Message from the Chair

To the Members of the Committee on Banking Law:

In the 13 years I have been actively involved with the Banking Law Committee, I have come to appreciate the "traditions" of the Committee. These include meeting in a hollow square, introductions of all present before each meeting, questions welcomed by any speaker at any time. I am prepared in introducing our third issue of the Committee's Quarterly Newsletter to declare that it has reached the status of "tradition" of the Committee. To me that means simply that Chris, Peter, Tom, Charlotte and Ray are are going to make this happen at the same high level of scholarship again and again. It is becoming our traditional link with that portion of our 1500 members whom we see infrequently at meetings. I commend these articles to you because for the most part they address topics discussed in recent Committee meetings.

I also invite you to become part of the tradition. Send Chris Bellini an article. So that is the assignment. Please read, ruminate and write.

Jim Scott
Chair, Committee on Banking Law
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Featured Articles

Is It Fair to Enforce the Information Security Guidelines Through Civil Money Penalties?
Peter Heyward

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Section 10A and the Internal Investigations at Financial Institutions
Thomas P. Vartanian, Lawrence R. Bard, Travis P. Nelson
In 1995 Congress added Section 10A to the Securities Exchange Act of 1934 ("Exchange Act") as part of the Private Securities Litigation Reform Act ("PSLRA"). Prior to the passage of the PSLRA, Congress had left the accounting profession to its own devices when it came to promulgating auditing standards. Congress enacted Section 10A with the intent "to require auditors to blow the whistle on the fraudulent activities of their clients." According to the bill’s chief sponsor, Rep. Ron Wyden of Oregon: "Because the regulators and the [accounting] profession have abdicated their responsibility, we feel it is time for Congress to step in." Although auditors are trained to investigate accounting irregularities, and reveal some types of accounting misconduct, they are not generally trained to detect fraud, especially in the complex world of financial institutions. But in the Post Sarbanes-Oxley corporate environment, the impact of Section 10A is being felt in a number of different ways, and creating greater pressure for internal investigations at financial institutions.

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**Basel I-A: A Capital Framework for the Rest of the Industry**
*Raymond Natter*

On October 20, 2005, the Federal Banking Agencies published an advanced notice of proposed rulemaking, or "ANPR," soliciting comments on proposed changes in the capital rules for banks, savings associations, and bank holding companies that will not be subject to the Basel II framework. The comment period closed on January 18, 2006.

The ANPR was issued in response to industry and Congressional concerns that establishing a separate Basel II capital structure for large institutions and leaving the rest of the industry subject to the Basel I standards could result in competitive disadvantages for the non-Basel II banking organizations. The ANPR is intended to be the first step in the agencies' attempt to address these concerns, while at the same time making progress in their long-term goal of making capital standards more risk sensitive. The modified capital standard is informally referred to as "Basel I-A."

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**Federal Banking Agencies Issue Proposed Guidance on Nontraditional Mortgage Products**
*Charlotte M. Bahin*

In response to a growing trend by lenders to develop and market and consumers to want mortgage products with nontraditional terms, the federal banking agencies have issued proposed guidance on Nontraditional Mortgage Products. The proposed guidance establishes the agencies’ expectations regarding the assessment and management of the risks involved in these types of products as well as expectations regarding communications with consumers who want these types of loans. As a result of the concerns raised that the issuance of the proposed guidance will have a negative impact on the ability of lenders to continue to offer the mortgage products identified, the agencies have extended the comment period. The agencies have asked a number of questions seeking details about the products, how they are offered and what are their features.

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IS IT FAIR TO ENFORCE THE INFORMATION SECURITY GUIDELINES THROUGH CIVIL MONEY PENALTIES?

Peter Heyward
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Introduction

There's a funny scene in the movie "Ghostbusters," when Bill Murray, as spook eradicator Peter Venkman, responds to a call from client and romantic interest Dana Barrett (Sigourney Weaver), who has reported disturbing supernatural phenomena in her apartment.

When Venkman arrives at her door, it is obvious that Dana is no longer herself: She appears sexily attired in a revealing dress and, drawing Venkman into her bedroom announces: "I am Zuul, the Gatekeeper . . . Do you want this body? Take me now!"

Venkman demurs, explaining: "I make it a rule never to get involved with possessed people." But as Dana, continuing to come on strong, pulls him down on her bed, he allows: "Actually, it's more of a guideline than a rule."

The line gets a big laugh, because everyone understands that you risk serious punishment for violating a "rule," whereas a "guideline" can be flouted with impunity. This understanding of the difference between a rule and a guideline may explain the lively reaction at a morning session during the Fall meeting of the Banking Law

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1 The author is a partner in the Financial Services Group of Venable, LLP, based in Washington, D.C. The opinions expressed in this article do not necessarily reflect the views of other partners or employees of Venable LLP, or any of its clients.

2 OK, maybe not with impunity, but at most with some bad publicity and, perhaps, an admonition to do better the next time. A case in point: the short-lived reaction to recent violations of the Fourth Guideline to the U.S. Constitution (recommending that law enforcement authorities "consider whether it is appropriate" to obtain a warrant before conducting wire taps or intercepting e-mail).
Committee, when a panelist representing one of the federal banking agencies reported that First Horizon Loan Corporation, a national bank operating subsidiary, had been tagged with a substantial civil money penalty for violations of the Interagency Guidelines Establishing Standards for Safeguarding Customer Information (the "Information Security Guidelines"). Despite the early hour, many a dozing lawyer – including me - jerked awake at that announcement. How could an agency impose a CMP for violating guidelines?

This question stemmed, at least in my case, from the belief that "guidelines" are inherently not the type of agency pronouncement that should be enforceable by civil money penalties or other punitive sanctions. Guidelines are generally drafted in broad, general terms, so it simply seems unfair to impose penalties when the supposedly prohibited conduct is not clearly spelled out.

