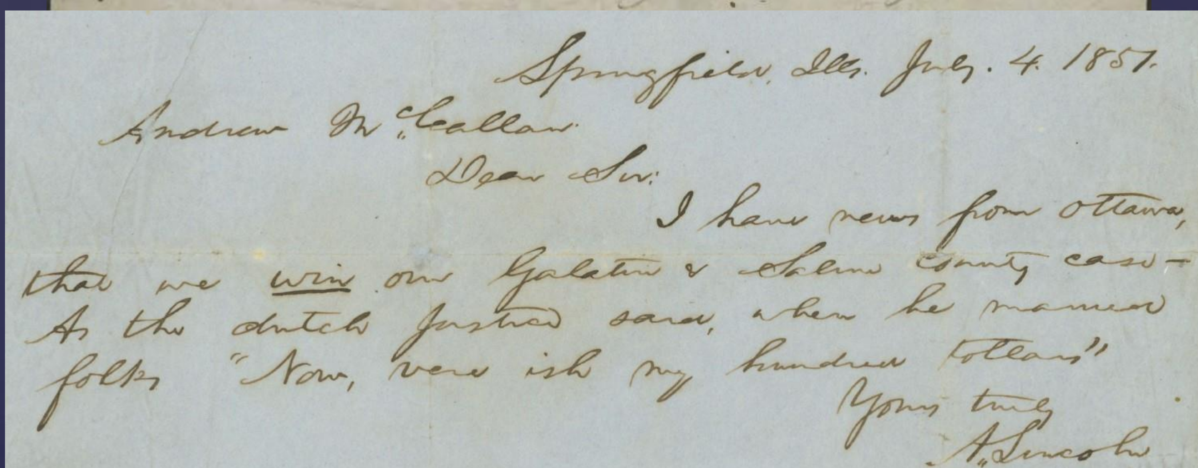
$24 00/100

A Lincoln

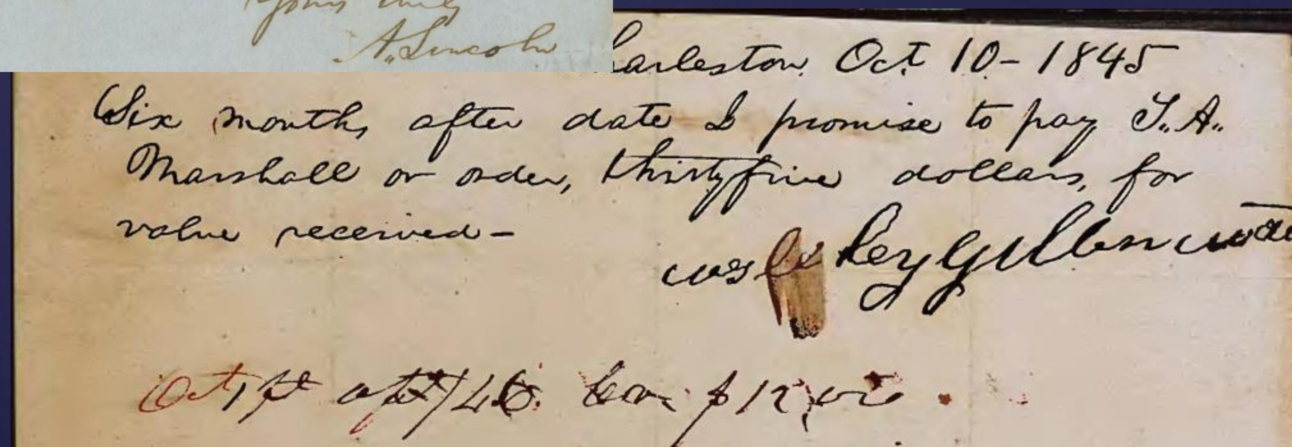
Richards & Smith, printers.



Springfield Feby 24th 1842
On or before the first day of November
next I promise to pay A. Lincoln twenty
dollars in good fire wood of about four
feet in length, at the selling price when
delivered, to be delivered at any place
designated by said Lincoln, in the city
of Springfield — for value received —
James Gambrel



Springfield, Ills. July. 4. 1857.
Andrew McCallan
Dear Sir:
I have news from Ottawa,
that we win our Galatin & Saline county case—
As the dutch Justice said, when he married
folks "Now, vere ish my hundred tollars"
Yours truly
A. Lincoln



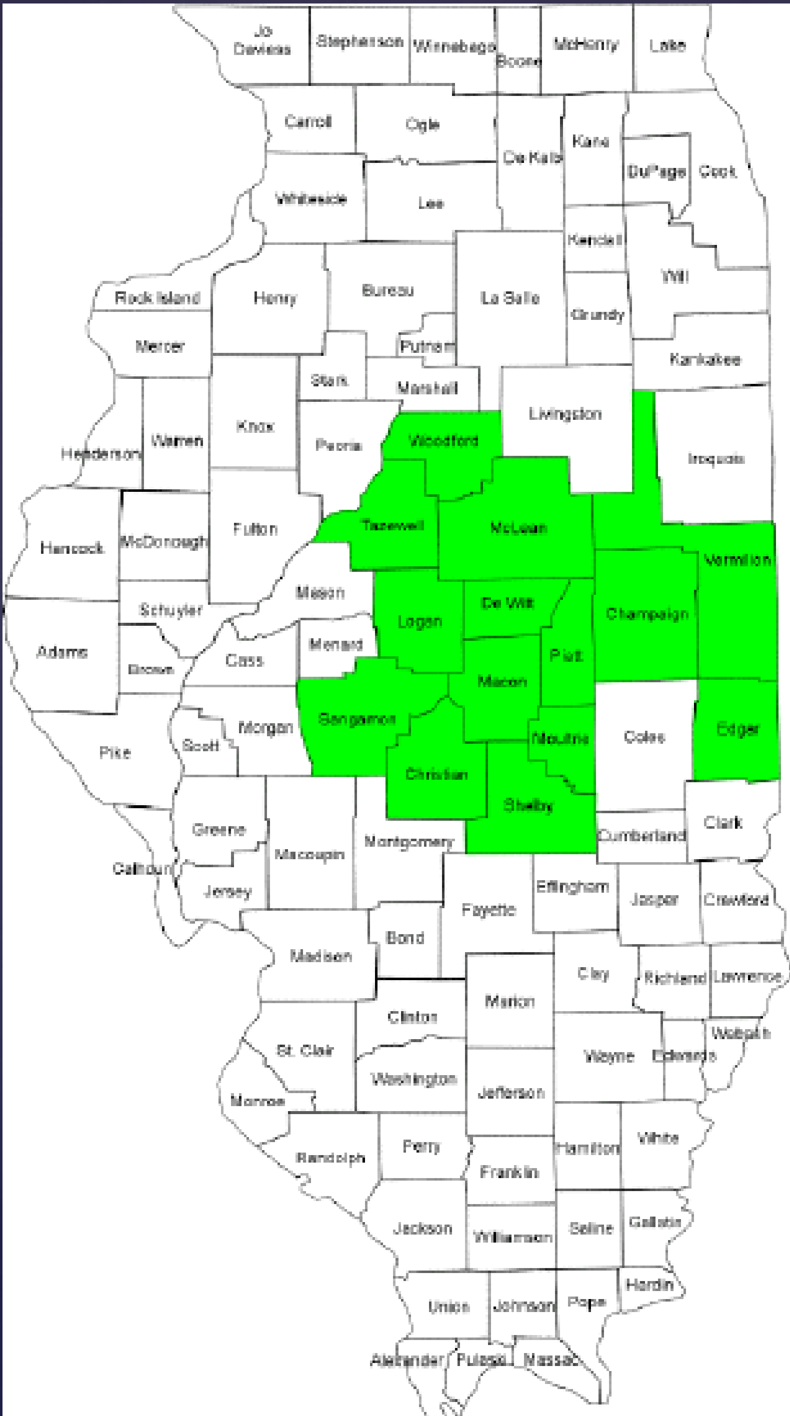
Charleston Oct. 10 - 1845
Six months after date I promise to pay T. A.
Marshall or order, thirty five dollars, for
value received —
Wesley Gilbert

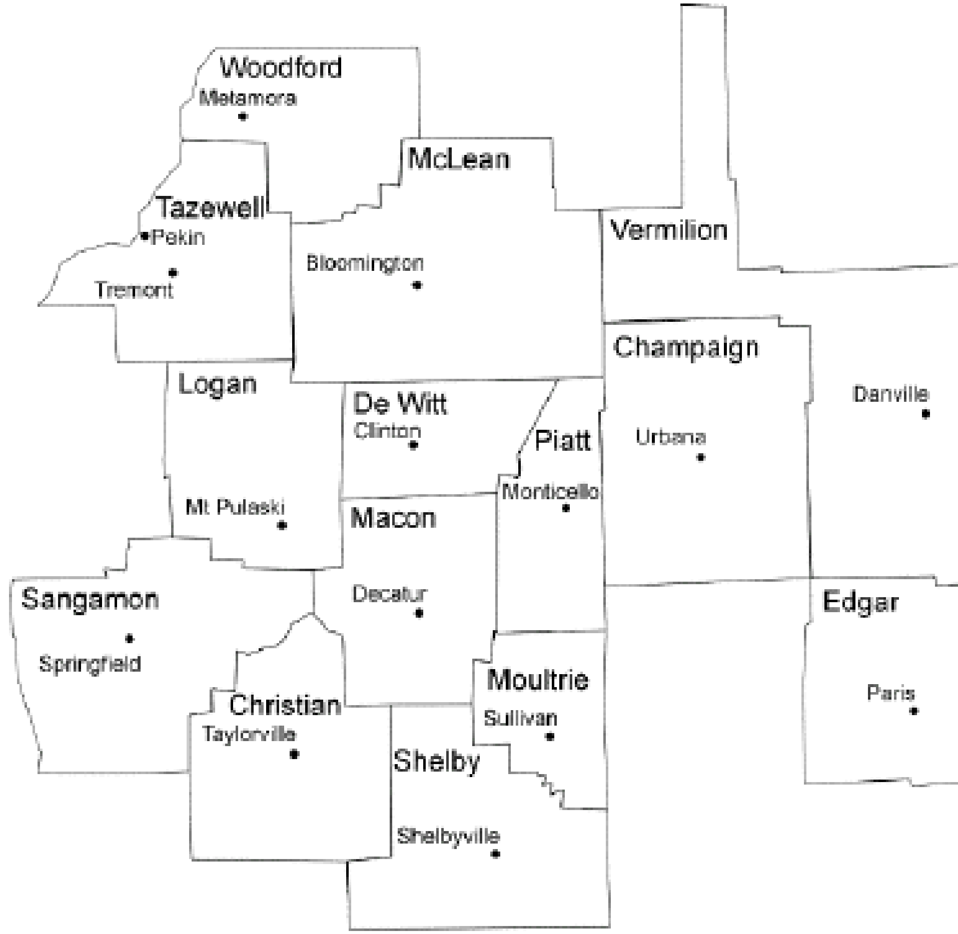
Comfortable Income:

- Earned on average \$10-\$25 per case.
- Higher fees for Illinois Supreme Court and federal cases

# Rich Exposure to Vital Issues:

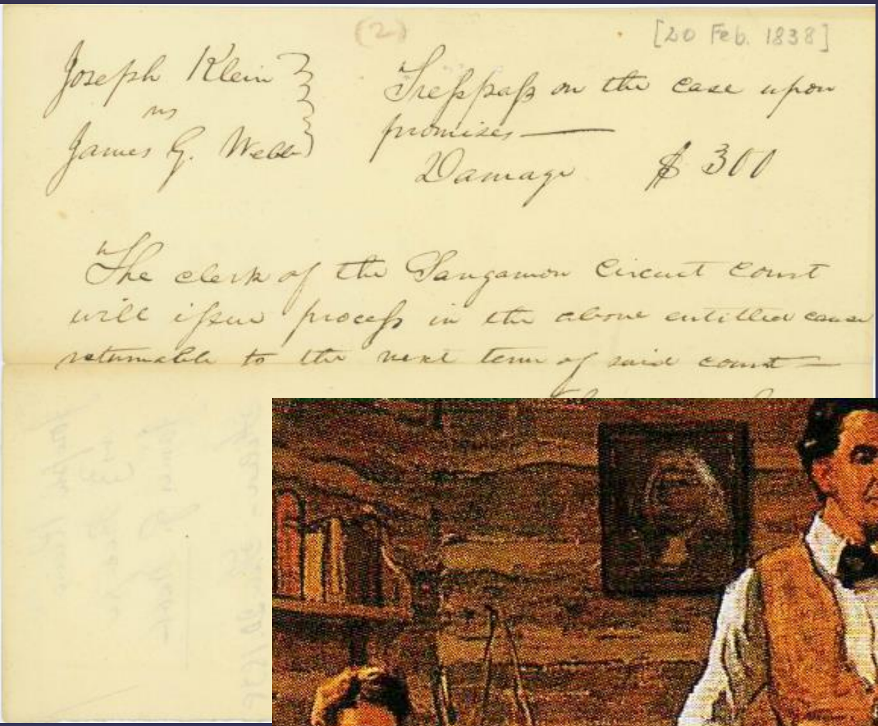
# Law and Politics:




Eighth Judicial Circuit (1847-1853)

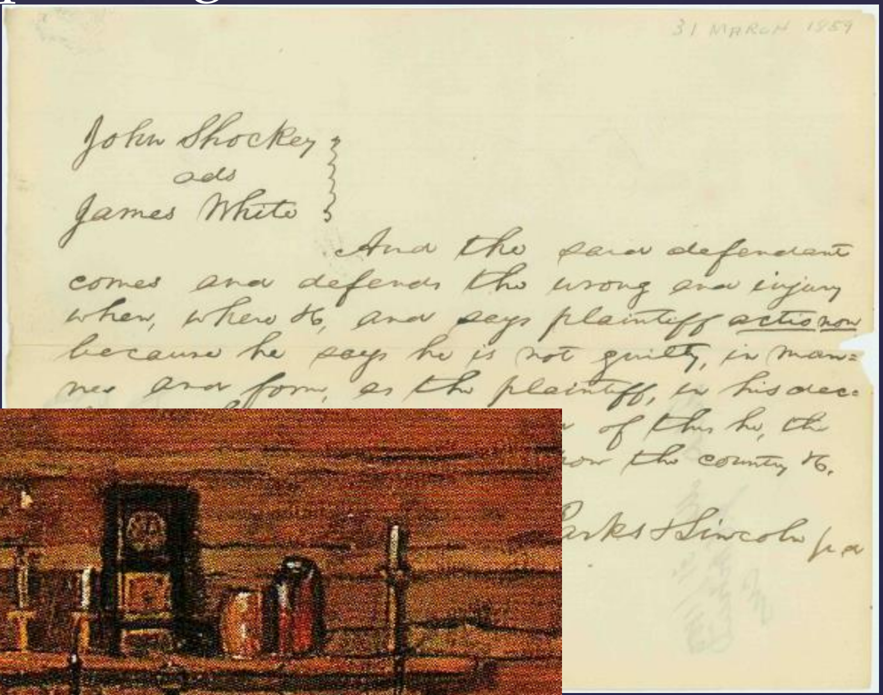
# Honed Writing and Speaking Skills:



(2) [20 Feb. 1838]

Joseph Klein vs James G. Webb — Trespass on the case upon promises — Damage $300

The clerk of the Sangamon Circuit Court will issue process in the above entitled cause returnable to the next term of said court —



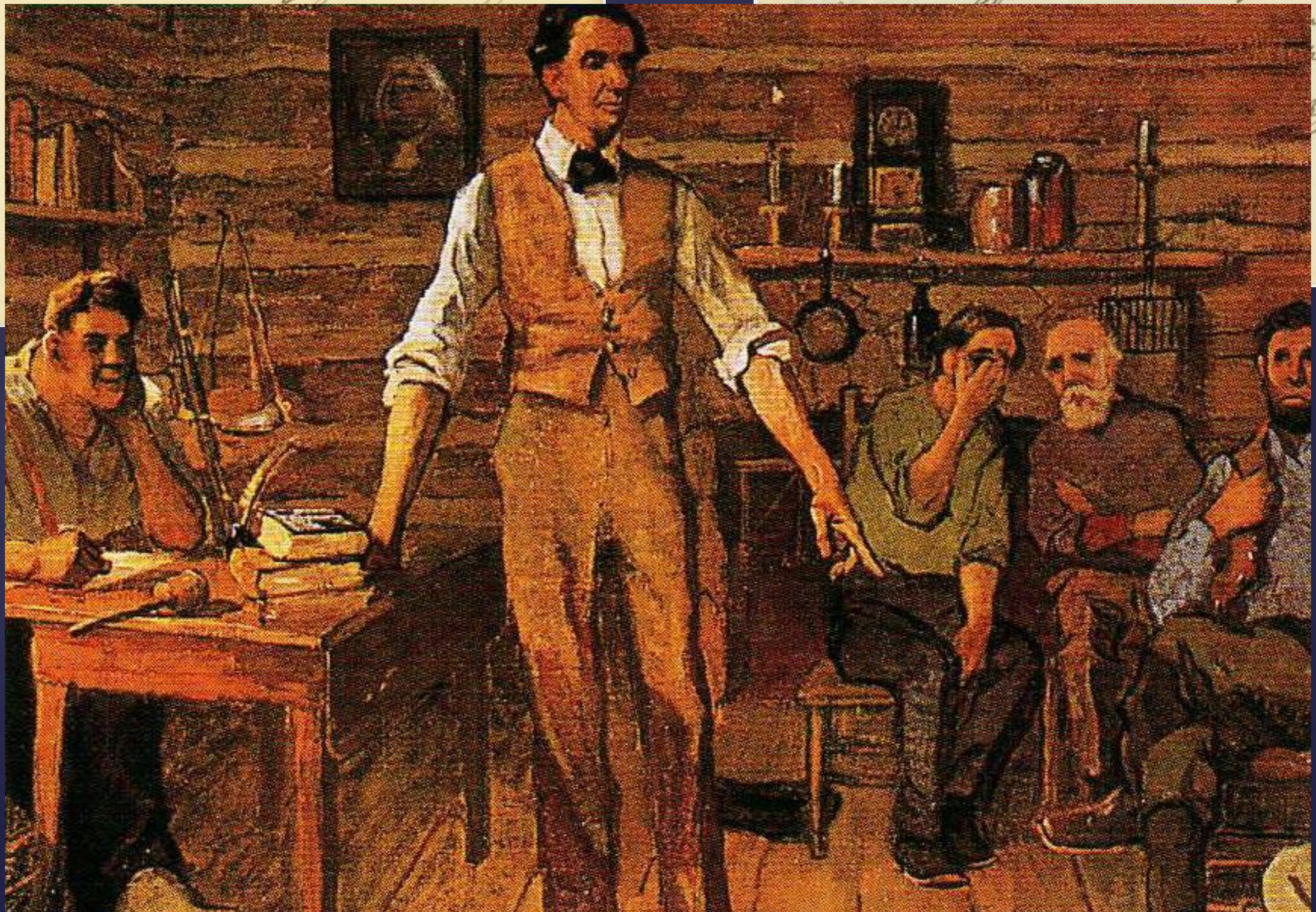
31 MARCH 1859

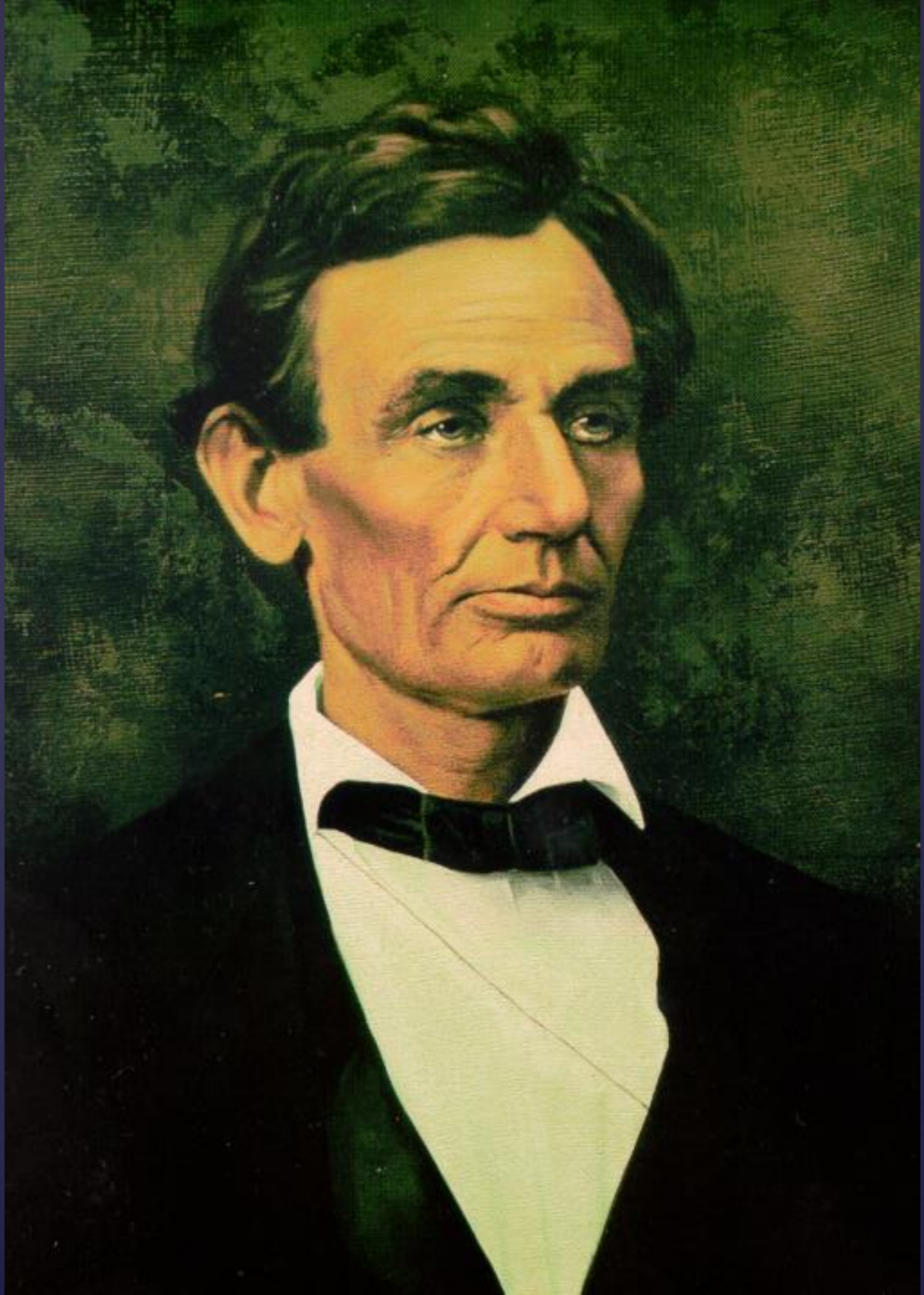
John Shockey ads James White

And the said defendant comes and defends the wrong and injury when, where &c, and says plaintiff actio non because he says he is not guilty, in manner and form, as the plaintiff, in his dec...

... of this he, the ... the country &c.

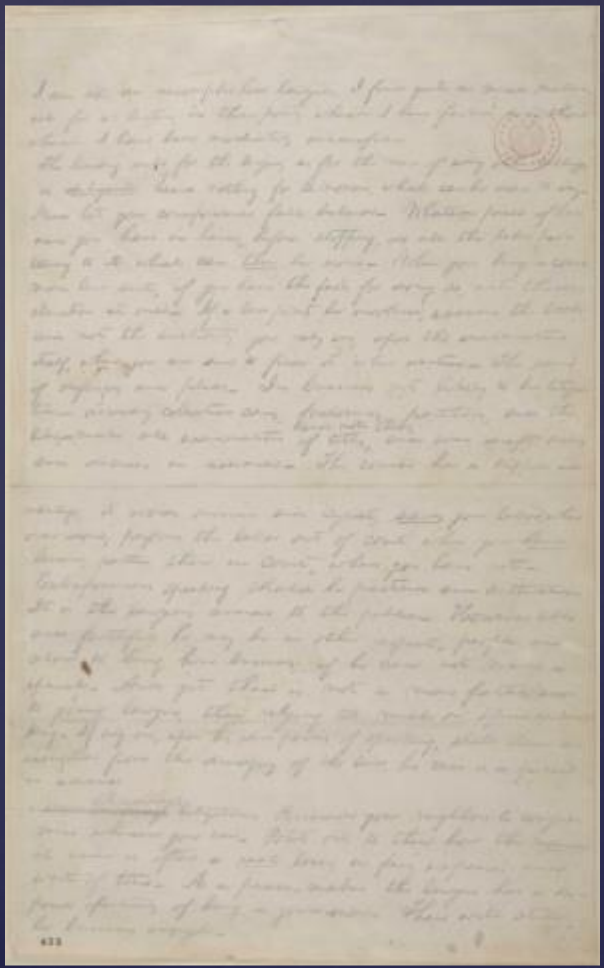
...arks & Lincoln p.q.

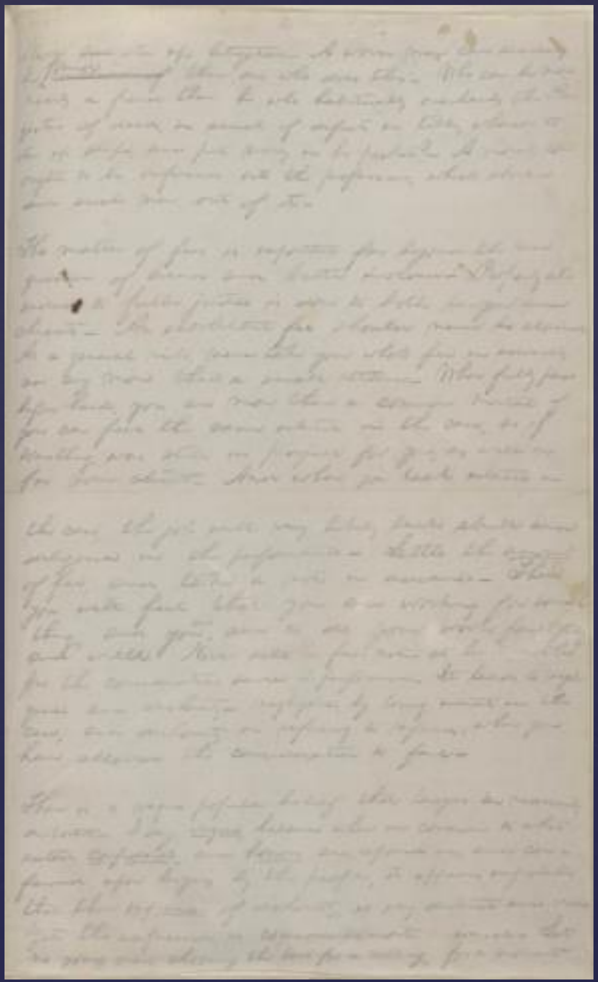




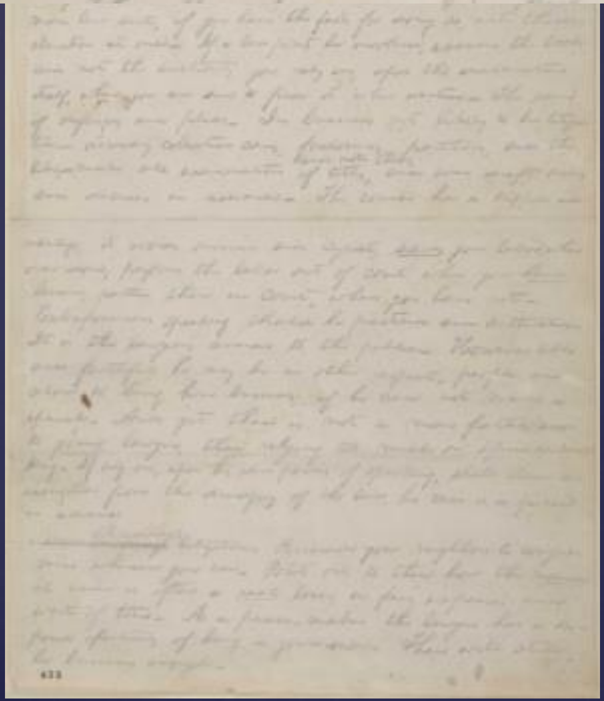
# 3. Notes for a Law Lecture

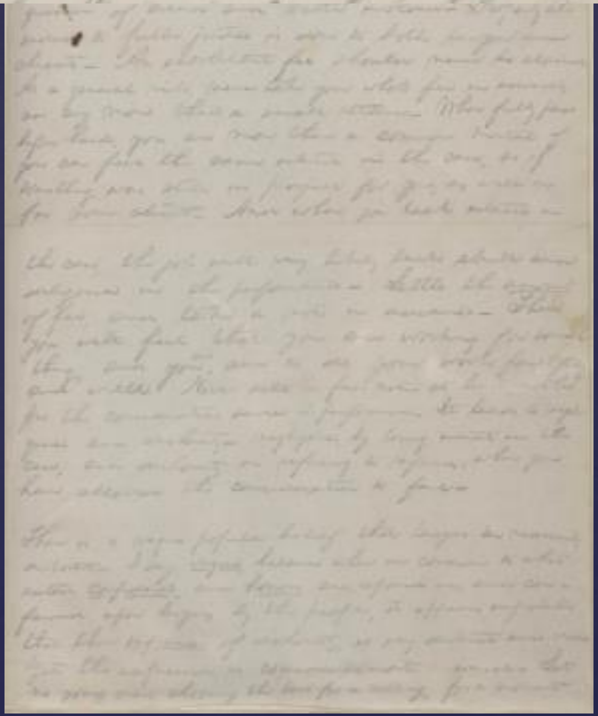
# Abraham Lincoln's Notes for a Law Lecture, ca. 1859

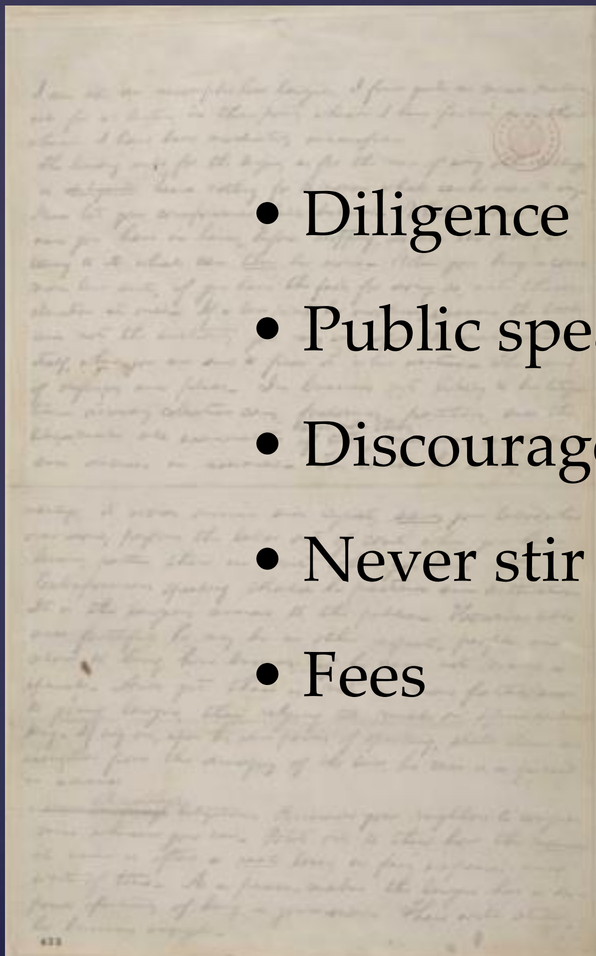




I am not an accomplished lawyer— I find quite as much material for a lecture, in those points wherein I have failed, as in those wherein I have been moderately successful—

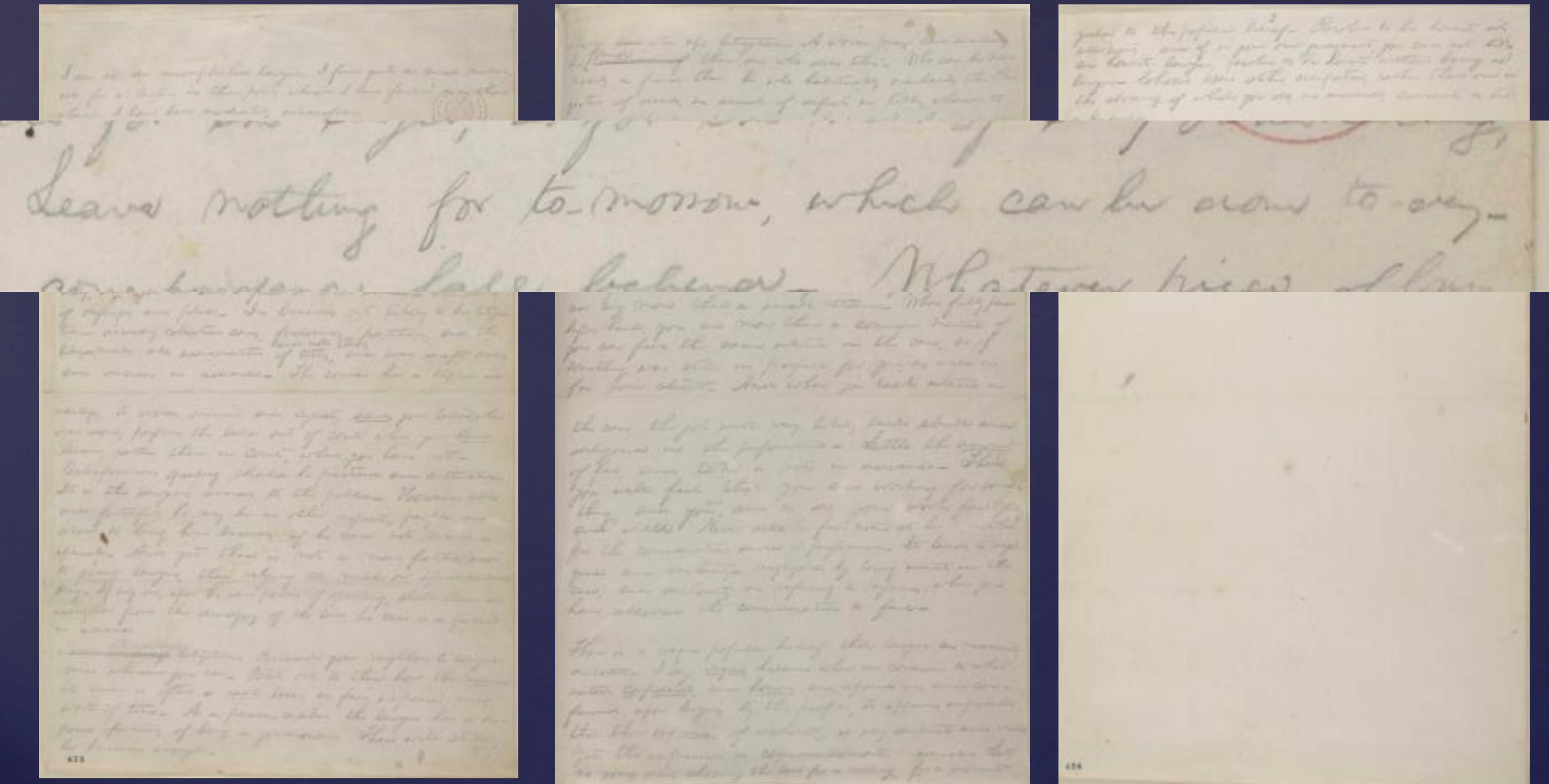






- Diligence
- Public speaking
- Discourage litigation
- Never stir up litigation
- Fees

# 1. Diligence:


Leave nothing for to-morrow, which can be done to-day.