Although the First Horizon case is not clear on the point, I understand that the legal theory on which the OCC relied was that First Horizon violated a "regulation," thereby becoming subject to first tier civil money penalties. 12 U.S.C. §1818(i)(2)(A)(i). The legitimacy of this approach, as a policy matter if not as a legal one, seems to me to be questionable. On the other hand, considering the Information Security Guidelines as they existed at the time of First Horizon's alleged misconduct, I believe that the OCC’s action could have been justified both legally and as a policy matter, provided one makes the crucial assumption that First Horizon's conduct was "reckless" and was either part of a pattern of misconduct, caused or was likely to cause more than a minimal loss to the

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4 These Guidelines, adopted by all the federal banking agencies, are codified at 12 CFR Part 30, Appendix B (national banks); 12 CFR Part 208, Appendix D-2 (state member banks); 12 CFR Part 364, Appendix B (state nonmember banks); and 12 CFR Part 570, Appendix B (thrift institutions).
institution (other than the CMP itself!), or resulted in pecuniary gain or other benefit to First Horizon.\(^5\) In the discussion that follows, I will try to explain these conclusions.

**Discussion**

First Horizon is a mortgage lender and operating subsidiary of First Tennessee Bank National Association, a subsidiary of financial holding company First Horizon National Corporation of Memphis, Tennessee. Without admitting or denying wrongdoing, it consented to the issuance of a civil money penalty in the amount of $180,000 for "violations of the customer information security protections" set forth in the Information Security Guidelines. The Consent Order reveals few of the underlying facts, but it was reported that the penalty related to an incident in November 2004 in which a customer found loan files for approximately 120 people in a dumpster outside a First Horizon office in Fairfax, Virginia.\(^6\) The company reportedly claimed that movers mishandled the information while the office was being moved, and that it had promptly notified the affected customers and the OCC when the problem was discovered.

The Information Security Guidelines were promulgated by the banking agencies under the authority of Sections 501 and 505(b) of the Gramm-Leach-Bliley Act ("GLBA"), codified at 15 U.S.C. §§6801 and 6805(b), respectively, and Section 39 of the Federal Deposit Insurance Act (the "FDI Act"), codified at 12 U.S.C. §1831p-1. Section 501(b) requires financial regulators to establish standards for the entities under their jurisdiction to protect the confidentiality of customers' records and information, while

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\(^5\)These are, of course, the standards for imposing second tier civil money penalties based on engaging in an unsafe or unsound practice in conducting the affairs of the institution. 12 U.S.C. §1818(i)(2)(B). I emphasize that I have no personal knowledge of the facts in the First Horizon case beyond what has been publicly reported, and I make no judgment that First Horizon's conduct in fact satisfied the statutory standard for the imposition of either first or second tier CMPs.

Section 505(b) directs the banking regulators to implement the information security standards mandated under Section 501 "in the same manner, to the extent practicable," as the safety and soundness standards prescribed pursuant to Section 39 of the FDI Act. It is noteworthy that Section 505(b) directs the regulators responsible for financial entities other than banks – the Securities and Exchange Commission, state insurance regulators, and the Federal Trade Commission – to implement the information security standards “by rule.” 15 U.S.C. §6805(b)(2).

Section 39 directed the banking agencies to prescribe various standards for safety and soundness, but it gave them the option to act by "regulation or guideline." 12 U.S.C. §1831p-1(d)(1). As it happens, by the time GLBA was enacted in 1999, the banking agencies had elected to prescribe all of the safety and soundness standards required by Section 39 by guideline rather than regulation. 60 Fed. Reg. 35674 (July 10, 1995). It therefore seems clear that Congress intended the information security provisions of GLBA to be implemented for banks through the flexible mechanism of guidelines, rather than by regulations. The deliberateness of Congress's choice is underscored by its decision to require that the standards be implemented “by rule” for financial institutions other than banks.

There is also some evidence in Section 39 for a preference for an enforcement mechanism that emphasizes corrective action rather than penalties: The provision authorizes the banking regulators to require a bank that fails to comply with a safety and soundness guideline to submit a corrective plan. Should the bank fail to submit or implement such a plan, the agencies are authorized to take various measures – restricting
asset growth, increasing capital, limiting interest rates – that focus on restoring the erring bank to financial soundness.

Nevertheless, it is hard to argue that Section 39 precludes the banking agencies from taking other enforcement actions. Subsection (g) expressly states that “the authority granted by this section is in addition to any other authority of the Federal banking agencies.” 12 U.S.C. §1831p-1(g). The banking agencies reaffirmed this principle in the Safety and Soundness Guidelines that they promulgated in 1995:

Neither Section 39 nor these Guidelines in any way limit the authority of the agencies to address unsafe or unsound practices, violations of law, unsafe or unsound conditions, or other practices. Actions under section 39 and these Guidelines may be taken independently of, in conjunction with, or in addition to any other enforcement action available to the agencies.


Therefore, while it is seems clear that Congress intended the banking agencies to employ guidelines rather than rules or regulations in implementing the information security provisions of GLBA, one must assume that Congress was also aware of this reservation of authority in Section 39. In other words, there is no necessary implication that Congress intended the banking regulators to refrain from using their usual supervisory tools in appropriate circumstances to enforce the Information Security Guidelines.

This evidently is the banking agencies' position. They included in the Information Security Guidelines a clause preserving their other enforcement authorities that is virtually identical to the preservation-of-authority provision in the Safety and Soundness Guidelines. See Interagency Guidelines Establishing Standards for Safeguarding

Still, federal banking laws nowhere refer to the imposition of civil money penalties for violating “guidelines.” To find a legal basis for assessing a first tier CMP against First Horizon, one must identify a violation of a "law or regulation." 12 U.S.C. §1818(i)(2)(A)(i). Based on discussions with a lawyer familiar with the First Horizon matter, the OCC's theory was that the Information Security Guidelines constituted a "regulation" for purposes of the civil money penalty provisions of Section 1818, and that First Horizon had violated the regulation, presumably (if the news reports were accurate) by improperly disposing of sensitive customer records.