When you cant find it anywhere
else look into this

Springfield, Ills. Sep. 25. 1860

J. M. Brockman, Esq

Dear Sir

Yours of the 24th asking
"the best mode of obtaining a tho-
rough knowledge of the law" is re-
ceived— The mode is very simple,
though laborious, and tedious—It
is only to get the books, and
read, and study them carefully.
Begin with Blackstone's Comment-
aries, and after reading it care-
fully through, say twice, take
up Chitty's Pleading, Greenleaf's
Evidence, & Story's Equity &c. in
succession— Work, work, work,
is the main thing—

Yours very truly

A. Lincoln

Springfield, Ills. Sep. 25. 1860

J. M. Brockman, Esq

Dear Sir

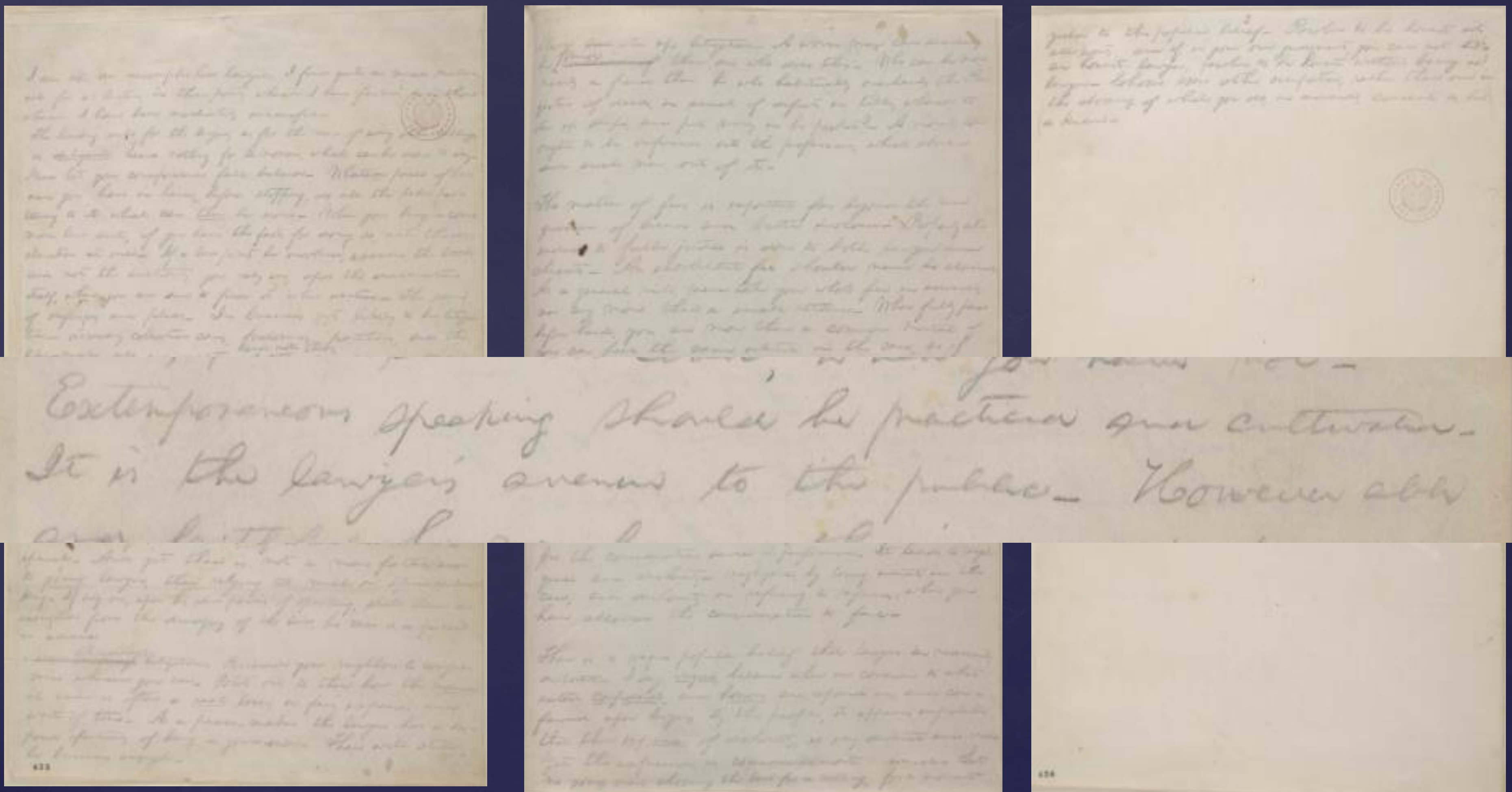
Yours of the 24th asking "the best mode of obtaining a thorough knowledge of the law" is received— The mode is very simple, though laborious, and tedious—It is only to get the books, and read, and study them carefully. Begin with Blackstone's Comment-

succession— Work, work, work, is the main thing—

Yours very truly

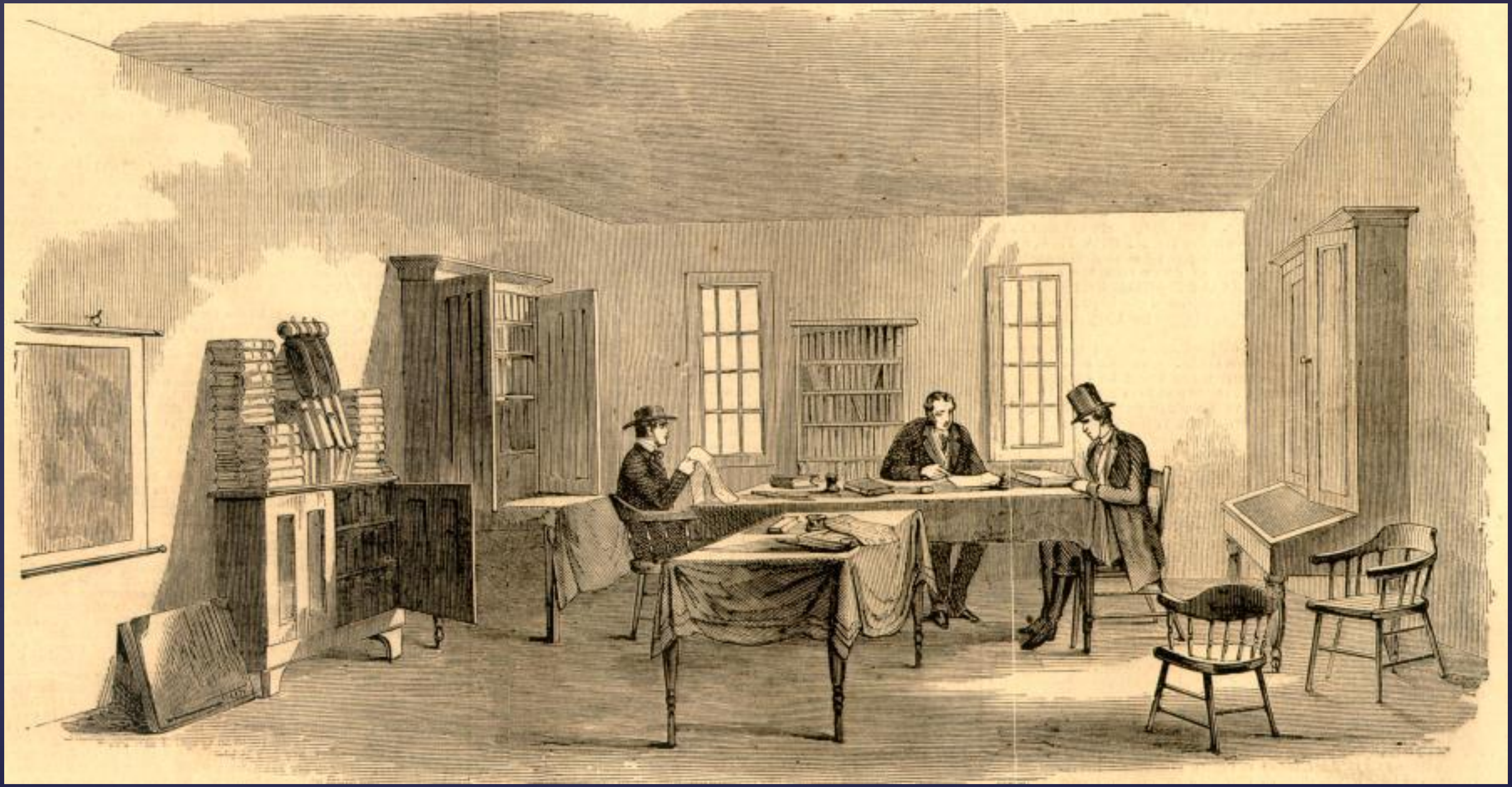
A. Lincoln

# 2. Public Speaking:

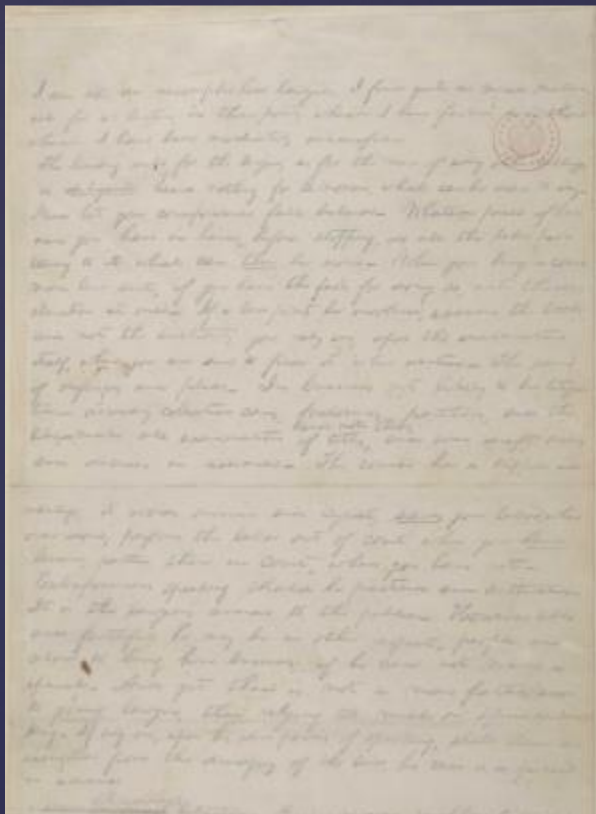


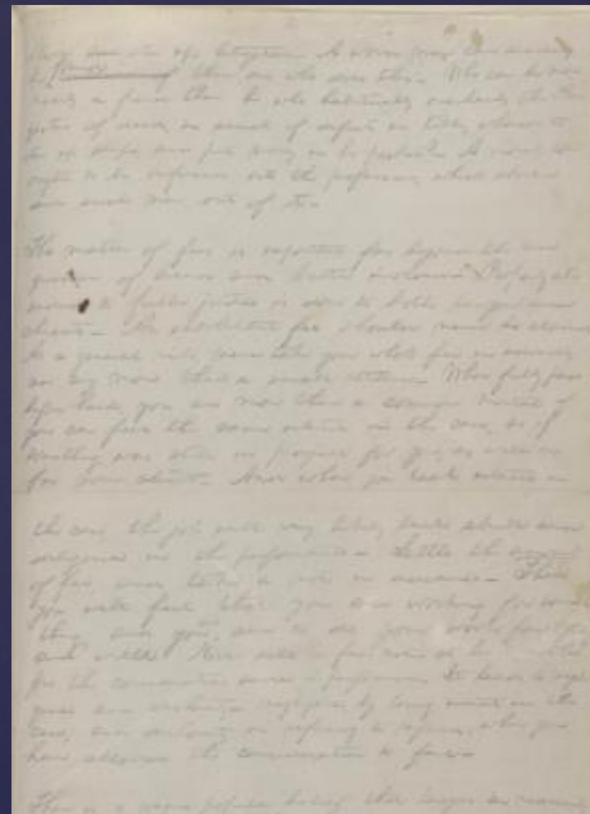
Extemporaneous speaking should be practiced and cultivated.
It is the lawyer's avenue to the public. However able

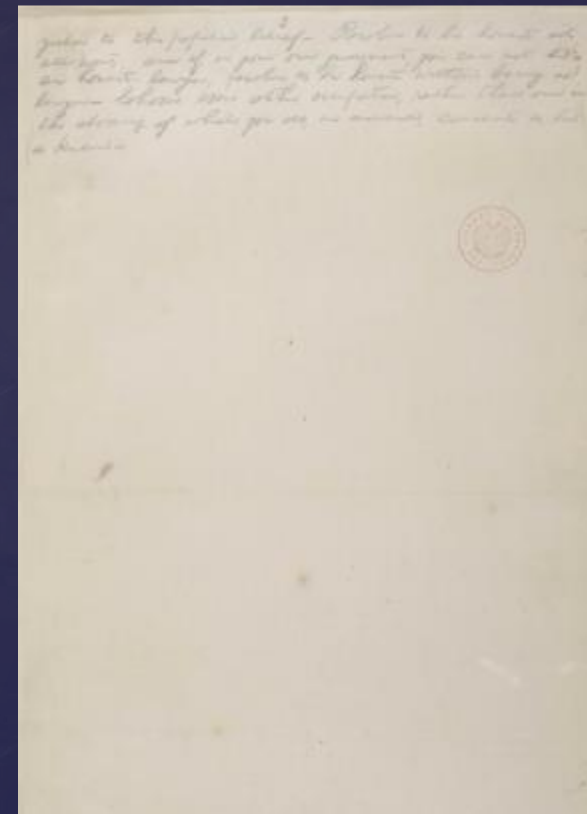
# Lincoln-Herndon Law Office, Springfield, Illinois, 1860

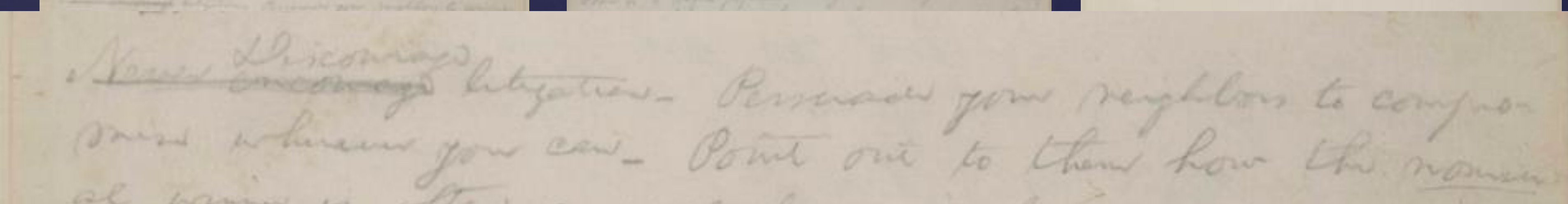


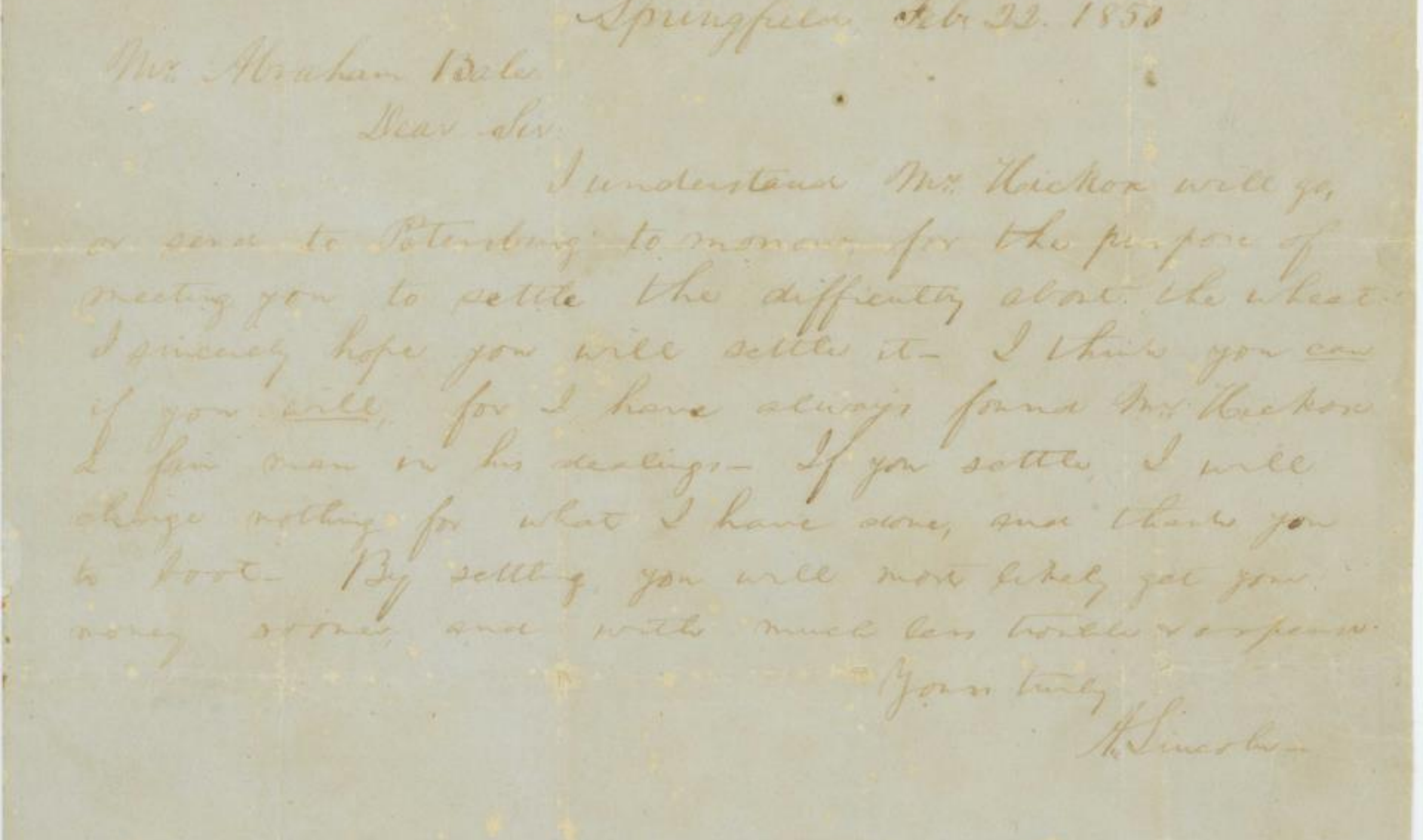
# 3. Compromise:











Springfield Feb. 22. 1850

Mr. Abraham Bale

Dear Sir

I understand Mr. Hickox will go, or send to Petersburg to-morrow, for the purpose of meeting you to settle the difficulty about the wheat. I sincerely hope you will settle it. I think you <u>can</u> if you <u>will</u>, for I have always found Mr. Hickox a fair man in his dealings. If you settle, I will charge nothing for what I have done, and thank you to boot. By settling you will most likely get your money sooner, and with much less trouble & expense.

Yours truly

A. Lincoln

"I sincerely hope you will settle it. I think you <u>can</u> if you <u>will</u>, for I have always found Mr. Hickox a fair man in his dealings. If you settle, I will charge nothing for what I have done, and thank you to boot. By settling, you will most likely get your money sooner, and with much less trouble and expense."

Mitchel
ads
Mitchel & wife

And the said defendant comes and defends the wrong and injury, when, where &c. and says plaintiff actio non because he says he is not guilty in manner and form as is in the plaintiffs declaration alleged; and of this he puts himself upon the country &c.

Thornton & Lincoln p.d.

And for further plea in this behalf defendant says actio non because he says he is not guilty of speaking the words, or any of them, in manner and form as is in the declaration alleged, at any time within one year next preceding the commencement of this suit; and of this he puts himself upon the country &c.

Thornton & Lincoln p.d.

And the plaintiffs are hereby notified that on the trial of said action, said defendant will offer to prove that said Missouri was guilty of fornication with said Elijah, before they were married.

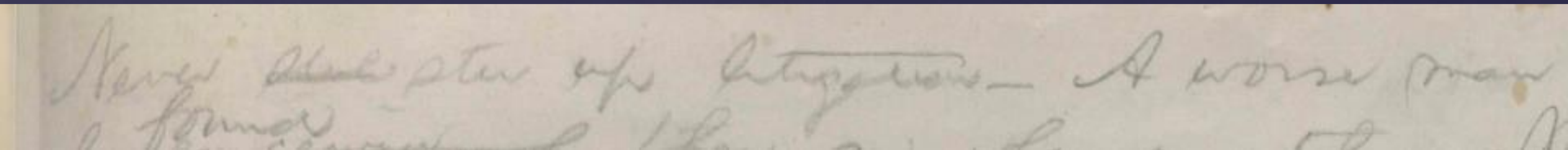
Thornton & Lincoln p.d.