The Information Security Guidelines do, in fact, meet at least one important requisite for being treated as a binding regulation under administrative law principles: they were issued after public notice and comment in June 2000 before being adopted in final form in late January 2001. This is not the case for all interagency guidance documents. Moreover, an agency lawyer has argued that, by avoiding the "regulation" label for the Information Security Guidelines, the banking agencies have greater flexibility with respect to remedial action in the event of a violation, which is desirable

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7 It is my understanding that there was no basis for alleging any of the other predicates for a first tier CMP, namely a violation of a final order, temporary order, condition imposed in writing by, or written agreement with, the OCC (as First Horizon's "appropriate federal banking agency"). 12 U.S.C. §1818(i)(2)(A)(ii) – (iv).
8 The Agencies published the proposed Guidelines on June 26, 2000 (65 FR 39472); their adoption in final form was announced in the Federal Register on February 1, 2001 (66 FR 8616).
9 For example, the Interagency Advisory in Influenza Pandemic Preparedness issued on March 15, 2006. Presumably, we won't be seeing any CMPs imposed on banks for failing to keep the washroom well stocked with clean towels.
from both the agencies' and the banks' perspectives. Under Section 39 of the FDI Act, 12 U.S.C. §1831p-1, if the Guidelines were a "regulation," the appropriate federal banking agency would have no choice but to require an acceptable corrective plan upon finding that an institution had failed to comply, whereas the agency is permitted, but not required to request such a plan if the Guidelines are "guidelines."\

I find this approach questionable for several reasons. First, as discussed above, Congress, in GLBA, may reasonably be understood to have directed the banking agencies to implement the Information Security Guidelines by guideline rather than by regulation. I don't believe that this statutory mandate is fulfilled by implementing standards that are called "guidelines" but treated as *regulations* for enforcement purposes. A second objection, related to the first, is that it is inconsistent to assert that the Information Security Guidelines are enforceable for civil money penalty purposes as "regulations," but should not be treated as "regulations" for purposes of the provisions of Section 39 of the FDI Act. It is not very convincing to argue that this approach avoids forcing the agencies to impose a corrective plan for every violation of the Guidelines, which would be the case (it is asserted), if the Information Security Guidelines were treated as regulations.

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10 The statute provides that when a bank fails to comply with a safety and soundness guideline, the banking agency "may" require the bank to submit an acceptable corrective plan within a specified deadline. 12 U.S.C. §1831p-1(e)(1)(A)(ii). The statute contemplated a slightly different consequence of failing to meet a safety and soundness standard that was imposed by *regulation* rather than guideline. In that case, the statute stated that the appropriate banking agency "shall require" the bank to submit a corrective plan. 12 U.S.C. §1831p-1(e)(1)(A)(i). In any event, once a corrective plan has been required (whether the requirement was mandatory or discretionary), the consequences of failing to submit such a plan or to implement it in any material respect, are the same: the agency "shall require" the bank to correct the deficiency and "may" take on or more of the following steps until the deficiency has been corrected:

(i) restrict the bank's asset growth (12 U.S.C. §1831p-1(e)(2)(B)(i));
(ii) require the bank to increase its ratio of tangible equity to assets (12 U.S.C. §1831p-1(e)(2)(B)(ii));
(iii) restrict the interest rates that the bank pays on deposits to those prevailing in the bank's region (12 U.S.C. §1831p-1(e)(2)(B)(iii)); or
(iv) require the bank to take "any other action that the agency determines will better carry out the purpose of" the prompt corrective action provisions codified at 12 U.S.C. §1831o ((12 U.S.C. §1831p-1(e)(2)(B)(iv)).
regulations under Section 39. I note that the civil money penalty provisions of Section 1818 also speak in mandatory terms, indicating that a bank which violates a law or regulation "shall forfeit and pay" a penalty. 12 U.S.C. §1818(i)(2)(A) (emphasis added) Yet the banking agencies do not feel compelled (nor should they) to impose a CMP for every violation by a bank, however trivial or inadvertent. Finally, and not least, it behooves the banking agencies to say what they mean. There is a "truth-in-labelling" problem with calling something a "guideline" but enforcing it like a "regulation."

In sum, in my judgment, the First Horizon civil money penalty can be justified, if at all, only if it meets the more stringent standards that apply to second tier CMPs for engaging in unsafe or unsound practices. The authority to impose civil money penalties on banks and IAPs for “recklessly” engaging in “an unsafe and unsound practice” has been part of the agencies’ enforcement arsenal since an amendment to that effect was made to the FDI Act in the Financial Institutions Reform, Recovery and Enforcement Act of 1989. Pub. L. 101-73, §907(a), codified at 12 U.S.C. §1818(i)(2)(B). The banking agencies clearly view the Information Security Guidelines as a statement of what constitutes “safety and soundness” in the context of protecting sensitive customer information and they have made no secret of this view.11 The question remains, however, whether the Information Security Guidelines, as in effect in November 2004 when the alleged breach occurred, were sufficiently clear to put banks on notice that a particular method of disposing of records was "unsafe and unsound."

As to this question, the OCC would appear to have been on solid ground in its action against First Horizon: The Information Security Guidelines have specifically

11 For example, in promulgating the Information Security Guidelines in final form in 2001, the agencies stated their belief that “a financial institution’s overall information security program is critical to the safety and soundness of the institution.” 66 FR 8616, 8620 (February 1, 2001).
referred to proper disposal of physical records containing sensitive information as a concern since they were first issued in final form in 2001. The preamble to that issuance noted:

The Agencies also have added a specific reference to records disposal in the definition of "customer information system." This is consistent with the proposal's inclusion of access controls in the list of items a financial institution is to consider when establishing security policies and procedures . . . given that inadequate disposal of records may result in identity theft or other misuse of customer information. Under the final Guidelines, a financial institution's responsibility to safeguard customer information continues through the disposal process.


The importance of proper disposal of paper records, with a clear recommendation to shred paper records before disposal, was also emphasized in the Information Security Booklet (the "IS Booklet") released by the Federal Financial Institutions Examination Council in January 2003. In the subsection addressing Disposal of Electronic and Paper-Based Media, the IS Booklet stated:

Financial institutions need appropriate disposal procedures for both electronic and paper-based media. Policies should prohibit employees from discarding sensitive media along with regular garbage to avoid accidental disclosure. Many institutions shred paper-based media on site and others use collection and disposal services to ensure the media is rendered unreadable and unreconstructable before disposal. Institutions that contract with third parties should use care in selecting vendors to ensure adequate employee background checks, controls, and experience.

IS Booklet at 63.

The banking agencies' again noted their concern with proper disposal of sensitive records with the issuance of a Request for Comment on Interagency Guidance on Response Programs to Protect Against Identity Theft in August 2003. The proposed Interagency Guidance cited, as an example of when customers should be notified of
possible unauthorized access to sensitive information, when "[a]n institution has not properly disposed of customer records containing sensitive customer information." 68 Fed. Reg. 47954, 47960 (August 12, 2003) (italics in original).

Finally, in 2004, in the context of implementing Section 216 of the Fair and Accurate Credit Transactions Act of 2003 (the "FACT Act"), which requires proper disposal of consumer information derived from credit reports, the banking agencies reiterated the importance of proper disposal of customer information. The Supplementary Information explaining the proposed FACT Act rule noted that proper disposal of sensitive customer information was already required under the Information Security Guidelines.