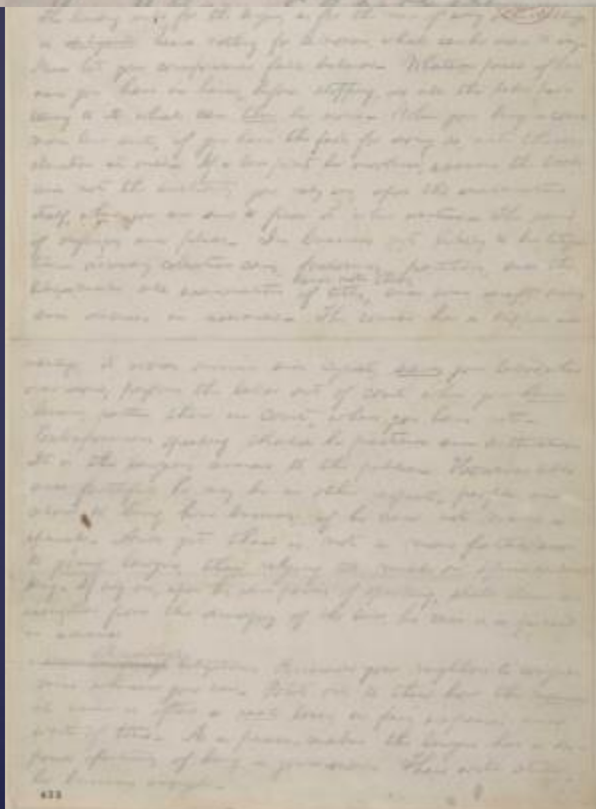
Mitchell et ux. v. Mitchell

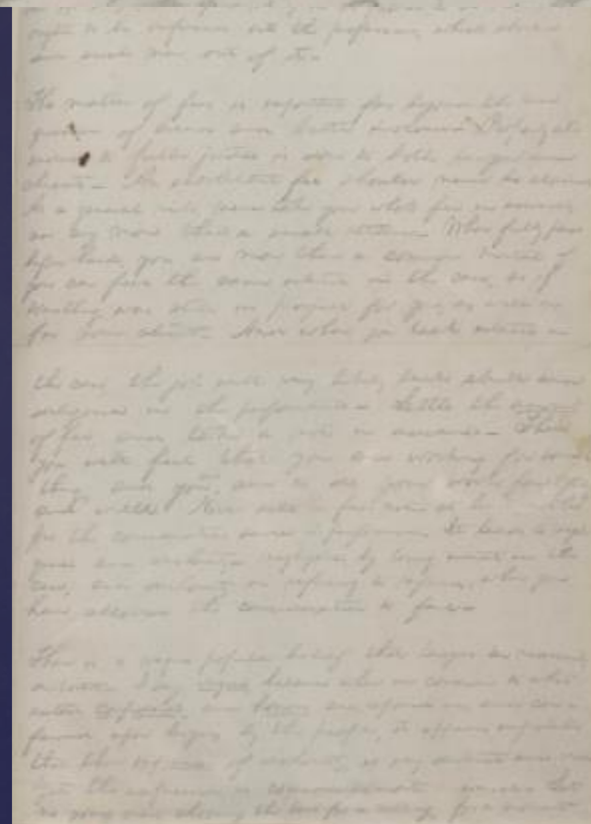
Slander

Shelby County, IL

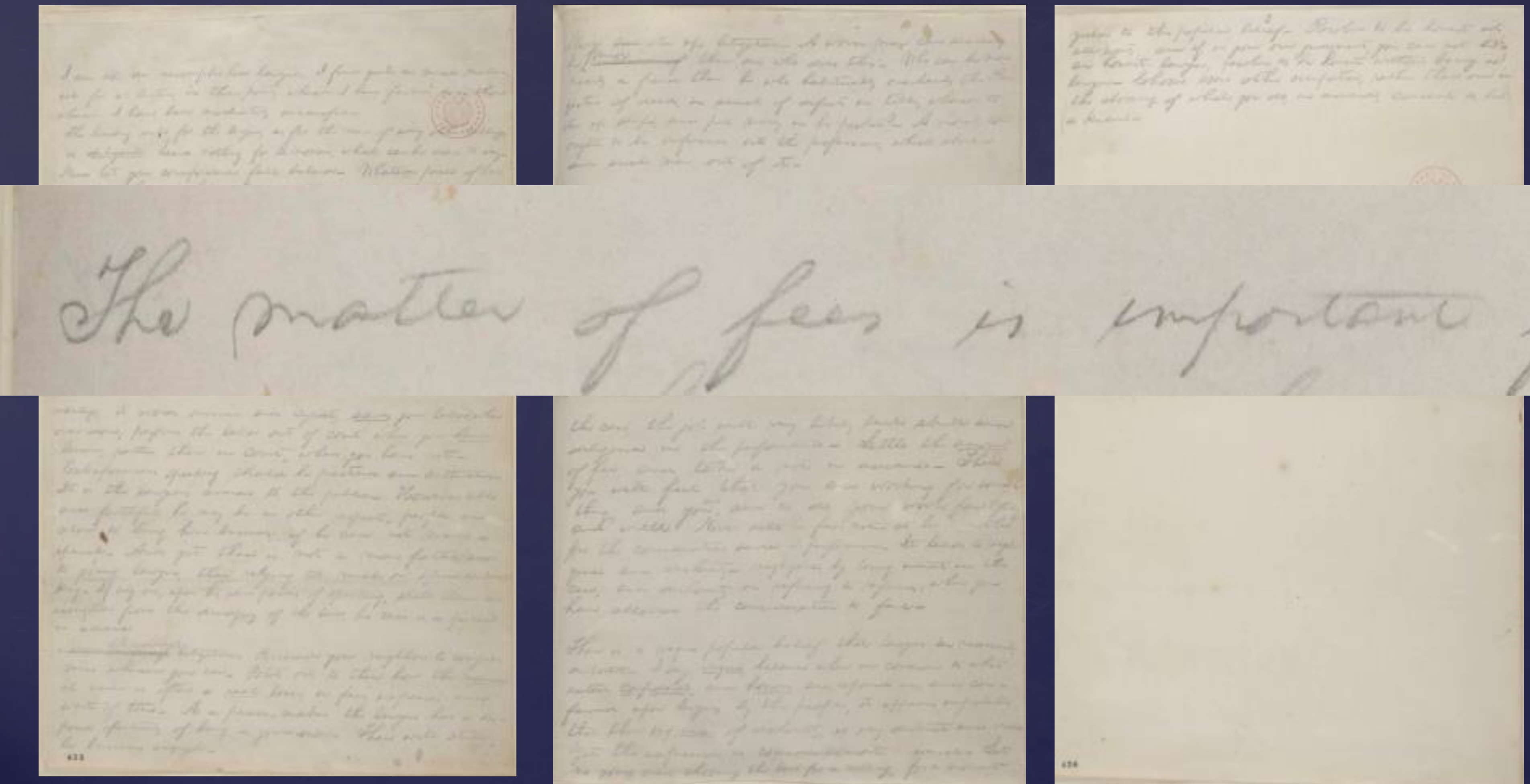
# 4. Never stir up litigation:





# 5. Fees:



The matter of fees is important

Springfield, Ills. July 23. 1859

T. A. Howland, Esq

Dear Sir:

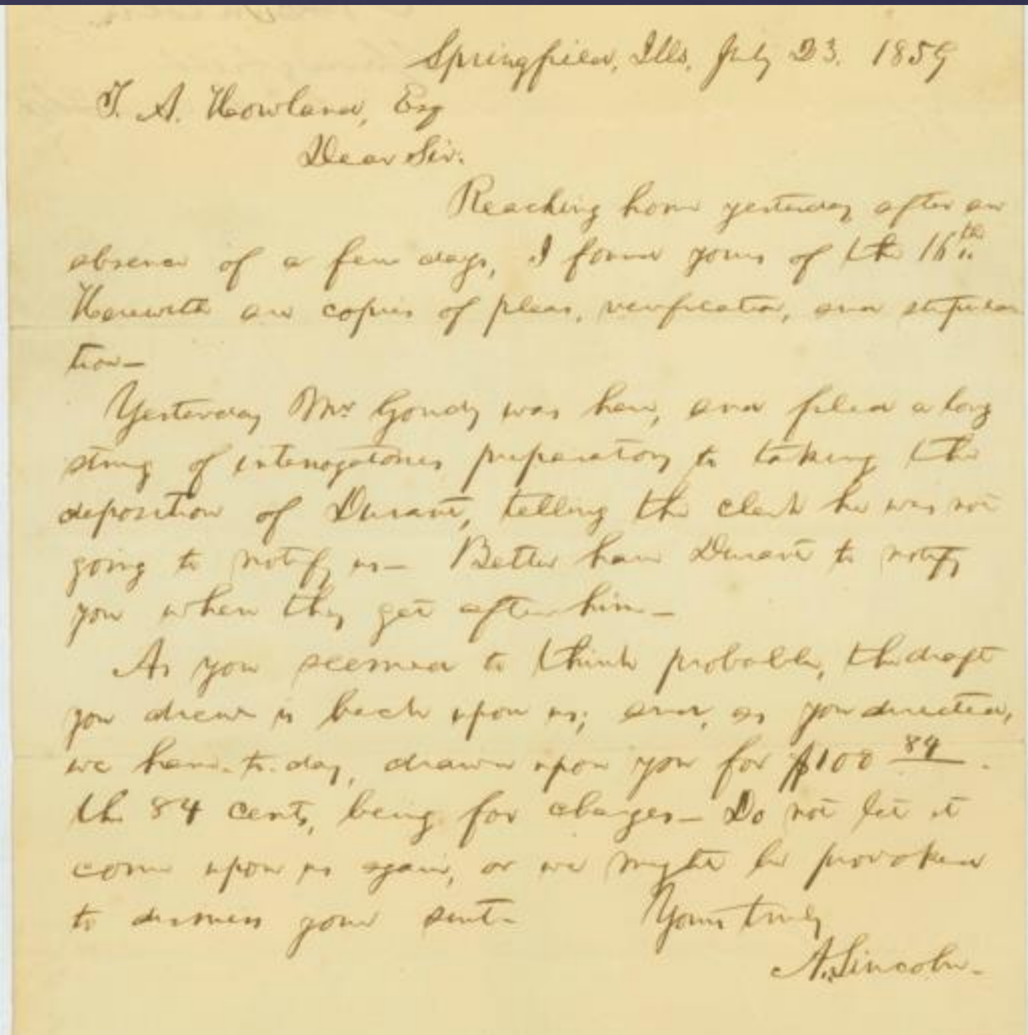
Reaching home yesterday after an absence of a few days, I found yours of the 16th. Herewith are copies of pleas, verification, and stipulation—

Yesterday Mr Gondy was here, and filed a long string of interrogatories preparatory to taking the deposition of Durant, telling the clerk he was not going to notify us— Better have Durant to notify you when they get after him—

As you seemed to think probable, the draft you drew is back upon us; and, as you directed, we have to-day, drawn upon you for $100 84/100. the 84 cents, being for charges— Do not let it come upon us again, or we might be provoked to dismiss your suit—

Yours truly

A. Lincoln—



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Yours truly

A. Lincoln—

"The draft [check] you drew is back upon us…Do not let it come upon us again, or we might be provoked to dismiss your suit."

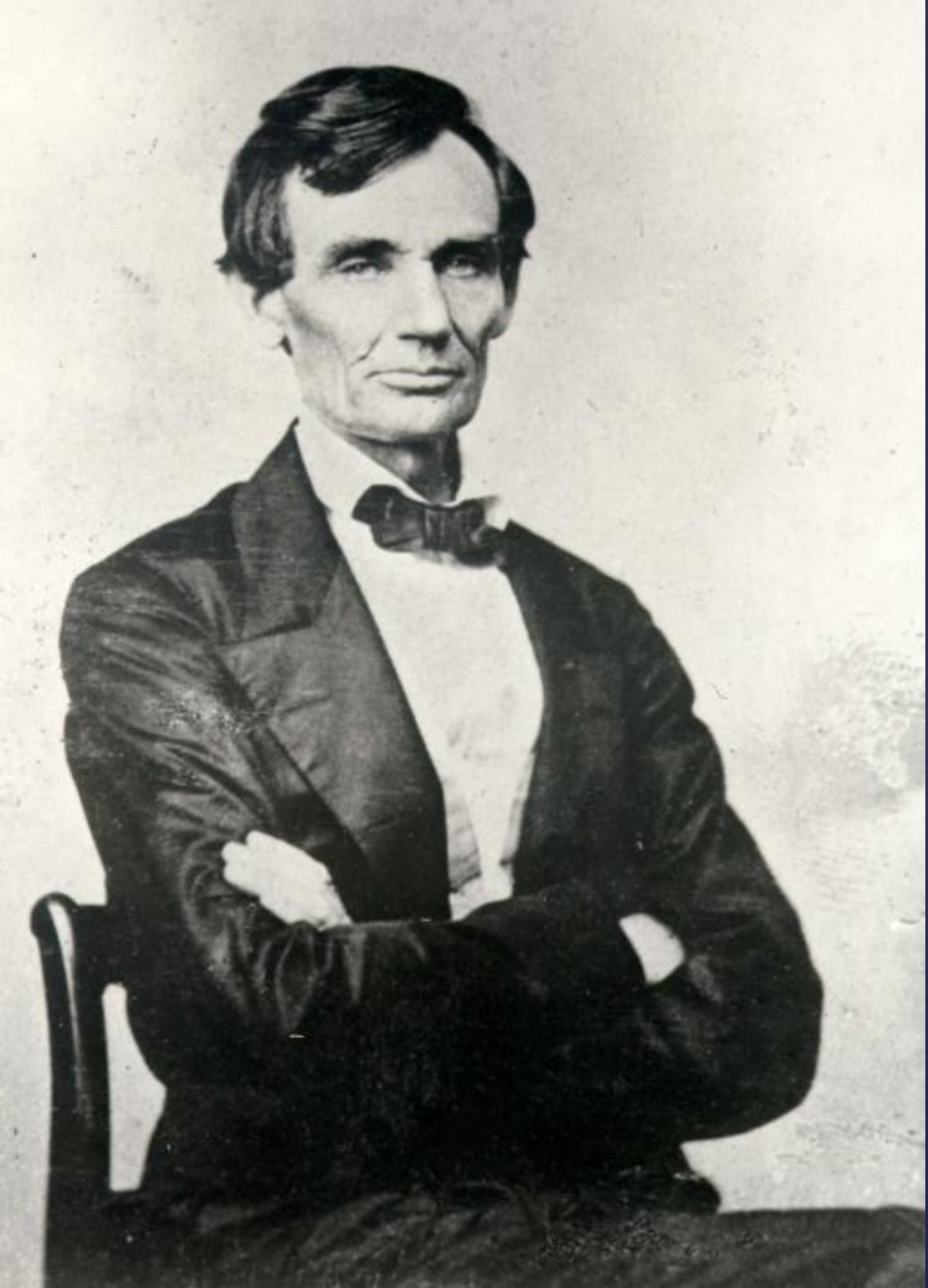
# Shelby County Courthouse, Shelbyville, IL

# McLean County Tax Case, 1853

# Illinois Supreme Court

There is a vague popular belief that lawyers are necessarily dishonest— I say vague, because when we consider to what extent confidence, and honors are reposed in, and conferred upon lawyers by the people, it appears improbable that their impression of dishonesty, is very distinct and vivid. Yet the expression, is common—almost universal— Let no young man, choosing the law for a calling, for a moment yield to this popular belief— Resolve to be honest at all events; and if, in your own judgment, you can not be an honest lawyer, resolve to be honest without being a lawyer— Choose some other occupation, rather than one in the choosing of which you do, in advance, consent to be a knave—

"There is a vague popular belief that lawyers are dishonest. I say vague, because when we consider to what extent confidence and honors are conferred upon lawyers by the people, it appears improbable that their impression of dishonesty is very distinct and vivid. Yet the expression is common, almost universal. Let no young man, choosing the law for a calling, for a moment yield to this popular belief. Resolve to be honest at all events; and if, in your own judgment, you can not be an honest lawyer, resolve to be honest without being a lawyer."



# Commercial Lending Update

## Recent Trends in State & Federal Court Decisions and Legislation

Michael L. Weissman, Of Counsel
Levin Ginsburg

# Illinois Bankers Association
# Bank Counsel Conference
# December 1, 2023

# Commercial Lending Update

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**Bank Wins Malicious Prosecution Case**

The United States Court of Appeals for the Seventh Circuit ruled on March 2, 2022, in *Birch|Rea Partners, Inc. v. Regent Bank,* 27 F.4th 1245 (7th Cir. 2022), that the bank was not liable for malicious prosecution based on a lawsuit it earlier had filed against an appraisal firm and then withdrawn.

On May 16, 2007, SunTrust Bank hired Birch|Rea Partners, Inc., to appraise certain Indiana real estate it was thinking of purchasing. Birch|Rea's appraisal report valued the property at $3.23 million. SunTrust accepted the appraisal report, as did PNC Bank, the source of mortgage financing.

On October 19, 2007, the property owner sold the real estate to a subsidiary of SunTrust Bank subject to a $2.3 million mortgage loan from PNC Bank. A few years later, PNC Bank assigned the loan to American Capital Group, LLC. Even later, the loan was sold to Regent Bank. (A footnote by the court indicates that Regent at some point stepped out of the picture: "Stonegate Bank and Home BancShares, Inc. are successors in interest of Regent. 'Regent Bank' refers to all three defendants in this case." 27 F.4th at 1248 n.1. Thus, although it is not the real party in interest in the case, the opinion continues to refer to Regent Bank.)

In February 2016, Regent began to question the real value of the property. It retained a new firm of independent appraisers that determined the value to be only $200,000. Not content, Regent hired a law firm to investigate further. Regent and the law firm hired another certified appraiser named Potter to review the Birch|Rea appraisal. Potter spotted nine shortcomings in the Birch|Rea appraisal. His report indicated Birch|Rea had not complied with the Uniform Standards of Professional Appraisal Practice and that Birch|Rea had not used proper methods in appraising the real estate.

Based on Potter's report, Regent sued Birch|Rea for professional negligence, negligent misrepresentation, constructive fraud, and breach of contract. For some reason not explained in the opinion, Regent later voluntarily dismissed its lawsuit against Birch|Rea.

That was followed by Birch|Rea's lawsuit against Regent for malicious prosecution. Regent replied with a denial and a request for attorneys' fees under the Indiana frivolous litigation statute, Ind. Code §34-52-1-1. When Regent moved to dismiss the malicious prosecution case and, simultaneously, sought leave to proceed with an award of attorneys' fees, the trial court ruled in favor of Regent on Birch|Rea's malicious prosecution claim but denied Regent the right to pursue its frivolous litigation claim against Birch|Rea. An appeal followed.