The Guidelines direct financial institutions to assess the risks to their customer information and customer information systems and, in turn, implement appropriate security measures to control those risks. For example, under the risk-assessment framework currently imposed by the Guidelines, each financial institution must evaluate whether the controls the institution has developed sufficiently protect its customer information from unauthorized access, misuse, or alteration when the institution disposes of the information.

69 FR 31913, 31914-31915 (June 8, 2004) (footnotes omitted).

Later in the same release, the agencies provided more specific information on their expectations regarding the proper disposal of sensitive customer information.

The Agencies believe that it is not necessary to propose a prescriptive rule describing proper methods of disposal. Nonetheless, consistent with interagency guidance previously issued through the Federal Financial Institutions Examination Council (FFIEC) [citing the IS Booklet excerpted above], the Agencies expect institutions to have appropriate disposal procedures for records maintained in paper-based or electronic form. The Agencies note that an institution's information security program should ensure that paper records containing either customer or consumer

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12 The distinction between "consumer information" for purposes of the FACT Act and "customer information" under the Information Security Guidelines is not relevant to the present discussion.
information should be rendered unreadable as indicated by the institution's risk assessment, such as by shredding or any other means.

69 FR 31913, 31916 (footnotes omitted; emphasis added)

In light of these agency pronouncements from January 2001 to June 2004, it seems fair to conclude that, by November 2004, banking organizations should have been on notice that they should not dispose of paper records containing sensitive customer information without shredding them or taking other protective measures. Considered against this backdrop, assuming that First Horizon was rightly found to have acted recklessly and to have met the other criteria for a second tier CMP, the OCC's action against First Horizon would not seem unreasonable.

Relying on the second tier CMP authority seems preferable from a policy perspective, as well, because it requires a greater degree of wrongful conduct before a penalty may be imposed. Safety and soundness is an inherently malleable concept, and the issuance of guidelines is an imperfect tool for informing the banking industry about what the concept requires in various contexts. There is a trade-off between flexibility and avoidance of overly prescriptive rules, on one hand, and the clarity and certainty that well-drafted rules and regulations provide, on the other. The potential for unfairness and undue harshness that exists when safety and soundness guidelines are enforced by civil money penalties is mitigated, if not entirely eliminated, by the requirement of recklessness and other prerequisites before a second tier CMP can be imposed. However fuzzy or imprecise may be the guidelines seeking to give content to the principle of “safety and soundness,” some conduct is so clearly reckless and improper that a civil money penalty can be justified. It does not seem defensible to
sanction a violation of "guidelines" based on the strict liability standard for first tier civil money penalties.

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Peter Heyward welcomes comments and questions about this article. His e-mail address is peheyward@venable.com.
Section 10A and the Internal Investigations at Financial Institutions

By:

Thomas P. Vartanian*
Lawrence R. Bard
Travis P. Nelson

Introduction

In 1995 Congress added Section 10A to the Securities Exchange Act of 1934 (“Exchange Act”) as part of the Private Securities Litigation Reform Act (“PSLRA”).\(^1\) Prior to the passage of the PSLRA, Congress had left the accounting profession to its own devices when it came to promulgating auditing standards.

Congress enacted Section 10A with the intent “to require auditors to blow the whistle on the fraudulent activities of their clients.”\(^2\) According to the bill’s chief sponsor, Rep. Ron Wyden of Oregon: “Because the regulators and the [accounting] profession have abdicated their responsibility, we feel it is time for Congress to step in.”\(^3\) Although auditors are trained to investigate accounting irregularities, and reveal some types of accounting misconduct, they are not generally trained to detect fraud, especially in the complex world of financial institutions. But in the Post Sarbanes-Oxley corporate environment, the impact of Section 10A is being felt in a number of different ways, and creating greater pressure for internal investigations at financial institutions.

Summary of Section 10A

Section 10A provides:

(a) Each audit . . . shall include, . . .
   (1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;

Although Section 10A requires that auditors conduct audits in accordance with the requirements of generally accepted accounting principles (“GAAP”), auditing standards “may be modified or supplemented from time to time by the [SEC].”\(^4\) Section 10A also provides that where an auditor discovers, either through its own work, through the client itself, or through an advisor to the client, that a reporting audit client may have committed an illegal act, the auditor must:

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\(^4\) Exchange Act § 10A(a).
• Determine whether it is likely that an illegal act has occurred; and
• If so, determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages; and
• As soon as practicable, inform the appropriate level of the management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such firm in the course of the audit, unless the illegal act is clearly inconsequential.

The triggering of an auditor’s investigation and reporting duties under Section 10A is the detection of an “illegal act,” which is discussed below in further detail. Once the auditor discovers an “illegal act” the auditor must disclose the matter to the institution’s management, audit committee, and the board of directors, regardless of the degree of effect on the financial institution, provided that the violation is not “clearly inconsequential.” Because Section 10A does not define a “clearly inconsequential” violation, and “no obvious consensus exists as to what acts fall within this category, audit committees should establish a clear understanding with the auditors as to the types of acts that will not be brought to the audit committee's attention, in order to avoid later recriminations.”

Response to Failure to Take Remedial Action

If the auditor, after reporting to senior management, audit committee, or other designated contact person, determines that

• The illegal act has a material effect on the financial statements of the issuer;
• The senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act; and
• The failure to take remedial action is reasonably expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement.

the auditor must report the illegal conduct to the institution’s board of directors.

Remediation Duties

Remediation in the current environment appears to be viewed in a less flexible way than perhaps it was in the past. For example, independent counsel engaged to evaluate the acts in question may generally conclude that: (i) no illegal act occurred; (ii) an illegal act did occur; or (iii) because of its lack of subpoena authority, for example, it cannot conclude that an illegal act

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did not occur. The tough question is what the auditors will require as remediation in the latter case. Recent examples suggest that unless counsel can categorically state that no illegal act occurred, remediation is required, and that remediation may likely be the termination of the officer/employees involved in the activity.