The Seventh Circuit stated that four elements constituted a cause of action for malicious prosecution: (1) the defendant brought an action against the plaintiff; (2) the defendant acted with malice; (3) the defendant lacked probable cause to file the action; and (4) the action was terminated in the plaintiff's favor. Regent argued it had probable cause to sue Birch|Rea and did not act with malice. The Seventh Circuit agreed.

Regent had probable cause, said the court, because it consulted with independent appraisers who disagreed with the original valuation, it retained a law firm and, with the law firm, hired a certified appraiser who prepared a report pointing out what Birch|Rea had done incorrectly, and it relied on the report in suing Birch|Rea. The court also held Regent did not act with malice even though it withdrew the original action before an adjudication on the merits. The court also said even if Regent had been negligent in filing the original action, that was insufficient as it takes more to establish malice than mere negligence. So much for the malicious prosecution case against Regent.

As to Regent's claim that Birch|Rea's lawsuit was frivolous and, therefore, warranted the award of attorneys' fees, the court denied Regent's request. The Indiana frivolous litigation statute penalizes those who, in a civil action, pursue a claim that is frivolous, unreasonable, or groundless. The Seventh Circuit ruled that "Birch|Rea did not file a frivolous, unreasonable, or groundless lawsuit against Regent Bank. There is no evidence that the malicious-prosecution claim was brought to injure Regent Bank." 27 F.4th at 1252. And, further, "[t]he fact that Regent Bank quickly dropped its underlying claim suggests that it may have lacked merit." *Id.* This left Regent without the right to pursue its claim for attorneys' fees against Birch|Rea under the Indiana statute.

*What's the point?* This case illustrates that before a bank initiates litigation, it must marshal all the evidence necessary to support the allegations it proposes to make. Although it may file its lawsuit in good faith, the bank must be able to sustain its position even if it later decides that pursuing the action is not warranted because of the economic position of the defendant or for any other valid reason.

**Bank Not Liable Under Statute of Frauds**

In *Modern Industries, Inc. v. Oxford Bank Corp.*, No. 356456, 2022 WL 268535 (Mich.App. Jan. 27, 2022), the claimants sued the bank for alleged negligence in unilaterally changing the terms of certain loans in violation of the parties' agreement, breach of fiduciary duty by failing to properly distribute loans, and engaging in constructive fraud and misrepresentation by waiting to disclose unilateral changes to the final loan documents until the claimants were left with no choice except to close the loans. The court ruled in favor of the bank on all of the claims.

Prior to December 2017, Ronald Lammy was the sole owner of Modern Industries, Inc., and the coowner, with Michael T. Horan, of Livingston County Concrete, Inc. In 2017, Horan agreed to sell his interest in Livingston to Lammy for $2.25 million provided the closing took place before December 31, 2017. Lammy applied to the bank for a loan to fund the buyout as well for a separate loan to refinance the debt of Modern.

The Livingston buyout was documented by two notes. One for $1,492,500 with a five-year amortization schedule and the other for $1,012,000 with a three-year amortization schedule. Each note required monthly payments of principal and interest. The Livingston loan documents included a release provision stating, "Borrower waives, releases and affirmatively agrees not to allege any and all . . . claims . . . it may have, or claim to have[,] . . . against Bank . . . from the date of the Borrower's first contact with Bank up to the date of this Agreement." 2022 WL 258535 at *1. Closing of the Livingston loan took place during December 2017.

Another loan for $1,794,000, guaranteed by the Small Business Administration, to refinance Modern's debts closed in January 2019. It was due in a single payment of interest only one month after closing and, thereafter, in monthly payments of principal and interest. There was no release provision in those loan documents.

After closing the Livingston loan in December 2017, Lammy raised objections to changes in the principal amount of the notes. He claimed that his agreement with the bank was for a five-year note in the principal amount of $2,013,930 and a three-year note in the principal amount of $786,000.

When the Modern loan closed, Lammy claimed the 2017 proposal he approved called for a note in the principal amount of $1,995,780, interest only payable for 12 months followed by 108 monthly payments of principal and interest. He also contested the distribution of the loan proceeds. In dispute was whether the bank had promised Lammy it would modify the notes to conform to a 2017 proposal if he proceeded to close the Modern loan.

No resolution of the dispute was reached, so Lammy refinanced the loans with another lender and paid the Livingston and Modern loans in full. He then sought redress from Oxford with a lawsuit.

The court first ruled that Lammy had not properly established a claim for fraud because any such claim was barred by Michigan's statute of frauds. Lammy had asserted that Oxford had verbally assured him that, after closing the two loans, the errors in the loan documents would be corrected. Oxford answered there was no such agreement. The court said whether there was such a verbal agreement was irrelevant. The Michigan statute of frauds plainly stated, "A person shall not bring an action against a financial institution to enforce any of the following promises or commitments of the financial institution unless the promise or commitment is in writing and signed with an authorized signature by the financial institution: (a) A promise or commitment to lend money, grant or extend credit, or make any other financial accommodation." 2022 WL 258535 at *4.

Because Lammy had no written proof of his allegations, based on the statute, the court dismissed his fraud claim.

Next, the court dealt with Lammy's contention that the bank's last-minute change in the terms of payment of the Modern loan was fraudulent. The repayment terms had indeed been changed. The 2017 proposal provided for one year of interest-only payments, whereas the Modern loan documents provided for only one month of interest-only payments. Although admitting there was a change, the court said, "we are hard-pressed to conclude this change was anything more than a change to the terms of the loan during the negotiation process." 2022 WL 258535 at *5. And, said the court, "[t]he record also indicates [the bank] sent an e-mail ith the draft documents to Lammy and his attorney . . . before each closing for [the borrower's] review and [the borrower] signed the loan documents." *Id.* Under Michigan law, "one who signs a written agreement knows the nature of the instrument so executed and understands its content," concluded the court. *Id.*

A claim by Lammy that the bank's withholding $85,000 of the Modern loan proceeds, and using $75,000 of the withheld funds to pay down the Modern loan, was an act of self-dealing and violated the terms of the Modern loan was also rejected. A review of the record showed that the application of funds was made when the double-counting of an item of collateral was discovered.

Finally, dismissing Lammy's claim against the bank for its alleged negligence, the court said the bank owed no duty to Lammy separate and apart from its contractual obligations, and thus all its obligations had been fulfilled.

*What's the point?* To avoid issues with prospective borrowers, term sheets used in negotiations should be carefully marked to indicate that they are for discussion only and create no binding obligations for either party. If a rejected borrower seeks redress against the bank by judicial means, a ready and reliable defense can be found in the statute of frauds or one of its offshoots found in many states.

## Bank Liability Under the Fiduciary Obligations Act

The Illinois Fiduciary Obligations Act (FOA), 760 ILCS 65/0.01, *et seq.*, was the foundation for United States District Judge Sara L. Ellis's decision in *PLB Investments LLC v. Heartland Bank & Trust Co.*, No. 20 C 1023, 2021 WL 492901 (N.D.Ill. Feb. 9, 2021).

The class action case arose on a motion to dismiss filed by the defendants, Heartland and PNC Bank N.A. A motion to dismiss tests whether the plaintiffs (the complaining parties) have alleged enough in their complaint to allow the case to go forward. The court ruled that they had, vis-à-vis Heartland, but only as to events that occurred after a certain point in time. Because this was simply a motion to dismiss, the case is not necessarily over. There was a subsequent decision by Judge Ellis (*PLB Investments LLC v. Heartland Bank & Trust Co.*, No. 20 C 1023, 2021 WL 5937152 (N.D.Ill. Dec. 15, 2021)) that sustained the earlier decision.

As is so often the case, the factual basis for the case stems from a Ponzi scheme, in this case called Today's Growth Consultant, Inc. (TGC). Its operator was Kenneth D. Courtright III, who owned it with his wife. It did business under the name "The Income Store."

Courtright was the chief executive officer and president from March 2009 through August 2019, when his wife took over. TGC advertised investment opportunities on websites and radio, soliciting investors to enter into consulting performance agreements (CPAs). From 2013 onward, TGC sold more than 700 CPAs to more than 500 investors. TGC promised the investors a minimum rate of return in perpetuity on revenues TGC would develop from websites it would create.

TGC was successful in generating investments raising $75 million between January 2017 and October 2019. But it was equally unsuccessful in its efforts to create and develop websites. To cover the shortfall in returns he promised to investors, Courtright adopted a Ponzi scheme paying earlier investors with funds provided by later investors. Between January 2017 and October 2019, TGC paid investors $30 million, even though its revenues were only $9 million. 2021 WL 492901 at *2. The shortfall was funded by money from new investors. TGC also borrowed $12 million from distressed lending companies.

As is typical in Ponzi-style cases, Courtright appropriated $1.5 million from TGC between January 2017 and October 2019 to pay personal expenses including $36,851 for credit card charges and over $36,000 in private secondary school tuition. *Id.*

On December 13, 2019, TGC announced a temporary cessation of payments to investors. Two weeks later, the Securities and Exchange Commission (SEC) sued Courtright and TGC to terminate the Ponzi scheme and freeze the assets of TGC. In February 2020, the federal government filed a criminal complaint against Courtright charging wire fraud. A receiver appointed at the request of the SEC sued Heartland and PNC for violation of the FOA, breach of fiduciary duty, aiding and abetting Courtright's breach of fiduciary duty, negligence, and unjust enrichment.

The court's opinion was primarily directed toward Heartland. PNC was dismissed from the case.

The court noted that TGC had a business bank account at Heartland with Courtright as an authorized signatory. Courtright also had a personal banking relationship with Heartland because it held a mortgage on his two residences. Courtright made 1,400 funds transfers aggregating $5 million out of TGC's Heartland business account for fast food, mortgage payments to Heartland, insurance, and automotive expenses. *Id.*

Heartland's loan officer on the loans to TGC and Courtright reviewed all of TGC's loan applications and prepared commercial loan credit memos that Heartland used to approve or deny TGC's loan requests. Beginning in 2015, TGC made a series of requests for loans to cover shortfalls. In response to an August 2017 request by TGC for the renewal of a $200,000 line of credit, Heartland required current financial statements from Courtright. 2021 WL 492901 at *3.

It was not until August 2018 that Heartland obtained the current financial statements. The 2017 statements showed an operating loss of $2 million, and the midyear 2018 financial statements also showed a loss. After Heartland's officers reviewed the financial statements, they spoke with TGC's controller, who admitted that money coming in from new investors was being used to fund payouts to existing investors. That was confirmed in a September 2018 meeting with Courtright. On September 18, 2018, Heartland advised Courtright it was terminating its relationship with TGC, and on October 23, 2018, Heartland closed TGC's checking account. *Id.* Heartland did not advise the TGC investors of the Ponzi scheme.

The court began its opinion by noting that the FOA generally protects a bank from liability for the misappropriation of investor funds by a fiduciary unless the bank has actual knowledge of the misappropriation or knowledge of sufficient facts that its actions amount to bad faith. Therefore, the opinion focused on three issues: (1) Did Heartland have actual knowledge of TGC's and Courtright's misappropriation of investor funds? (2) Did Heartland have knowledge of sufficient facts with respect to TGC's and Courtright's misdeeds such that its actions amounted to bad faith? (3) Did Courtright violate his fiduciary duty to investors by making payments to Heartland on his personal debt? The court answered each of these questions in the affirmative.

First, the court said "actual knowledge" means what it says. 2021 WL 492901 at *5. It does not mean what Heartland should have known. It means facts that give rise to the inference that Heartland actually knew of TGC's and Courtright's misconduct. So the fact that Heartland knew that investors wired money into TGC's account does not provide a basis for inferring that the bank actually knew of the misconduct that followed. In addition, the fact that Courtright made many money transfers from the TGC accounts to his personal account did not, in the view of the court, give rise to an inference that the bank had actual knowledge of wrongdoing because there are many legitimate reasons why a fiduciary would move large sums of money on behalf of those persons he or she represents.

The court concluded Heartland did not have actual knowledge of the Ponzi scheme until the September 10, 2018, meeting when TGC's controller admitted that new investor money was being used to make payments to established investors. That meant the claimants could pursue claims against Heartland only on the "actual knowledge" allegations that arose from misconduct occurring after September 10, 2018. But that was not the end of the story. There was still the issue of Heartland's potential liability for bad faith.

Here, the court pointed out that "bad faith" includes situations in which a bank suspects the fiduciary is acting improperly and deliberately refrains from investigating in order to avoid having knowledge that the fiduciary indeed is acting improperly. Negligence alone is not adequate to satisfy the bad-faith standard.

The court went on to say that the allegations made by the claimants against Heartland "suggest that Heartland only took cursory steps to investigate while at the same time ignoring signs of wrongdoing." 2021 WL 492901 at *8. It concluded that "[t]aken together, Plaintiffs' allegations against Heartland give rise to an inference of bad faith, allowing them to more generally pursue their claims against Heartland under the FOA." *Id.*

On the claimants' assertions they also had causes of action on a common-law aiding and abetting theory, the court said that those claims could also be advanced but only as to misconduct occurring after September 10, 2018.

As to other allegations of common-law liability that hinge on the existence of a fiduciary duty owed to the claimants, the court made the familiar observation that banks do not owe a duty of care to noncustomers, and even if they did, there was no allegation in the complaint that the claimants had reposed their trust and confidence in Heartland.

*What's the point?* Generally speaking, a bank has no liability under FOA for engaging in ordinary day-to-day banking activity. Liability under FOA arises when circumstances surrounding the relationship become suspect and the bank makes little or no effort to investigate.

## Bank and Borrower Did Not Collude To Injure Another Lender

Under §9-332 of the Uniform Commercial Code, a party is liable for colluding with another when there is evidence that the two parties acted pursuant to an agreement or otherwise in concert with each other and the purpose of the concerted action was illegal, fraudulent, or otherwise wrongful toward the injured third party. In *NextGear Capital, Inc. v. Bank of Springfield,* Case No. 4:18-CV-01086-NCC, 2019 WL 2525753 (Bankr. E.D.Mo. June 19, 2019), the question was whether Bank of Springfield had colluded with its borrower, Gateway Buick GMC, Inc., to injure Gateway's floor-plan lender, NextGear Capital, Inc.

Gateway operated an automotive dealership in Hazelwood, Missouri, selling new Buick and GMC vehicles. Between August 11, 2015, and January 12, 2016, it executed a series of promissory notes totaling $13,625,000 with Bank of Springfield. The notes were secured by a blanket lien on all of Gateway's real property.

NextGear provided Gateway with floor-plan financing pursuant to a demand note and a loan and security agreement dated October 27, 2014. Gateway granted NextGear a blanket lien on its personal property, thereby giving NextGear a senior lien position in Gateway's accounts receivable and any funds Gateway would receive from General Motors. Gateway received two types of payments from General Motors: vehicle rebates and holdbacks that were proceeds from vehicles floor-planned by NextGear; and dealer incentive payments.

With Gateway experiencing financial difficulties, the three parties executed a series of forbearance agreements. On October 1, 2015, NextGear agreed to subordinate its claim to payments Gateway had coming from General Motors, except for the sales proceeds arising from the vehicles NextGear had floor-planned and for which it had not been paid. The parties executed an amended forbearance agreement on May 27, 2016, and another amended forbearance agreement on July 10, 2017. In the last of these agreements, there was a provision prohibiting Gateway from any further borrowing from the bank.

Because NextGear found, as early as May 2016, that Gateway was selling vehicles out of trust and not remitting the sales proceeds, it stationed risk managers at Gateway's premises to ensure that the sales proceeds were delivered to NextGear. The bank was aware of this as well as Gateway's financial difficulties.

Gateway had bank accounts with several different banking institutions, including Regions Bank. The NextGear loan documents obligated Gateway to deposit vehicle rebates and holdbacks from the sale of vehicles floor-planned by NextGear into the

Regions account. NextGear was party to a tripartite control agreement giving it control over the Regions bank account.

Gateway directed General Motors to deposit rebate, holdback, and incentive payments into Gateway's account at Bank of Springfield. Bank of Springfield knew the source of the deposits was General Motors. These deposits were a direct violation of the forbearance agreements, the floor-plan financing agreements, and the subordination agreements.

NextGear accused Bank of Springfield of acting purposefully to induce Gateway to deposit monies Gateway received from General Motors into Bank of Springfield for the purpose of making payments due the Bank on its Gateway notes. These moneys were supposed to be placed on deposit at Regions Bank. Despite demands from NextGear, Bank of Springfield refused to turn over the disputed funds. Litigation between NextGear and Bank of Springfield followed.

The decision arose from a motion to dismiss the case filed by Bank of Springfield. The Bank claimed its conduct fell within the protection of §9-332 of the Uniform Commercial Code. The court agreed.

Section 9-332 of the UCC states, "a transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party." 2019 WL 2525753 at *3. In the view of the court, the decision hinged on whether the bank was acting in collusion with Gateway when it obtained the General Motors payments.

The court said there was an insufficient allegation of collusion and ruled as follows:

> **[A] junior secured creditor is under no obligation to identify and segregate cash proceeds for the benefit of the senior secured creditor. . . . This is the case even if the junior secured creditor knew of the senior secured party's interest. . . . The collusion standard in Article 9 does not impose a duty on a transferee of funds to identify and segregate the funds absent a contractual obligation to do so. . . . As long as** [Bank of Springfield] **acts rightfully, it cannot be responsible for Gateway's potentially wrongful actions.** [Citations omitted.] 2019 WL 2525753 at *4.

*What's the point?* Courts do not penalize alleged collusion between a bank and its customer absent definitive proof of concerted conduct with a malicious purpose.

**Bank and Borrower Did Collude To Injure Another Creditor**

Keeping in mind *NextGearCapital,* in which a Missouri bankruptcy court rejected an assertion that a bank had colluded with a borrower to injure another creditor, we will revisit the issue of collusion in a Montana federal district court decision that came to quite a different conclusion. *Banner Bank v. First Community Bank,* 854 F.Supp.2d 846 (D.Mont. 2012).

*Banner Bank* arose on Banner's motion for summary judgment. It raised a number of legal issues and ultimately resulted in a judgment in favor of Banner.

Banner was the successor to F&M Bank. F&M loaned $5 million to Superior Propane, LLC, in 2006. Two of the three principals of Superior, Gary Hebener and Dean South (H&S), guaranteed repayment of the loan. F&M was granted a security interest in all of Superior's assets that it perfected by the filing of a UCC1 Financing Statement with the Montana Secretary of State.

In April 2009, H&S obtained a $400,000 loan from First Community Bank. They granted FCB a security interest in five propane tanks. Superior guaranteed repayment of the loan. FCB filed a UCC1 Financing Statement with the Montana Secretary of State's office on April 23, 2009, listing four 30,000-gallon tanks and one 60,000-gallon propane tank as collateral. 854 F.Supp.2d at 849 n.2. South and Hebener were listed as debtors. The loan collateral was actually part of Superior's inventory and had not been purchased by H&S. The $400,000 loan had a term of six months and was supposed to provide funding to assist Superior in making its loan payments to Banner.

The loan proceeds from the $400,000 loan initially were deposited in H&S's checking account at FCB on April 21, 2009. The following day, South wrote a $200,000 check on that account payable to Superior, and Superior signed the check over to Banner as a partial payment on its debt to Banner. A week later, on April 29, 2009, South wrote another check, this time for $172,000, payable to Superior. Once again, Superior signed the check over to Banner as a partial loan repayment.

On October 8, 2009, South wrote a check for $78,000 on the account of Harold's Meter Service (an adopted d/b/a of Superior) at Mountain West Bank payable to the H&S account at FCB. Two months later, on December 4, 2009, there was a payment of $80,000 on the H&S personal loan account at FCB from the H&S checking account. The regular monthly payment on the H&S loan was $78,000 and the source of the funds, presumably, was the sale of the propane tanks. (That was confirmed by trial testimony by South that two of the 30,000-gallon tanks had been sold to a party in Wyoming for $80,000.)

Banner was not informed of the sale of the tanks. Before FCB made the personal loan to H&S, H&S told FCB they would get a release from Banner of its security interest in the tanks. But that never happened.

Banner did not learn of the sale until a year had passed. When it did, it demanded the $78,000 from FCB based on its perfected security interest in the tanks. FCB refused, and litigation followed.

FCB's first defense was that Banner would be unjustly enriched if it were awarded the proceeds of the sale of the tanks because Banner had been compensated by the almost $300,000 payments it received in 2009. The historical background was that when South and Hebener procured their $400,000 loan from FCB, they paid $300,000 to Superior and Superior, in turn, paid those funds to Banner. The remaining $100,000 was paid to Superior to try to keep it going. FCB's position was that when H&S paid the $300,000 to Banner, they were "paying" for the two propane tanks. The court summarily rejected that contention because when the $300,000 was paid to Banner, South and Hebener "did not tell Banner Bank that the payment was for the two propane tanks." 854 F.Supp.2d at 852. And in answer to the assertion that the $100,000 payment to Superior was for the tanks, the court said, "South testified that he and Hebener gave $100,000 to Superior for operating expenses, not as payment for the tanks. . . . Banner Bank believed that it was being paid what it was owed on the $5 million note. Banner Bank never granted a release of its security interest; nor did it know that a release was being sought." *Id.*

FCB next argued that it had perfected a purchase-money security interest in the tanks. It lost that argument too. The court's conclusion was that "FCB's argument that it has a purchase-money security interest is without merit, first because the propane tanks are inventory and second because there is no record of any purchase of the tanks from Superior by South and/or Hebener." 854 F.Supp.2d at 854. In the view of the court, FCB did not have a valid perfected security interest in the propane tanks because South and Hebener did not have rights in that collateral. It said that "FCB never demanded documentation of ownership in the collateral from [H&S] or any other proof that they had the power to transfer rights in the collateral." *Id.*

Advancing to the issue of collusion, the court detailed why a finding of collusion between FCB and South and Hebener was warranted. It said:

> **The court does not find that FCB intended at the outset of its loan transaction to collude with Superior Propane to the detriment of Banner Bank, but little by little FCB's conduct during the South/Hebener loan transaction edged toward and eventually transformed into a *de facto* collusion with Superior against Banner. FCB's complete failure to ascertain the ownership or power to transfer rights in the collateral as pledged by South and Hebener certainly permitted Superior Propane to defraud its primary secured creditor. Essentially FCB's inattention to the most important details of the loan transaction allowed South and Hebener to pledge assets they did not own for their $400,000 personal loan. Further, FCB's failure to require South and Hebener to provide documentation of Banner Bank's waiver of its security interest effectively kept Banner Bank completely in the dark about a potential bank conflict over Superior's assets or about a possibility that Superior might want to sell these encumbered assets.** 854 F.Supp.2d at 856.

The court's final comments are worth noting: "FCB either was aware of the wrongfulness of this transaction or chose to remain willfully ignorant." Such willful ignorance is ample evidence of collusion, said the court. *Id.*

*What's the point?* The Montana court essentially ruled that a bank, acting in concert with one of its borrowers, can be held to have colluded with its borrower if the bank remains passive in the face of mounting evidence that the borrower's intention is to harm another creditor. That test holds a bank to a far stricter code of conduct than that articulated in the collusion case previously reviewed here.

## Bank Liability Due to Ambiguity in Deposit Agreement

Columbian Spot, LLC v. Dollar Bank, 2022 U.S. Dist. LEXIS 179888, 2022 WL 4610644 (W.D. Pa September 30, 2022, arose as a putative class action that sought to impose liability on the bank for charging its customers fees that were in violation of federal law and contrary to the deposit account agreement they signed .

These were some examples of the improper fees: (1) two or more fees for overdraft and non-sufficient funds on a single ACH transaction debit or check, (2) using a lesser balance than the money in the customer's account to determine when to assess an overdraft fee. It was also alleged that the Bank had not complied with Regulation E before being allowed to charge overdraft fees on certain transactions.

The complaint contended such practices constituted a breach of contract including a breach of the implied covenant of good faith and fair dealing. The bank argued that the fees it charged were in accordance with the unambiguous terms of the account agreements its customers had signed. The court said if the terms of the account agreements were unambiguous the Bank's motion would be granted. But not if there were any ambiguities.

The court stated it had reviewed the account agreements and, without disclosing what they were, said, "...the account Documents at issue contain sufficient ambiguities to render dismissal of the breach of contract claim inappropriate." The court also said because the breach of contract claim was not to dismissed, the claim of a violation of the covenant of good faith and fair dealing would not be dismissed.

What's the point? Ambiguities in written documents are construed most stringently against whomever has drafted them. This case is a good example of that rule applied to bank documents.

## Bank Not Liable for Honoring Fraudulently Endorsed Checks

*Navigators Specialty Insurance Co. v. California Bank & Trust,* Case No. 8:17-cv-0991-JLS-KES, 2021 WL 4929554 (C.D.Cal. Sept. 27, 2021), arose on a bank's effort to avoid being held liable for checks it honored that bore fraudulent endorsements. It was successful, with the court basing its decision on California law.

A general contractor entered into a subcontract with a subcontractor under which the general paid the subcontractor's suppliers and sub-subcontractors via a joint check procedure. The procedure called for the subcontractor to obtain a lien waiver from its supplier and deliver it to the general. Then, the general would issue a check drawn on the general's account at its depository bank that named both the subcontractor and its supplier as payees. The subcontractor was to endorse the check and hand it to its supplier.

In January 2016, the subcontractor began forging the lien waivers and submitting them to the general. Unsuspecting, the general continued to issue checks on its depository bank. When the checks reached the subcontractor, the subcontractor endorsed them, forged the supplier's endorsement, and deposited the checks in the subcontractor's own account.

Months later, the general discovered the fraud, made a claim with its insurer under its crime and fraud policy, and was paid. The insurer then sued the bank that honored the fraudulent endorsed checks.

The case was in its second go-around, having been considered earlier by the Ninth Circuit Court of Appeals and remanded to the district court because the bank had not been given an opportunity to present an important defense the first time around.

That defense was §3405 of the California Uniform Commercial Code §1101, *et seq.,* the California version of UCC §3-405. But first, what lead to that defense: To begin, the court cited Cal.Com. Code §4401, which plainly states that a bank may charge against its customer's account only "an item that is properly payable from that account." But the court also noted an exception in circumstances in which a bank, "in good faith, pays an instrument" when "an employer entrusted an employee with responsibility with respect to the instrument and the employee or a person acting in concert with the employee makes a fraudulent indorsement of the instrument." 2021 WL 4929554 at *3, quoting Cal.Com. Code §3405(b).

The bank contended that the exception meant the fraudulent endorsements on the checks were effective and that the bank was not liable. Not so fast, said the court. There were a couple of hoops the bank still had to jump through.

First, there was the question of whether the subcontractor was the general's "employee." For that, the court turned to the California Labor Code. The Code defined the term "employee" to include an independent contractor. The court found the subcontractor to be an independent contractor because the general retained control over the performance of the job the sub was hired to do but not the means by which the subcontractor might accomplish the result. So, because the subcontractor was an independent contractor, it was an employee under California law.

Next, the question was whether the subcontractor was a " 'responsible' employee." California decisions, said the court, hold that a separate entity, or the employee of a separate entity, may serve as an employee or agent for purposes of Cal.Com. Code §3405.

Continuing, the court said even though the subcontractor did not operate within the framework of the general — as a traditional employee might — the general nonetheless had solely authorized the subcontractor to supply the information used to prepare the checks.

Thus, the subcontractor fell under the classification of an employee, even though it was an independent contractor, and was a responsible employee because of its role in the preparation and distribution of the checks bearing the fraudulent endorsements.

The public policy reason for UCC §3-405 was explained as follows: "Section 3-405 is based on the belief that the employer is in a far better position to avoid the loss by care in choosing employees, in supervising them, and in adopting other measures to prevent forged indorsements." 2021 WL 4929554 at *5, quoting UCC §3-045, cmt. 1.

The conclusion: UCC §3-405 made the forged endorsements of the checks legally effective, and the general and its insurers must bear the loss. The bank is not liable under UCC §4-401. NOTE: The result would be the same in Illinois under 810 ILCS 5/3-405(a)(3).

**Bank Wins Contest with Grain Co-op**

In *MidWestOne Bank v. Heartland Co-op,* 941 N.W.2d 876 (Iowa 2020), a farmer's secured lender prevailed over a grain co-op in a battle over whether the grain co-op could deduct drying and storage charges from sales proceeds due the farmer.

The farmer in question regularly delivered his crops to the co-op, a licensed grain dealer with a grain warehouse and handling facility. He had a contract with the co-op for the storage, drying, and sale of the grain. The farmer was also a customer of the local bank, borrowing money from 2013 through 2016, to fund operating expenses, and granting the bank a security interest in the grain and the proceeds of sale. The bank filed a UCC-1 financing statement with the Iowa Secretary of State's office on February 29, 2012, and renewed it on November 15, 2016.

The farmer signed an agricultural security agreement with the bank under which he was to keep the bank fully informed about the location of the grain, to permit no other liens to be asserted against the grain, and to make certain the grain was properly maintained. The farmer was to do any and all things necessary to cultivate, harvest, and protect the crops and was to provide the bank with a list of potential buyers of the crops. Once the crops were sold, payment was to be in the form of a check payable jointly to the farmer and the bank. The bank notified the co-op on three occasions between 2014 and 2016 of its security interest.

he co-op made six grain sales on behalf of the farmer between January 7, 2014, and February 24, 2017. In each case, the co-op deducted its cost of drying and storing the grain from the amount of the joint check it sent to the farmer and the bank. On March 16, 2018, the bank sued the co-op to recover the withheld funds. The co-op defended on the grounds that it was entitled to retain the funds based on the value of the services it had provided to protect the grain. It invoked the concept of equitable estoppel. After considering the effect of the applicable Iowa statute of limitations, the court ruled in favor of the bank. It said:

> **We have never held that a grain elevator, as an unsecured creditor, can recover under a common law or equitable unjust enrichment theory against a bank with a valid perfected security interest in the grain and proceeds. To the contrary, we have held the bank is entitled to summary judgment enforcing its security interest in the grain proceeds.** 941 N.W.2d at 886, citing *First State Bank v. Clark,* 635 N.W.2d 29, 34 (Iowa 2001).

In a footnote, the court observed that legislation had been introduced in the 2019 legislative session to give grain elevators a new priority over secured lenders, but it was never enacted. To that, the court said: "We defer to the legislature whether to give grain elevators lien rights for storage and drying costs superior to a lender's prior perfected security interest in crops and their proceeds." 941 N.W.2d at 887 n.5.

Finally, in response to the co-op's argument that the bank waived its lien rights by cashing the joint order checks without objection, the court said there was no evidence that the bank discovered the deductions until 2017 so that, "while the actions of [the bank] may not have been a model of diligence, and even rather gullible, there is no triable issue on the question of an intentional and knowing waiver of [the bank's] interest in the proceeds through clear, unequivocal, and decisive conduct." 941 N.W.2d at 888, quoting *Peoples Trust & Savings Bank v. Security Savings Bank,* 815 N.W.2d 744, 764 (Iowa 2012).

*What's the point?* It takes a great deal of compelling evidence to induce a court to countenance an equitable carveout from the UCC's hierarchy of priorities.

## Ode to the UCC

How Wondrus Art Thou, Oh my UCC,
Verily I Do Adore Thee,
Thou Has Given Me Tools,
To Outwit an Army of Fools,
Thou Hast Saved Me on Many a Day,
Against Those Who Wouldst Engage in Foul Play,
Three Steps I Coordinate,
So There Will Be Collateral to Liquidate,
First, Searching Takes Me Hither and Yon,
To Names and Places I Must Ponder,
And Finding No Other Filer Means I Need Not Go Yonder,
Second, Having Filed a Financing Statement There Will Be No Surprise,
That I Have Topped Everyone In Getting to the Prize,
And Last, Confirming That I Have Attained Priority,
Creates a Poorly Disguised Feeling of Superiority.
So Whence Cometh Judgement Day,
I Will Be Proud to Say, "I Did It the UCC Way".

## The UCC Meets SRECs

*Skyview Finance Co. v. Kearsage Trading, LLC,* Civil Action No. 20-11666-PBS, 2023 WL 179837 (D.Mass. Jan. 13, 2023), tests whether a new species of collateral will be introduced to the Uniform Commercial Code. For that reason alone, it is noteworthy.

The case arose out of a pitched battle over whether certain contracts for the purchase of the alleged new collateral had been breached.

But first, to set the stage as had the district judge. An SREC is a tradeable environmental commodity that represents one megawatt hour of electricity generated by solar energy.

In certain states, including Massachusetts, there are regulations known as Renewable Portfolio Standards (RPS) requiring electricity suppliers to generate a portion of their electric power from a renewable energy source. If they do not produce enough on their own, electricity providers can purchase SRECs to ensure their compliance with RPS.

The year that an SREC is generated is known as a vintage year. Once produced, SRECs are " 'minted,' *i.e.,* certified, by a regulatory agency on a quarterly basis." 2023 WL 179837 at *1. A party can enter into a forward contract for SRECs that have not yet been generated or minted, meaning it can contract to purchase SRECs identified by a future vintage year at a set price. SRECs are generally delivered to a buyer as they are minted.

Any SRECs that are produced but not sold may be entered into a clearinghouse auction. There is no assurance that all the SRECs will be sold.

Now, to the case at hand. It was a contract dispute between a consolidator and trader of SRECs that acquired SRECs and resold them to utilities. The other contracting party was an independent producer of renewable energy that generated SRECs. They had entered into a series of contracts, some of which had been fully performed and others that were in dispute. Litigation arose over the disputed contracts.

As the court's opinion put it, "[o]n the eve of trial, [one party] submitted the novel argument that Article 2 of the [UCC] should apply to this case." 2023 WL 179837 at *6.

The court proceeded to consider that argument but found it wanting. It began by noting that UCC §2-105 applied to "goods" and that goods are "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale." *Id.,* quoting Mass.Gen. Laws ch. 106, §2-105. So, said the court, the question is whether SRECs are goods. And that was a question on which "there is no case law on point." 2023 WL 179837 at *6.

Nonetheless, the court noted that a 2010 Massachusetts bankruptcy court had ruled that electricity was a "good" as defined by the UCC. In reply, the defendant argued that the SRECs were not goods because "they are not 'moveable' or 'tangible.' " *Id.* At best, said the defendant, the SRECs could be considered general intangibles, and even if so considered, they were still not subject to Article 2.

The court agreed with the defendant. It said the bankruptcy court case was based on the fact that "electricity is tangible and does possess physical properties." *Id.* But SRECs, said the court, are different. They are instrumentalities resulting from Massachusetts state regulations. Furthermore, in Massachusetts, SRECs are divorced from the underlying energy, and therefore they do not possess any of the physical properties of a tangible good. So far, so good.

But then the court made a comment that flies in the face of judicial economy. The court remarked, "Whether or not SRECs are intangibles for purposes of the UCC need not be decided now." *Id.* Despite the fact that the proponent of Article 2 coverage had focused on the "goods" argument, the case was an opportunity for a court to provide clarity on an issue that was bound to require judicial consideration in the future.

*What's the point?* As far as it goes, the decision is helpful since the future is likely to present other instrumentalities of a similar character.

## Lien Lost by Surrender of Possession

*In re Leaver,* 627 B.R. 517 (Bankr. W.D.Wis. 2021), is a reminder that a lien initially perfected by possession can be lost by surrender of possession even if the debtor stipulates the lien continues.

Mr. Leaver was a dairy farmer who had business loans with Wisconsin Bank & Trust and the Farm Service Agency. In 2017, he entrusted dairy cows and youngstock he could not care for to Hillside Dairy. Hillside housed, cared for, milked, and managed Leaver's cows and youngstock until May 20, 2020.

Under Wisconsin law, Wis.Stat. §779.43(3), Hillside had a statutory lien on the livestock for its efforts. But the statutory lien would be lost if the lienholder surrendered possession.

Leaver filed his Chapter 12 petition for relief on April 21, 2020. Sixty days later, Hillside filed a proof of claim for $106,448.84. It was based on the statutory lien it had for boarding the livestock. Leaver filed a plan on July 20, 2020. Then, Leaver and Hillside executed an agreement that provided for the release of the livestock to Leaver and that Hillside would retain its lien rights. The agreement was approved by the court on July 31, 2020.

Leaver, with the obvious background support of the bank and the Agency, objected to the amount claimed by Hillside, but the objection did not raise the question of whether Hillside's secured status was still in place.

Since Hillside had voluntarily surrendered possession of the livestock, the court said, "Hillside gave up the priority its lien might have against [the Bank]." 627 B.R. at 523. But that was not the end of the story. The remaining question was wh ther Hillside still retained its secured status vis-à-vis Leaver. Did the agreement for Hillside to retain its lien, the one the court had approved, save the day for Hillside? No such luck.

The court said that once Hillside's statutory lien was terminated by its surrender of possession, "Article Nine applies to the transaction described in the Stipulation." *Id.* ad

The court then observed that Hillside's underlying transaction with Leaver met all the re uirements for the attachment of an Article 9 security interest.

However, the court ruled that Hillside had not perfected its ecurity interest. Hillside h not filed a UCC1 Financing Statement, nor had it remained in possession of the livestock.

Addressing the stipulation that the parties had executed and that the court had approved, the bankruptcy judge noted, "Neither the Stipulation nor any motion . . . included provision for post-petition perfection of the lien that was being granted." 627 B.R. at 527. Continuing, the court said, "The parties did not ask the Court to treat the Stipulation as a motion to approve credit that would be secured by a lien either junior, equal, or senior to the lien of [the Bank]." *Id.* And finally: "The failure to obtain a Court order deeming perfection or authorizing the credit given by Hillside leads to only one result. Hillside's claim in this case is not secured by a perfected security interest." 627 B.R. at 528.

*What's the point?* When perfection of a security interest depends wholly on possession of the collateral, surrender of the collateral terminates perfection and permits junior lienholders to advance their priority status.