If, however, the auditor reports to the board of directors that remedial action has not been taken to correct the detected illegal act, the institution must inform the SEC within one business day, providing the auditor with a copy of the notice provided to the SEC. If, however, the institution fails to report such conduct to the SEC, or the auditor fails to receive a copy of the board’s notice to the SEC, then the reporting obligation falls to the auditor, who must then resign from the engagement or furnish the SEC with a copy of the audit report the following day. If the auditor resigns from the engagement, the reporting responsibility continues, for the auditor must still provide the SEC with a copy of the auditor’s report within one day following the client’s failure to do so.6

Decisions by the board regarding these matters should be memorialized in writing. Where possible illegal acts have been identified by the auditors, management should be able to demonstrate that it was informed of the matter, that management proposed a remedial approach to addressing the problem, and that the auditors posed no objection to management’s proposed course of action. Where management rejects the suggestions of the auditors, the basis for such rejection should be recorded, supported, and discussed with the auditors. “A close working relationship between management and a company's auditors is critical to allay any concerns on the part of the auditors that management is prepared to, and will, respond appropriately and promptly to any concerns that may be brought to management's attention.”7

Safe Harbor

The PSLRA provides the auditor with protection against private actions based on any finding, conclusion, or statement by the auditor in the report to the board of directors or the SEC.8 The statute also authorizes the SEC to bring a civil action against an auditor who violates the reporting obligations.9

Triggering Section 10A Obligations

The statute describes the “illegal act” requirement in very general terms: “an act or omission that violates any law, or any rule or regulation having the force of law.”10 The accounting industry has also provided a definition for “illegal acts” in Statement of Auditing Standards No. 54, which describes “illegal acts” as “violations of laws or governmental regulations.”11 Unlike the triggering acts for other reporting obligations, for example suspicious activity reports (“SAR Reports”) where the relevant statute requires a violation specifically of

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7 Classical GAAS at p 5.
8 Exchange Act § 10A(c).
9 Classical GAAS at p. 3.
10 Exchange Act § 10A(f) (emphasis added).
11 AICPA Auditing Standards Board Statement of Auditing Standards No. 54 at 317.02.
federal criminal law to trigger the reporting requirement, any violation of law may trigger Section 10A reporting obligations.

Federally insured financial institutions, such as banks, thrifts, and their respective holding companies, are subject to a broad range of complex laws, the violation of which could trigger Section 10A. These laws are derived from statutes and regulations, found in such fields as securities, banking and thrift law. Experienced practitioners understand that bank examination reports often contain allegations or conclusions that laws or regulations have been violated. While it is not every such violation that triggers Section 10A, regulated financial institutions are certainly in a much different position under Section 10A because they are so closely regulated. For example, it may often be the case that the purported violation of law is first brought to the auditor’s attention by an exam report or counsel.

In *SEC v. Solucorp Indus., Ltd.*, a U.S. District Court in New York, on a motion for summary judgment, addressed the level of knowledge that an auditor must have of illegal acts on the part of a registrant so as to trigger the reporting requirements of Section 10A. The auditor in *Solucorp* argued that he was entitled to summary judgment “because the SEC fail[ed] to allege facts showing that he had actual knowledge of, or was reckless as to the existence of, any illegal acts.” The court rejected this interpretation of Section 10A and concluded “that under the plain and unambiguous terms of the statute an auditor becomes subject to the § 10A requirements upon acquiring knowledge of information indicating that an illegal act has or may have occurred.” Further, the court stated that as Section 10A “requires only knowledge of facts indicating that an illegal act may have occurred, any failure on the part of the SEC to allege reckless or fraudulent behavior [by the auditor] is immaterial.”

**Role of Auditor in Examination Findings**

Although examination findings may serve as the basis of a Section 10A investigation, increasingly auditors are assuming the role of quasi-examiners. The banking regulators “encourage[] auditors to attend examination exit conferences upon completion of field work or other meetings between supervisory examiners and an institution's management or Board of Directors (or a committee thereof) at which examination findings are discussed that are relevant to the scope of the audit.” When attending these types of meetings, auditors are bound by agency-imposed confidentiality requirements. Moreover, “[u]nauthorized disclosure of confidential supervisory information may subject the auditor to civil and criminal actions and fines and other penalties.”

Bank regulators view the audit function as “an essential component of risk management for the banking industry, and it is becoming more critical as banks expand into new products,
services, and technologies.”

As part of the regulators’ review of an institution, examiners review a bank's internal controls and audit processes during examinations. Conclusions by auditors have an “important influence” on the work performed by agency examiners and “examiners will often rely upon work performed by the auditors, rather than engage in direct validation and testing of bank operations.” Therefore, where examiners find deficient internal controls, and the auditors have not otherwise cited such in their audit report, the examiners may conclude that the failure to discover imprudent practices or even violations of law may reflect a failure in the audit process generally.

In SEC v. KPMG, LLP, et al., the SEC brought a civil action alleging that Joseph T. Boyle, CPA, a KPMG partner permitted Xerox Corp. to manipulate its accounting practices to close a gap between actual operating results and results reported to the public, among other accounting improprieties. Among the several alleged violations of law cited by the SEC, was a violation of Section 10A by Mr. Boyle for failing to raise the issue of possible fraudulent financial reporting to the Xerox audit committee.

Role of Outside Counsel

Where an auditor has reason to believe that an illegal act may have been committed so as to invoke the procedures required by Section 10A, the auditor may require the bank’s audit committee to conduct an internal investigation to determine whether a violation of law which will have a material affect on the financial statements has in fact been committed, what remediation is required to correct such violation, and whether the board and management have taken adequate steps to achieve such remediation.

Reports of examination of troubled institutions often will contain the examiners’ findings and impressions as to the operations, effectiveness, and sometimes integrity of bank management. The report of examination may also detail how conduct on the part of management has resulted in violations of law or exposed the bank to other regulatory, reputation, and litigation risks. These situations often pit management against their own boards as auditors, examiners, shareholders, and the media, attempt to determine where culpability lies. Experienced outside counsel is essential in these situations to assist the board, especially the independent directors, in maintaining its focus on guiding the bank through the examination and 10A processes.

Where the issues or problems raised by the auditor or ROE are especially pervasive and involve senior officers of the institution, the institution’s normal outside counsel may be viewed

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19 Id.
by the auditor as not being “independent.” In such situations, it is necessary for the board of directors to retain independent counsel, which has little or no prior history with the institution and its management.

Independent counsel likely will provide an oral (and sometimes written) report of their factual findings and legal conclusions as to whether the conduct identified by the auditors actually constituted violations of law. This report usually will be presented to the audit committee, the board of directors, and then to the auditor. Bank regulators and the SEC may also request either an oral or written description of counsel’s findings. The issue of whether attorney/client privilege is waived by such a process is the subject of other articles that we have authored. Suffice it to say that it is an issue that must be evaluated before the process begins.

Practical Tips

A financial institution should observe the following in avoiding triggering a Section 10A report and in dealing with Section 10A if it is triggered:

- Senior management shall be proactive in working with auditors to learn of, investigate, and respond to, any auditor concerns about, or suspicions of, illegal conduct.
- Audit committees should insist upon an ongoing, periodic dialogue with senior management to ascertain whether there have been indications of potential illegal acts, and to satisfy themselves as to the ability of management to timely respond to such indications.
- Any and all indications of possible illegal conduct should be dealt with carefully and effectively, whether brought to management's attention by the outside auditors or otherwise.
- Discuss with the auditing firm any special or unique circumstances that may have an impact on the financial statements, prior to commencing the audit.
- Key bank employees must clearly understand the lines of communication and how the bank will address internal control or other problems noted by the external auditor.
- Assign responsibility to a member of management who reports directly to the bank's board of directors, to serve as a liaison between the bank and the audit firm.
- Have a contingency plan in place should an audit engagement be suddenly terminated, whether for Section 10A, regulatory pressures, or other reasons, in order to mitigate any significant discontinuity in audit coverage.
- Maintain effective internal systems and controls so as to uncover illegal acts before they are discovered by third parties.

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See e.g., Thomas P. Vartanian, Lawrence R. Bard & Travis P. Nelson, Internal Investigations in the Post-Sarbanes-Oxley Era, Newsletter of the ABA Section of Business Law Committee on Banking Law (Nov. 2005).
Introduction

On October 20, 2005, the Federal Banking Agencies published an advanced notice of proposed rulemaking, or “ANPR,” soliciting comments on proposed changes in the capital rules for banks, savings associations, and bank holding companies that will not be subject to the Basel II framework.1 The comment period closed on January 18, 2006.

The ANPR was issued in response to industry and Congressional concerns that establishing a separate Basel II capital structure for large institutions and leaving the rest of the industry subject to the Basel I standards could result in competitive disadvantages for the non-Basel II banking organizations. The ANPR is intended to be the first step in the agencies’ attempt to address these concerns, while at the same time making progress in their long-term goal of making capital standards more risk sensitive. The modified capital standard is informally referred to as “Basel I-A.”

The agencies announced that they will be guided by the following principles in developing the Basel I-A proposal: (i) promotion of safe and sound banking and a prudent level of regulatory capital; (ii) the need to balance risk sensitivity and operational feasibility; (iii) the avoidance of undue regulatory burden; (iv) establishment of incentives for banking organizations; and (v) the mitigation of material distortions in capital requirements between large and smaller institutions.

General Comments

The ANPR solicited comment on both specific proposals and more generally on how to improve the capital requirements. After considering these comments, the agencies intend to publish a revised notice of proposed rulemaking implementing the Basel I-A standards, as well as a notice of proposed rulemaking to implement the Basel II standard, in the same time frame.

Specific Proposals

1. **Increase the Number of Risk Weight Baskets**

Under the current risk-based capital standard assets are assigned one of five risk weights. Thus, for example, U.S. Treasury securities are given a risk-weight of 0 percent; claims on depository institutions incorporated in a country that is a member of the Organization for Economic Cooperation and Development (OECD) are given a risk-weight of 20 percent; prudently underwritten mortgage loans are given a risk-weight of 50 percent; commercial loans are risk-weighted at 100 percent; and certain below investment grade asset-backed securities are given a 200 percent risk weight.

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The ANPR sought comments on increasing the number of risk-weight baskets, and suggests adding four new baskets: 35, 75, 150, and 350 percent. The ANPR asked whether this will permit better alignment of required capital and risk, whether the suggested additional baskets are appropriate, and whether more or fewer baskets should be added, and whether a lower weighted basket should be included for high quality assets with very low historical default rates.

2. Use of External Credit Ratings

Under the existing regulatory framework, banking organizations may rely on external ratings from a nationally recognized statistical rating organization (NRSRO) for certain assets, e.g. recourse obligations, direct credit substitutes, residual interests in securitizations, and asset- and mortgage-backed securities. Depending on the rating, these assets may be assigned a risk-weight as low as 20 percent or as high as 200 percent. The ANPR proposes using NRSRO ratings to establish the risk weight for a broad range of exposures.2

The ANPR asked for comments on whether the proposal is appropriately risk sensitive, the amount of burden that this approach may generate for the industry, the use of other methodologies to establish risk weights for rated exposures, and methods to assign risk weights to unrated positions.

3. Financial Collateral and Guarantors

Under existing regulations, a banking organization will get preferential capital treatment if an asset is collateralized by cash on deposit, U.S. or OECD Government securities, U.S. agency obligations, Government Sponsored Entity obligations, and securities issued by multilateral lending institutions or regional development banks. Guarantees are also recognized, but again only if issued by certain recognized types of entities. Entities seeking better capital treatment based on collateral must have management systems that can track collateral and readily determine its realizable value.

According to the ANPR, the agencies are considering expanding the types of collateral that will be recognized for capital purposes to include externally rated debt and asset-backed securities (including mortgage-backed securities), as well as non-OECD Government obligations that have an investment grade rating. The agencies are also considering increasing the list of recognized guarantors for capital purposes to include any entity whose long-term senior debt has an investment grade rating.

4. One-to-Four Family Mortgages

First lien residential mortgage loans that are prudently underwritten are currently placed in the 50 percent risk-weight basket. The agencies note that this treatment does not accurately reflect the risks of these assets, and are therefore proposing several options to correct this problem. The ANPR is also proposing modifications relating to non-traditional loans and certain second mortgage loans and home equity lines of credit.

- LTV Option

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2 Proposed risk-weights would range from 20 percent (highest two long-term investment grades) to 350 percent (two or more categories below investment grade).
One option is to assign a risk weighting to first lien mortgage loans based on the loan-to-value (LTV) ratio. Loans with an LTV of 60 percent or less would be assigned a risk-weight of 20 percent, loans with an LTV of between 61 and 80 percent would be assigned a risk-weight of 35 percent, and loans with an LTV of 90 percent or less would have a risk-weight of 50 percent. Mortgage loans with an LTV above 90 percent would be assigned a risk-weight of 100 percent.