**Security Interests Lost Due to Inadequate Description of Collateral**

Two recent cases emphasize the need for an adequate description of collateral when attaching and perfecting a security interest in commercial tort claims.

In *Polk 33 Lending, LLC v. Schwartz,* 555 F.Supp.3d 38 (D.Del. 2021), a lender sought to enforce a security interest against a debtor's directors and officers (D&O) liability claims. The alleged D&O claims arose in connection with the sale of the assets of a Chapter 11 debtor corporation. Polk, the lender, had provided debtor-in-possession (DIP) secured financing to the debtor under a DIP credit agreement.

The debtor corporation denied there were any D&O claims. The bankruptcy judge found that the assets were sold in an orderly fashion pursuant to an arm's-length asset purchase agreement in a competitive bidding environment. Ergo, no D&O claims.

On appeal in the district court, Polk contended there were D&O claims and that it was entitled to assert those claims because it had a perfected security interest in them. Turning attention to the DIP credit agreement, the court noted that it provided only that the collateral subject to Polk's security included "all commercial tort claims (including D&O Claims)." 555 F.Supp.3d at 43.

The court said, "The question is whether the DIP Credit Agreement identified the claims with the requisite specificity to convey a security interest in those claims to Polk." *Id.*

It did not, said the court, concluding: "This is the overgeneralized 'type of collateral' identification that is insufficient according to DCC Section 9-108(e)(1) and did not convey to Polk a security interest in the D&O claims." *Id.*

In *In re Main Street Business Funding, LLC,* 642 B.R. 141 (Bankr. D.Del. 2022), Lane, a creditor, was seeking an order directing the trustee of a bankruptcy estate to turn over the proceeds received from a court-approved settlement of a lawsuit.

Prior to the debtor's bankruptcy filing, Lane had loaned a debtor corporation $852,000. The debtor concurrently executed a security agreement ith a collateral description beginning "[a]ll tangible and intangible personal property of Debtor" and proceeding to list the usual UCC collateral categories. 642 B.R. at 146. Lane also perfected his security interest.

After the bankruptcy case had begun, the trustee settled litigation that the debtor had commenced prior to the bankruptcy filing. Lane's efforts to reach the settlement proceeds raised two questions: (1) did the settlement involve commercial tort claims?

(2) was the collateral description in the security agreement sufficiently detailed to cover those claims?

The claims sounded in fraudulent misrepresentation, conversion, civil conspiracy, breach of fiduciary duty, and aiding and abetting a breach of fiduciary duty. The court ruled they were clearly commercial tort claims.

Turning to the collateral description in the security agreement, the court held it was inadequate. It said, "a security interest in commercial tort claims cannot be obtained simply by generically describing collateral as 'all property' or even as commercial torts. . . . Instead, security interest in commercial tort claims must be specifically identified or described in the security agreement." [Footnote omitted.] 642 B.R. at 153.

*What's the point?* If a lender wants to have a security interest in a matter in litigation, the description in the security agreement must read as follows: "All funds and any other proceeds arising in any manner or form from that certain matter captioned ABC Industries, Inc. v. XYZ Corporation, No.__ in the XXXXXX Court for the XXXXXX District of XXXXXX State of XXXXXX."

## UCC Misuse Results in Criminal Conviction

In *State of Tennessee v. Lyons,* No. M2019-01946-SC-R11-CD, 2023 WL 3446554 (Tenn. May 15, 2023), the Tennessee Supreme Court dealt with an instance in which Uniform Commercial Code (UCC) filings were the tools for criminal conduct. It sustained a judgment of the Tennessee Court of Criminal Appeals that misuse of the UCC filing system could support a conviction of criminal conduct for forgery and other crimes.

The four defendants had filed 102 different UCC1 financing statements with the Secretary of State of Tennessee. One of them was listed as the secured party in each instance. The collateral was shown as a "claim of lien" based on a contract or lien for an amount between $4 million and $12 million. The address shown for the secured party was the address at which the filer (secured party) lived.

Certain victims testified to the impact the false UCC filings had on them. A home seller almost lost the sale; another was denied a request for a personal loan; another had it show up on his credit report as a lien on his property.

The jury convicted each of the four defendants. Each was given a significant prison sentence. The Tennessee Supreme Court allowed them to appeal "solely on the issue of whether the evidence was sufficient to support the convictions for forgery." 2023 WL 3446554 at *4.

The court began by commenting on the UCC filing system, saying, "Unfortunately, the ease of the system, meant to facilitate painless secured transactions, left it vulnerable to persons with ill motives." *Id.* Because many of these fraudulent filings have been against prosecutors, judges, and other public officials, remedies have been added to the UCC to afford them relief. See, *e.g.,* Tenn. Code Ann. §47-9-513(e).

For a conviction of forgery to occur in Tennessee, there has to have been the making "of false entries in books or records." 2023 WL 3446554 at *6. The defendants contended that what they had done — filing the UCC1 financing statements — did not involve "false entries." They said that what the Tennessee statute addresses is "false making," creating a document that is something other than what it seems to be. But, said the defendants, the law does not cover a genuine document (such as a bona fide UCC1) containing false information. Finding another part of the Tennessee statute covered "false making," the court rejected the defendants' argument.

The next argument advanced by one defendant was that the UCC1s had not been entered in "books or records" as the forgery statute required. In essence, it was an appeal for the court to limit "books or records" to private records of a business and/or financial nature. There was no basis for that limitation in the statute, said the court.

Next, the court considered the requirement for conviction that the fraudulent conduct had been undertaken "with intent to defraud or harm another." 2023 WL 3446554 at *8. It said intent rarely can be proven by direct evidence, so "[i]t can be inferred from . . . all the circumstances of the case in evidence." The court noted the UCC1s were filed without any legal basis, the victims had no business dealings with the defendants, and the victims owed no money to the defendants. Thus, it concluded, "The evidence was clearly sufficient for a rational juror to find intent to defraud or harm." 2023 WL 3446554 at *9.

*What's the point?* The court's decision is consistent with discouraging blatant misuse of the UCC filing system. Even though the offenders did not gain any monetary advantage, their widespread harassment of innocent victims warranted a significant penalty.

**Validity of UCC Filing Must Be Tested by Standard Search Logic**

In *In re NRP Lease Holdings, LLC,* 50 F.4th 979 (11th Cir. 2022), the decision was supposed to be based on answers to three questions the Eleventh Circuit had certified to the Florida Supreme Court. But the Florida court found that the case turned on an issue the Eleventh Circuit did not address.

Beach Boulevard and its affiliated businesses filed petitions for Chapter 11 relief. The debtors were jointly and severally liable to the lender on two Small Business Administration-guaranteed loans. The loans were supposed to be secured by a security interest on all the debtor's assets. The lender filed two UCC1 Financing Statements identifying the debtor as "1944 Beach Blvd., LLC" rather than its actual legal name "1944 Beach Boulevard, LLC" as shown on the articles of organization filed with the Florida Secretary of State. 50 F.4th at 982.

Beach Boulevard contended that because of the lender's mistake, the lender's financing statements were seriously misleading and did not perfect its security interest. Beach Boulevard prevailed.

The controlling statutory provision was Fla.Stat. §679.5061 (Uniform Commercial Code §9-506), which deals with errors or omissions in financing statements. The statutory section begins with a validation of a UCC filing in case of "minor errors or omissions" unless those minor errors or omissions make the filed UCC1 Financing Statement "seriously misleading." Fla.Stat. §679.5061(1); UCC §9-506(a). It goes on to state that a financing statement that fails to sufficiently provide the name of the debtor is seriously misleading unless "a search of the records of the filing office under the debtor's correct name, using the filing office's standard search logic" would disclose the otherwise insufficient filing. Fla.Stat. §679.5061(3); UCC §9-506(c).

Disregarding the three questions certified to it by the Eleventh Circuit, the Florida court said the dispositive question was, "Is the filing office's use of a 'standard search logic' necessary to trigger the safe harbor protection of Section 9-506(3)?" The Florida Supreme Court said that it was. 50 F.4th at 984.

The Florida court noted that the Florida UCC does not explain what "standard search logic" means. The court said that it means a procedure that identifies the set of financing statements on file that constitute hits for the search or, stated differently, that produces an unambiguous identification of hits. It continued that the Florida registry provides for a search but does not have an option that is standard search logic.

Because Florida's UCC registry lacks a standard search logic, the safe-harbor test of §9-506(c) cannot be performed and the zero-tolerance rule of §9-506(b) controls. The court's ruling was, "Because [the lender's] financing statements are seriously misleading under Florida law, they were not effective to perfect its security interest in all of Beach Boulevard's assets." 50 F.4th at 985.

**Bank's Election of UCC Foreclosure Bars Other Remedies**

In *Bank of America, N.A. v. City View Blinds of N.Y., Inc.*, CIVIL ACTION NO. 20 Civ. 9911 (SLC), 2022 WL 580764 (S.D.N.Y. Feb. 25, 2022), Bank of America sued City View Blinds of N.Y., Inc., and others for breach of a loan and a security agreement. Bank of America asserted claims for breach of contract, replevin, conversion, unjust enrichment, and account stated.

On April 8, 2019, Bank of America had entered into a loan agreement with City View, under which City View was granted a revolving line of credit of up to $4.8 million. 2022 WL 580764 at *1. The agreement was to be governed by New York law. That same day, City View executed a security agreement granting Bank of America a security interest in certain collateral. *Id.*

The honeymoon was short-lived. On October 21, 2019, Bank of America sent City View a notice of default. Apparently, the honeymoon was revived with a waiver of the default. But not for very long. *Id.*

On February 20, 2020, Bank of America delivered a notice of nonrenewal stating that on the expiration date of the note, all principal, interest, and other charges and fees would then be due and payable. 2022 WL 580764 at *2. The next day, Bank of America sent notice that it had elected to accelerate the maturity of the loan, making it immediately due and payable.

Thereafter, the parties negotiated a restructuring of the loan. On October 1, 2020, Amendment No. 1 was executed resulting in a new maturity date of April 30, 2021. Certain guarantors also stepped forward, securing their guaranties with collateral. But the required payment due under the restructure was not made.

On October 30, 2020, Bank of America demanded payment. But none was made. Two weeks later, the bank sent another notice of acceleration and demand for turnover of collateral demanding payment within seven days. The demand was unanswered.

On November 24, 2020, Bank of America filed suit and moved for summary judgment. The motion was unopposed.

With respect to Bank of America's claim for breach of contract, Bank of America prevailed. It also prevailed on its request to foreclose its security interests. But that was as far as the court was prepared to go.

Under New York law, in order to succeed in replevin (seizure of the collateral upon an event of default), Bank of America had to prove that its right to the collateral was superior to the right of City View. 2022 WL 580764 at *6. Having a security interest in the collateral was not sufficient because that simply imposed a lien on the collateral. Ownership remained with City View. Further, the claim for replevin was duplicative of the foreclosure claim because both would end up with the same result.

And the same reasoning applied to Bank of America's claim for conversion (unauthorized dominion over personal property resulting in interference with a party's superior right of possession). The conversion claim was duplicative of the foreclosure claim.

Bank of America was granted the relief it requested but on only one of the claims it advanced.

*What's the point?* To borrow a phrase from the vernacular, when pursuing a borrower in default, a bank is entitled to just "one bite of the apple." That is, if the bank has chosen a remedy that is dispositive of all of its claims against the borrower's collateral, it will not be permitted to concurrently pursue other remedies that will produce the same ultimate result.

**Bank's UCC Liens Trump Wage Claims in Federal Receivership**

In a federal court receivership in the United States District Court for the District of Kansas, reported in *Bank Midwest v. R.F. Fisher Electric Co.*, 514 F.Supp.3d 1310 (D.Kan. 2021), the contestants were a bank with unpaid loans due from R.F. Fisher Holdings and G & G Leasing, LLC, and the International Brotherhood of Electrical Workers (IBEW) Local 124 representing employees with wage claims that were not paid when the borrowers ceased operations.

The case was a battle between the bank and the IBEW over the relative priority of their claims. The bank was due $11,416,051.84, *i.e.,* the unpaid balances of five promissory notes plus an overdraft. A series of security agreements were executed by the borrowers concurrently with the notes, and the bank had duly perfected its security interest by filing UCC1 Financing Statements with the Secretary of State of Kansas. The wage claims asserted by the IBEW totaled $137,955.11 and were for wages and benefits due IBEW members for their last week of work, which ended September 16, 2019.

In response to the IBEW's assertion that the order appointing the receiver gave it priority over the bank, the court turned attention to the section that granted a third priority to the costs of operating, maintaining, and repairing the collateral and a fourth priority to payment of the expenses of the collateral. Indebtedness due the bank was afforded only a sixth priority. But the court ruled against the IBEW. It noted that the term "Collateral" was defined in the order and included "all assets of debtor." The court then stated that "[e]mployee wages cannot be considered a cost of operating the collateral," that "the Union's argument conflates the operational costs of running Defendants' business with the costs of operating the Collateral," and that "employee wages are not 'payment of expenses of the Collateral.' " 514 F.Supp.3d at 1314. And, further, that there was no clear language in the order granting priority to wage and benefit claims over secured bank debt.

Having no luck with its contentions with respect to the order appointing the receiver, the IBEW then argued for various Kansas statutes that it said supported its claim of priority.

The first of these was Kan.Stat.Ann. §44-312. It stated that when a receiver was appointed for a corporation, copartnership, or individual under Kansas law, the wages due employees for the six-month period preceding the appointment "shall be preferred to every other debt" and shall be paid from the moneys "which shall first come into the hands of such receiver." 514 F.Supp.3d at 1316. In response, the bank argued the statute did not apply because the receiver had been appointed under federal, not state, law. The court said it did not matter which law applied because the statute "does not provide the [IBEW] with the relief it seeks in this case." *Id.* The court said the plain language of §44-312 "does not give employee wages a lien or priority over secured liens. Instead, it simply indicates a preference for wages over other general debts." 514 F.Supp.3d at 1317.

Not yet finished, the IBEW then invoked Kan.Stat.Ann. §17-6910. It stipulated that when a corporation becomes insolvent, the employees shall have a lien on its assets for an amount not exceeding two months' wages, which shall be paid prior to any debts of the corporation. The court said the statute posed the question of "whether the [borrower's] assets [we]re subject to existing liens or whether such existing liens are included in the debts of the corporation." *Id.* The bank's position, of course, was that the employees' lien for wages was on the corporate assets, and those assets were subject to the preexisting liens of the bank. Addressing the language of the statute, the court said, "[a]lthough the plain language of §17-6910 grants employees a lien on the corporation's assets for wages due to them, it does not provide that this lien takes priority over existing and prior liens on those assets," "[n]or does it provide that the lien will take priority over secured interests." 514 F.Supp.3d at 1319. The result: judgment for the bank.

*What's the point?* Even though courts are generally sympathetic to wage claims of employees of insolvent borrowers, they will not use state statutory law to subordinate earlier perfected security interests in the borrower's assets to those wage claims unless the state law clearly grants the wage claims a lien priority position.

**Can a Wire Transfer Be Recalled After It Is Accepted?**

In *Blue Flame Medical LLC v. Chain Bridge Bank, N.A.*, 563 F.Supp.3d 491 (E.D.Va. 2021), a case involving Article 4A of the Uniform Commercial Code (UCC), the district court was called to decide when an accepted payment order may be cancelled. The factual background was a bit complex, so it is set forth in chronological order as follows.

1. March 20, 2020: John Thomas and Michael Gula contacted the California Department of General Services (DGS) about supplying N95 masks even though they had no previous experience with medical supplies.

2. March 23, 2020: Thomas and Gula formed a limited liability company called Blue Flame Medical LLC in the State of Delaware. They also opened an account for Blue Flame at Chain Bridge Bank, N.A., where they advised the officers that the account would receive domestic and foreign wire transfers totaling $100 million per month and would be directed to wire out an average of $25 million per month. They were provided with wire transfer instructions for the account.

3. March 25, 2020: DGS issued a purchase order to Blue Flame for a total of 100 million N95 masks for a total purchase price of $609,161,000, 75 percent being prepaid. The purchase order included a provision that DGS could "terminate performance of work under this Contract for its convenience . . . if [DGS] determines that a termination is in the State's interest." 563 F.Supp.3d at 496. The California purchase order included a delivery date of April 3, 2020.

4. March 25, 2020: Thomas sent a message to DGS at 11:46 p.m. that included a list of delivery dates for the 100 million masks indicating that the first million would be delivered on April 2, 2020, and that the entire shipment would be in California no later than April 24, 2020. At that point, DGS officials did not know that Blue Flame had been organized only two days earlier, was not qualified to transact business in California, had never delivered any masks to customers, and had opened its bank account only one day earlier.

5. March 25, 2020, 3:30 p.m.: Gula told Chain Bridge Bank that California is sending a wire transfer to Blue Flame account for $450 million. At 6:15 p.m., a Chain Bridge Bank officer asked Gula what the purpose of the incoming wire transfer was. Gula replied that it was the purchase of 100 million masks. In response to a question, Gula stated he did not know how long the incoming wired funds would remain in the account. The Chain Bridge Bank officer advised senior bank management, who said so large a wire transfer could not be held entirely at Chain Bridge Bank but would have to be spread over various accounts. Senior management stated it was "unbelievable" a two-day-old business could receive a $450 million contract from the State of California.

6. March 25, 2020: Chain Bridge Bank's senior management advised Gula by telephone that a $450 million deposit would not be covered by FDIC insurance and that it would have to be placed in "sweep" accounts at several institutions.

7. March 25, 2020, 6:17 p.m.: The senior management of Chain Bridge Bank asked Gula to identify the recipient of funds to be wired out of the account. They are told Wingar Industrial, Inc.

8. When searched for on the Internet, Wingar Industrial turned out to a cutlery company. Chain Bridge Bank's senior management became more suspicious.

9. March 26, 2020, 11:21 a.m.: The California State Treasurer's Office originated a wire transfer for $456,888,600 for the benefit of Blue Flame through the state's bank, JPMorgan. The transaction triggered a warning to JPMorgan's Fraud Payments Control Team that looks out for suspicious transactions. The team asked DGS to confirm the transaction, and it did so. Receipt of the wire transfer occurred at 11:55 a.m. at Chain Bridge Bank, and at 11:57 a.m., Chain Bridge Bank's personnel advised Gula that $456,888,600 had been received for the benefit of Blue Flame.

10. March 26, 2020, 12:07 p.m.: Concerned about the transaction, Chain Bridge Bank management placed a hold on the funds. JPMorgan's team asked Chain Bridge Bank if it knew the beneficiary of the funds and what their ultimate disposition would be, saying JPMorgan had concerns about whether the transaction was bona fide. Chain Bridge Bank management said it had its own concerns and put a hold the funds.

11. March 26, 2020, 12:44 p.m.: JPMorgan's Team questions Chain Bridge Bank's management, asking if Blue Flame is a new account or a well-established business.

12. March 26, 2020, 12:51 p.m.: An employee of DGS called Chain Bridge Bank in response to a message left on DGS's voicemail, confirming that the wire transfer was legitimate.