With respect to this proposal, the agencies note that the LTV would be determined after taking into account private mortgage insurance (PMI) provided by an insurer with a long-term credit rating of “A” or higher (third highest investment grade rating). However, PMI covering a pool or portfolio of loans is not currently considered when determining the LTV of an individual loan. The agencies also note that some PMI contracts require the lender to absorb some measure of loss before the insurance is payable, and such insurance would not be recognized at all under the proposal. The agencies are also concerned that a blanket acceptance of PMI might overstate its effectiveness in mitigating risk. Thus, the agencies suggest that a floor might be placed on the risk-weight for certain PMI protected mortgages.

The ANPR asked for specific comment: (i) on the use of LTV to determine risk weights; (ii) whether the LTV ratio should be updated periodically; (iii) whether portfolio level PMI should be considered when determining risk-weight assignments; (iv) alternative approaches that are sensitive to counterparty credit risk associated with PMI; and (v) whether the regulation should impose floors for certain mortgages subject to PMI, especially higher-risk loans and novel products.

- **Credit Risk and LTV Option**

An alternative approach raised in the ANPR is to consider credit risk and LTV ratios in assigning risk weights. Credit risk would be determined by credit scores, debt-to-income ratios, or another relevant measure of credit quality. The measure of credit risk would then be related to the LTV of the loan to determine the proper risk-weight basket for that asset.

ANPR sought comments on: (i) the use of an assessment mechanism based on LTV ratios in combination with a measure of credit risk; (ii) the impact of the use of credit scores on the availability of credit or prices for lower income borrowers; and (iii) whether LTV ratios and measures of creditworthiness should be updated annually or quarterly, and how these parameters might be updated to reflect the changing risks of the loan as it matures and as property values and the borrower’s credit assessment fluctuate.

- **Non-traditional Mortgage Products**

The ANPR specifically addresses non-traditional mortgage products, such as interest-only mortgages, loans with an LTV in excess of 100 percent, and loans with a negative amortization feature. The agencies solicited comments on whether these loans should be included in the same matrix as traditional mortgages or whether these loans pose unique risks that warrant a higher capital requirement.

- **Second Liens and Credit Lines**

Currently, if a lender holds both a first and second mortgage (including a home equity line of credit (“HELOC”)), both loans are aggregated when determining the LTV ratio and risk-weight. The agencies are not proposing to change this treatment.
If a lender holds only a second lien or HELOC, but not the first lien, the agencies look at the combined LTV for both loans at the time of origination of the second lien or HELOC. If the combined LTV exceeds 90 percent, the agencies are proposing to assign a risk-weight to the second lien or HELOC in excess of 100 percent.

- **Multifamily Residential Mortgages**

  Generally, multifamily residential mortgage loans are currently risk-weighted at 100 percent. The ANPR sought comments and data on whether such loans or a specific subset of such loans (e.g., based on size, maturity, LTV, or other factors) should receive a more favorable risk-weight assignment.

5. **Other Retail Exposures**

  The ANPR seeks comments on whether other retail exposures, such as consumer loans, credit cards, and automobile loans could be assigned risk weights based on the actual riskiness of the loan. One approach might be to base the risk-weight on the borrower’s credit score or ability to service the debt, and collateral LTV ratios. The ANPR solicited comment on this and other methods that would increase risk sensitivity without undue burden. Comments were also requested on what risk-baskets would be appropriate for different risk measures, and the impact of any changes on credit availability for lower income borrowers.

6. **Short-Term Commitments**

  Banks that hold short-term commitments of less than one year in duration, such as an unfunded line of credit that expires within 12 months, are not required to hold capital to support these obligations.\(^3\) Long-term commitments of one year or greater are converted to on-balance sheet credit equivalent using a 50 percent conversion factor.

  The agencies note that since short-term commitments expose banking organizations to credit risk, it may be more appropriate to subject these obligations to a capital charge. The ANPR suggests that a 10 percent conversion factor be applied to short-term commitments. Exceptions would be made for commitments that are cancelable at any time by the banking organization without prior notice, and for commitments that effectively provide for automatic cancellation due to deterioration in a borrower’s credit. Comments were solicited on this approach as well as on an alternative approach that would apply a 20 percent conversion factor to all commitments, both short- and long-term.

7. **Loans 90 Days Past Due or in Nonaccrual**

  The ANPR proposes to increase the risk-weight assigned to loans that are 90 days or more past due and those in nonaccrual status. The amount of the exposure assigned to the higher risk-weight basket would be reduced by any reserves directly allocated to cover losses on the loan. The ANPR solicits comments on all aspects of this proposal.

8. **Commercial Real Estate**

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\(^3\) One exception is for short-term unfunded liquidity facilities supporting asset-backed commercial paper programs. These facilities are converted to on-balance sheet credit equivalent using a 10 percent conversion factor.
The current risk weight for commercial real estate loans, including acquisition, development and construction loans, is generally 100 percent. The ANPR is proposing that these loans be given a higher risk-weighting, unless the loan satisfies all of the requirements set out in the agencies prudential standards for such loans and the project is supported by a substantial amount of borrower equity, such as 15 percent of the completion value. If a loan meets these two requirements, it would continue to be assigned a risk-weight of 100 percent. The agencies are interested in other factors that could be used to determine the riskiness of the loan, such as LTV ratios and credit assessments.

9. Small Business Loans

The ANPR is proposing to reduce the risk-weight for small business loans. To qualify, the total exposure to that business entity would have to be less than $1 million. Under one alternative, to be eligible for the lower capital requirement, the loan would have to fully amortize over a period of 7 years or less, fully perform, and be collateralized. The loan underwritten would have to include an assessment of the collateral and the borrower’s financial condition and ability to repay the debt. Under these circumstances, the agencies suggest that a risk-weight of 75 percent might be acceptable. Another alternative is to assign a risk-weight based on a credit assessment of the principals, if the principals personally guarantee the loan. The agencies sought comment on any alternative approaches for improving risk sensitivity for small business loans.

10. Early Amortization

The ANPR notes that securitizations of revolving retail credit facilities, such as credit cards, typically contain provisions for the early amortization of the securitization if certain triggering events occur, such as a decline in the excess spread account. The agencies believe that an early amortization event creates risks for the originating lending institution. First, during the early amortization distribution, the interests of the originating bank or savings association will typically be subordinated to those of the security holders, thus absorbing more than its pro rata share of any loss. Second, the lending institution will need to obtain a new source of liquidity, and therefore may face significant liquidity risks. Third, the desire to avoid an early amortization provides incentives for the originating lender to provide additional financial support to the securitization.