13. March 26, 2020, 12:55 p.m.: Chain Bridge Bank managers asked JPMorgan for documentation to support that the funds were transferred properly. DGS replied in the affirmative and referred the managers to an official in the California State Treasurer's Office.

14. March 26, 2020, 1:19 p.m.: Officials from the California State Treasurer's Office called Chain Bridge Bank and were told that Blue Flame's account had just been opened the previous day and that the funds had not been credited to the bank account of Blue Flame at that time.

15. March 26, 2020, 1:34 p.m.: Managers of Chain Bridge Bank asked JPMorgan's team whether a recall could be issued for the wired funds Chain Bridge Bank held. The

answer was that JPMorgan felt comfortable because Chain Bridge Bank was holding the funds.

16. March 26, 2020, approximately 1:39 p.m.: JPMorgan advised Chain Bridge Bank that JPMorgan was recalling the funds. Chain Bridge Bank asked for an official communication from JPMorgan requesting a recall of the funds.

17. March 26, 2020, 1:55 p.m.: Chain Bridge Bank advised Gula that it had received an official notice from JPMorgan to return the wired funds and that he should resolve the matter with the State of California.

18. March 26, 2020, 2:05 p.m.: JPMorgan sent a message to Chain Bridge Bank officially asking for a return of the funds. The recall corresponded to a 2:00 p.m. request from the California State Treasurer's Office that JPMorgan recalled the funds because the Treasurer was not satisfied with DGS's due diligence.

19. March 26, 2020, 2:30 p.m.: Gula visited with Chain Bridge Bank's senior managers, apologized for the transaction, and stated that he did not object to the return of the funds.

20. March 26, 2020, 3:21 p.m.: Chain Bridge Bank returned the funds to JPMorgan. The funds are credited to the account of the State of California at 4:02 p.m. The litigation followed.

On June 12, 2020, Blue Flame sued Chain Bridge Bank, claiming violations of §§4A-404(a) and 4A-204(a) of the UCC. On October 13, 2020, Chain Bridge Bank sued JPMorgan for indemnification of its litigation expenses. Each party filed a motion for summary judgment. The result was a ruling against Blue Flame on its claim against Chain Bridge Bank and in favor of Chain Bridge Bank on its claim against JPMorgan.

Blue Flame's claims against Chain Bridge Bank were based on an alleged violation of §4A-404(a) that occurred when Chain Bridge Bank returned the wired funds to JPMorgan. Section 4A-404(a) states that "if a beneficiary's bank accepts a payment order, the bank is obliged to pay the amount of the order to the beneficiary of the order." The court said there was no question whether the funds in question had been accepted because they had been credited to the account of Blue Flame. Despite that, Chain Bridge Bank argued that although the payment was accepted, it was not liable to Blue Flame for having returned the funds because JPMorgan had cancelled the payment. In making that contention, Chain Bridge Bank relied on §4A-211(e), which states: "A canceled payment order cannot be accepted." Section 4A-211(c)(2) provides that a cancellation order can trump an acceptance only if the cancellation is "effective." 563 F.Supp.3d at 503.

Section 4A-211(e) stated that a cancellation of a payment order is effective only if the order was issued to implement an unauthorized payment or, because of a mistake by the sender, the payment order (1) is a duplicate of a prior order, (2) directs payment to a beneficiary not entitled to payment, or (3) directs payment of too great an amount. Finding none of the foregoing was present, the court said Chain Bridge Bank could not nullify its obligation to Blue Flame because JPMorgan's effort at cancellation was not effective.

Alternatively, Chain Bridge Bank argued the entire wire transfer was clearly in error because "California originated the funds transfer only as a result of having been misled about Blue Flame's bona fides as a PPE supplier." *Id.* The court made short work of that argument saying, "Chain Bridge cannot rely on problems with the underlying transaction to escape its obligation to its customer under the banking regulations." 563 F.Supp.3d at 504. But then the court said that despite Chain Bridge Bank's violation of the banking regulations, judgment would be in favor of Chain Bridge Bank because "[Blue Flame] cannot establish that it sustained any damages from that return. . . . The UCC does not provide for, and Blue Flame has not claimed, statutory damages for a violation of §4A-404(a)." *Id.* Moreover, said the court, even if the funds had been released to Blue Flame, there was ample evidence in the record that Blue Flame could not have fulfilled its contract with the State of California.

The remaining issue was whether JPMorgan had to indemnify Chain Bridge Bank for fees and expenses it had incurred in the litigation. Applying §4A-211(f), the court ruled that it did because that provision applies when "a sender has no right to cancel a payment order after it is accepted by the receiving bank." 563 F.Supp.3d at 510. Finding no evidence of an agreement between the two banks overriding that rule, the court entered judgment in favor of Chain Bridge Bank on its indemnification claim against JPMorgan.

*What's the point?* The rules of §4A of the UCC operate independently of the contractual arrangements that give rise to the origination, implementation, and possible cancellation of a payment order. Section 4A emphasizes finality so that financial transactions can be executed with the expectation that the sender and recipient of a wire transfer will abide by their respective obligations.

**Bank Loses Claim to Collateral**

In *Rome Granite, Inc. v. Pinnacle Bank,* A22A0447, 2022 WL 1492854 (Ga.A p. May 5, 2022), the bank lost its claim to certain collateral because it was unable to provide sufficient evidence that both it and the borrower intended to include the collateral but failed to do so as a result of a mutual mistake.

The borrower's relationship with the bank began before 2004 with a commercial loan secured by real estate. After 2004, the borrower acquired two additional tracts, named "Tracts 6 and 7," but they were not added to the collateral description in the bank's security documents. In 2012, the bank and the borrower consolidated separate loans into one secured by real estate, but the collateral description was not modified. Subsequently, the borrower built a loading dock on its property that extended over Tracts 6 and 7. In 2015 and 2016, the bank's security documents were modified again, but again no changes were made to the original collateral description.

The borrower later defaulted, and in 2019, the bank conducted a nonjudicial foreclosure under a power of sale. The bank was the purchaser at the sale. Thereafter, for a year following the sale, the parties acted as though the bank had foreclosed on all of the property owned by the borro er, including Tracts 6 and 7. But in 2020, the borrower learned that it still owned Tracts 6 and 7 and quitclaimed them to a limited liability company organized by the owner of the borrower.

Once it became aware of the fact that it did not own Tracts 6 and 7, the bank sued to reform the loan documents to include Tracts 6 and 7 as collateral because they had been excluded as a result of a mutual mistake of the parties. The trial court denied the bank's request for reformation of the loan documents, and the appeals court confirmed the decision.

The appeals court said that the burden on the party attempting to prove mutual mistake is a heavy one and that a court will relieve mistakes only if the evidence to support it is "clear, unequivocal, and decisive as to the mistake." Ga. Code Ann. §§23-2-21(a), 23-2-21(c).

Reviewing the evidence, the court found it conflicting. There was testimony by bank officers that they believed all of the borrower's real estate was covered by the security documents. There was evidence that Tracts 6 and 7 were located at the same treet address mentioned in the security documents as well as testimony from the borrower's owner that he did not realize that Tracts 6 and 7 were not covered by the security documents.

Conversely, the court found no evidence of specific discussions concerning the collateral to secure the borrower's indebtedness in the 2012 documentation. The bank officers did not inform the borrower that it intended Tracts 6 and 7 to be covered by its security interest. The borrower's owner testified that he signed the 2012 loan documents without giving any thought as to whether Tracts 6 and 7 were included. The court also noted that the 2012 transaction did not involve any additional financing, that the real estate appraisal for the 2012 transaction did not reference Tracts 6 and 7, and that the title insurance policy issued in 2012 did not cover Tracts 6 and 7.

Based on the foregoing, the court said the bank had not established clearly, unequivocally, and decisively that Tracts 6 and 7 were excluded from the 2012 loan documentation due to a mutual mistake.

*What's the point?* Although after-acquired personal property collateral can be included in a bank's collateral by using an after-acquired clause in the collateral description, that is not true of real estate. If it is intended that after-acquired real estate is to be part of the collateral securing the borrower's indebtedness, appropriate modifications must be made to the loan documentation.

**Election of Wrong Remedy Blocks Creditor's Claim**

In *Durham Commercial Capital Corp. v. Ocwen Loan Servicing, LLC*, 777 Fed.Appx. 952 (11th Cir. 2019), a pleading error prevented a secured creditor from enforcing its rights against its collateral. The result is informative for secured lenders and their counsel.

The facts were rather simple. A law firm was retained by a mortgage loan servicer to initiate foreclosure proceedings and to remit the amounts collected to it. Concurrently, the law firm entered into a factoring agreement with plaintiff Durham Commercial Capital Corporation, under which Durham purchased some of the law firm's accounts receivable and was granted a security interest in all of the law firm's accounts receivable. Durham sent notice to the mortgage servicer that Durham was owed what the mortgage servicer paid the law firm for its legal services.

Durham also sent notice to the mortgage servicer to pay Durham directly, but the mortgage servicer ignored the notice and paid the law firm $1,340,865.21 after receiving the notice. The law firm paid $202,238.47 to Durham, but Durham asserted it was entitled to $1,138,626.74 more. 777 Fed.Appx. at 953. The law firm sought bankruptcy relief, and Durham sued the mortgage servicer for $1,138,626. A jury trial ultimately ensued with an award to Durham. An appeal followed with a reversal in which the mortgage servicer prevailed based on New York law.

Counsel for Durham had founded Durham's entire case on §9-406(a) of New York's Uniform Commercial Code. That section provides that a debtor may satisfy its obligation by paying its creditor until a third party notifies the debtor that the right to collect the debt has been assigned to the third party. After that, the debtor cannot extinguish the debt except by paying the third party. Of course, the third party must have the right to enforce collection of the debt and that depends on showing that it has the status of an assignee.

The mortgage servicer argued on appeal that Durham failed to establish in the trial court that Durham had the status of an assignee of the law firm's accounts. Durham's reply in its brief was that the argument was immaterial because §9-406(a) provided a right to collect to both explicit assignees as well as secured parties. But later in the appeal, Durham's counsel admitted there was nothing in the record to suggest that the law firm had secured its account with the mortgage servicer to Durham. Thus, Durham was left with the argument that §9-406(a) afforded it a private right of action to collect. But that was too big a fish for the Eleventh Circuit to swallow.

The Eleventh Circuit reviewed §9-406(a) and found nothing to indicate that it creates a private right of action in favor of a secured party against an account debtor. Therefore, it said, if there is any such right of action, "such a right must be implied." 777 Fed.Appx. at 955.

The court concluded there was no implied right of action for a secured party against an account debtor. The principal test was whether recognizing an implied right of action would be inconsistent with the New York legislative scheme. The court said §9-607(a)(3) already grants a secured party the right, after default, to enforce the obligations of an account debtor; thus, to grant an implied right of action under §9-406(a) "would be inconsistent with the overall legislative scheme." 777 Fed.Appx. at 956. Furthermore, in *IIG Capital LLC v Archipelago, L.L.C.,* 36 A.D.3d 401, 829 N.Y.S.2d 10 (2007), a New York state court had ruled that there is no authority to treat a factor's security interest as an assignment for collection. 777 Fed.Appx. at 957.

*What's the point?* This decision provoked the Permanent Editorial Board of the Uniform Commercial Code to publish PEB Commentary No. 21, which states that "an 'assignment' [is understood to be] an outright transfer of ownership of a specified payment right or a [security interest to secure an obligation] in a specified payment right." Under that approach, Durham won.

## Signatories to Note Liable to Payee Even if Not Named in Note

**In *Solidarity Ltd. v. JeffEx, LLC,* No. 20 CV 1456, 2023 WL 2683215 (N.D.Ill. Mar. 29, 2023), the principal issue as whether three individuals who had signed a promissory note were liable to repay it even though they weren't named in the body of the note. The court held they were.**

Jeffrey Cioni, James Cioni, and David Brittsan were partners in a company called Rescue Tire Recycling (RTR). In 2015, they sought capital to fund RTR's operations. They retained a venture capital firm, Venture DNA, to assist in raising $20 million.

When that failed, they sought a bridge loan from Solidarity Ltd. to fund their operations pending receipt of funds from a bond issue. In September or December of 2015, Brittsan met with TJ Weber, an agent of Solidarity, to discuss a $175,000 bridge loan to JeffEx, an excavating contracting business owned by Jeffrey Cioni. In exchange for the loan, JeffEx would pledge certain items of equipment as collateral. Once the bond issue had been resolved, RTR would purchase the equipment from JeffEx, and JeffEx would use the funds it received from RTR to repay Solidarity.

On December 28, 2015, the Cionis and Brittsan signed a $175,000 commercial note. The note began with the usual language: "The Undersigned (whose principal place of business is listed below), jointly and severally, if more than one, for value received, promise to pay to the order of Solidarity Limited . . . the principal sum of $175,000 . . . [o]n or before 90 days from receiving the Principal Sum ('Maturity Date') [and i]n addition . . . $50,000 in interest." 2023 WL 2683215 at *2.

The "Defaults and Remedies" section of the commercial note stated that the "[f]ailure of the Undersigned to pay any amount due hereunder for a period in excess of ten days after it becomes due . . . shall constitute an event of default (Default) hereunder." *Id.* It also empowered Solidarity to declare the commercial note immediately due and payable without notice at any time during a default.

The commercial note reiterated, "The Undersigned, if more than one, agree that they are jointly, severally, and primarily liable for repayment of this Note." *Id.*

The signature page of the commercial note showed four signatures: Jeffrey Cioni signing on behalf of JeffEx, and separate individual signatures by Jeffrey Cioni, James Cioni, and David Brittsan, followed by their respective addresses. Nowhere in the text of the commercial note were the Cionis or Brittsan referenced. A security agreement was also executed by JeffEx in favor of Solidarity covering certain equipment.

In December 2015 and January 2016, Solidarity distributed a total of $175,000 to JeffEx. The commercial note matured on April 6, 2016, and was not repaid. A loan modification agreement was executed in April extending the maturity date to May 15, 2016, but, once again, the commercial note was not repaid. The modification agreement was signed by JeffEx and each of the three individuals.

In February 2020, Solidarity sued JeffEx and the three individuals. Although they admitted the commercial note had not been paid, the individuals denied they had personal liability.

The court denied the individual defendants' contention that the terms of the note were ambiguous. It said: "The Note unambiguously provides that any person who signed the Note would be jointly and severally liable for the debt to Solidarity. Because the Cionis and Brittsan signed the Note, they are jointly and severally liable to Solidarity." 2023 WL 2683215 at *4. Also, the court held that the contractual term "the Undersigned" unambiguously refers to those whose names were signed at the end of the note, including the Cionis and Brittsan.

*What's the Point?* The defendants attempted to manufacture an ambiguity where none existed. The fact that a contractual term is not defined in a loan document does not make it ambiguous. An undefined term will be given its plain and ordinary meaning as found in a standard ordinary definition.

# Consumer Banking Update

## Recent Trends in
## Consumer Financial Services

Marc P. Franson, Partner
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# Consumer Finance Update

Illinois Bankers Association

Bank Counsel Conference

December 1, 2023

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# On the Supreme Court Docket

- Preemption:  Payment of Interest on Escrow Accounts – Cantero v. Bank of America
- Deference to Regulatory Agencies (Chevron Doctrine) – Loper Bright Ent. v. Raimondo and Relentless v. Dep’t. of Commerce
- Consumer Financial Protection Bureau v. Community Financial Services Association of America, Ltd.  - is the funding mechanism of the CFPB constitutional?
    - Oral Argument held October 3, 2023
    - 5th Circuit Decision
    - Effect on Existing Actions/Implications on Future Actions

# CFPB:  An Agency Gone Awry

- Section 1071 Dodd Frank – Small Business Data Collection –Enjoined, US Senate votes to rescind
- Examination Guide Changes on Fair Lending – Beyond its power; Appealed to 5th Circuit
- Illinois case:  CFPB v. Townstone Financial – redlining case dismissed-CFPB exceeded its authority
- Auto Loans:  CFPB v. Credit Acceptance Corp. – challenge to auto practices that are widespread in the industry (S.D. N.Y.)
- Challenges to Rent to Own:  CFPB v. Snap Finance LLC (D. Utah)
- CFPB Rebuked by 11th Circuit:  CFPB v. Brown
- It's Cathcy:  FDIC sued by Minnesota Bankers on NSF Guidance

# Recurring Themes

- Arbitration: North Carolina Supreme Court – Change of terms valid: *Canteen et al. v. Charlotte Metro Credit Union* Case # 10A23 and *Mascasero v. ENT C.U. (Colo.) (electronic transactions)*
- Arbitration: US Supreme Court: Coinbase decision: Case stayed while arbitration being appealed
- Arbitration: Avoiding class actions – *Fama v. OppFi* (W.D. Wash) (high rate lender)
- Arbitration: Consumer Groups Petition CFPB for Rulemaking
- Overdrafts: From large to small institutions: B of A - $8.8 million settlement – violation of policies; NBT Bank - $4.25 million settlement; Redstone Fed. C.U. (Alabama) – $3.7 million settlement, Empower F.C.U. (N.D. N.Y. ) - $5.2 million settlement, Desert Fin. C. U. (Arizona -$6 million settlement).

# CFPB on the Offense

- October Guidance on Immigration Status
- October Guidance on Junk Fees
- October Guidance on Open Banking
- October Guidance on Fees for Providing Customer Information
- Artificial Intelligence: Fair Lending and Adverse Action Requirements
- Interagency: Third Party Risk Management
- Credit Card Fee Limits - $8 late fee – possible court challenge
- Elimination of creditor use of medical data
- Recent Enforcement Actions: Add ons/cancellation<br>Credit Reporting<br>Debt Accounts without Authorization<br>Fair Lending

# CFPB Regulatory Agenda

- Overdraft fees as Finance Charges under Reg. Z
- Revisions to Fair Credit Reporting Act
- NSF Fees
- FIRREA – Quality Control on automatic valuation models
- Consumer Data
- PACE (property assessed clean energy financing ) – ability to repay
- Larger participants – payments
- Non banks – registration (“bad boy” list) and terms
- Consumer Group Petitions - Arbitration

# Consumer Law Decisions

- HUD – disparate impact:  where politics and regulation meet
- Fair Debt Collection Practices Act:  Standing – Choice v. Kohn Law Firm – 7th Circuit
- Fair Credit Reporting Act:  reasonable investigation of disputes – *Saluki v. Credit One Bank, N.A.* (2nd Circuit); Standing and Damages – Santos v. Experian (11/6/23 – 11th Circuit)
- Date Breaches – Marriott – class action waiver effectiveness
- GAP Refunds
- State Privacy Laws

# Update on New Products and Innovation

- Buy Now Pay Later (BNPL) – Regulations Coming?
- Income Sharing Agreements – Is it credit?  - CFPB/AG Suit
- Tips and Donations – disguised interest?
- Earned Wage Access – the new cash advance
  - Nevada and Missouri – it is not credit
  - CFPB - it is credit

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