To address these concerns, the ANPR suggests imposing a capital charge on the securitized personal and business credit card assets, as well as possibly other securitizations of revolving credit exposures. One option is to impose a 10 percent conversion factor against such receivables in a securitization with an early amortization feature. Another approach is to impose a capital charge against the bank’s interest in the securitization (the seller’s interest) based on a trigger, such as the level of the excess spread account. As the level of the spread account declines toward the trigger point, the capital charge against the seller’s interest would increase from 0 percent to 100 percent.

The agencies solicited comments on whether to adopt either approach, and whether either treatment fully addresses the potential risks of these securitizations. Comments were also solicited on whether other early amortization triggers are used, such as the level of delinquencies, and if there are other factors or approaches the agencies should consider.

11. Application of the Proposed Revisions

The agencies are considering whether to permit some banking organizations to elect to continue to use the current Basel I framework, or portions of it, in lieu of the Basel I-A approach.
The ANPR requested comments on whether there is an asset size below which banking organizations should be given this option. Comments were also solicited on the concept of allowing banking organizations to choose between Basel I and Basel I-A standards for certain classes of assets.

12. Basel II Floor

When the Basel II framework is implemented, the agencies expect to establish a floor for the first three years. The floor would provide that banking organizations must maintain a certain percentage of capital as calculated under Basel I, even if the Basel II framework would result in a lower amount of capital. The agencies asked for comments on whether the Basel II floor should be based on the current Basel I, or the modified Basel I-A to be developed under the ANPR.

Conclusion

The Basel I-A ANPR represents a good first step by the agencies in making the current capital framework more risk sensitive and for alleviating potential competitive concerns with a two-tiered capital system. However, as in any first attempt in adjusting a complex regulatory structure, improvements can be made to make the proposal even more risk sensitive and to provide additional comfort to the non-Basel II institutions concerned about the competitive impacts of the Basel II framework. One fundamental issue that must be addressed is whether this proposal goes far enough to achieve these goals. This is a factor that the agencies must consider if they wish to obtain widespread industry support for Basel II.
Federal Banking Agencies Issue Proposed Guidance on Nontraditional Mortgage Products

By:
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In response to a growing trend by lenders to develop and market and consumers to want mortgage products with nontraditional terms, the federal banking agencies have issued proposed guidance on Nontraditional Mortgage Products. The proposed guidance establishes the agencies’ expectations regarding the assessment and management of the risks involved in these types of products as well as expectations regarding communications with consumers who want these types of loans. As a result of the concerns raised that the issuance of the proposed guidance will have a negative impact on the ability of lenders to continue to offer the mortgage products identified, the agencies have extended the comment period. The agencies have asked a number of questions seeking details about the products, how they are offered and what are their features.

This proposed guidance would have broad application in the lending industry but would exclude a diverse group of entities that originate mortgage loans that are not regulated by the federal banking agencies. It would apply to the activities of all banks and their subsidiaries, bank holding companies and their non bank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries and credit unions. The lenders not included with the scope of this proposed guidance are the independent mortgage lenders, those with no affiliation with insured depositories.

The loan products to which the proposed guidance would apply are Interest Only Mortgage Loans, Payment Option ARMs, loans with reduced documentation, and Simultaneous Second Lien Loans. For purposes of this proposed guidance the terms mean:

- Interest-Only Mortgage Loan is a mortgage on which the borrower is required to pay only the interest due on the loan for a specified number of years, for example three or five years. During that time, the rate on the mortgage may fluctuate or may be fixed. At the conclusion of the specified interest-only period, the rate may be fixed or may fluctuate based on a prescribed index and the payments will include both principal and interest.

- A Payment Option ARM is a mortgage that allows the borrower to choose from a number of different payment options. A borrower may choose a minimum payment option based on an introductory rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on either a 15-year or 30-year loan term plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.
• A loan that is frequently referred to as a reduced documentation loan may include features such as “low doc/no doc,” “no income/no asset,” “stated income” or “stated assets.” For loans with any of these features, the institution establishes reduced or minimal documentation standards to substitute the borrower’s income and assets.

• A simultaneous second lien loan is an arrangement under which either a closed-end second-lien or a home equity line of credit is originated simultaneously with the first lien mortgage loan, frequently in lieu of a higher down payment.

Although the mortgages that are currently being labeled “nontraditional” have been available for a number of years in some markets to some borrowers, the trend to offer Option ARMS, Interest Only Loans and Hybrid Arms has become more widespread. For over 15 years, these types of loans were originated primarily by savings associations on the west coast. The institutions that offered these products did so, and continue to do so, using conservative underwriting and risk management strategies. The OTS, the primary federal regulator of most of the institutions with a history in making these types of loans, has developed supervisory processes to mitigate any concerns the agency may have. Given the historical analysis that is possible of the offerings of these products by these institutions, the OTS has an understanding of the product and has developed a comfort level based on the agency’s experience.

Recently, a number of mortgage lenders, both insured depositories and independent mortgage companies have begun to offer these types of loan products at least partially because of consumer demand. The interest from consumers has been generated by a number of economic factors as well as changes in the way that consumers feel about mortgages. In many geographic areas, rapid house price appreciation has resulted in the inability of many consumers to be able to afford to buy a home. These types of ARM products make owning a home possible for many consumers who could not otherwise qualify for a loan. Another factor that makes these loans attractive is the reduced length of time many borrowers expect to be in the homes they are financing with these mortgages.

One of the results of the growing trend and expansion of the universe of lenders making these loans and of consumers requesting these loans has been an increase in the attention the products have received. The news media labeled these products “exotic” and called them risky while writing articles about concerns that the federal banking regulators were expressing. The agencies, particularly the OTS, have had experience supervising institutions originating these types of loans, but they determined that an increased level of scrutiny was necessary as the availability of these loan products became more widespread. Another factor leading the agencies to want an additional review of these products was the concern that consumers did not understand the risks involved with these loans, especially in a rising rate environment.

The federal banking agencies responded to these concerns by issuing proposed guidance that if adopted will provide insight into what the agencies are looking for in an examination from both a safety and soundness and a consumer protection perspective. The agencies have indicated that they will carefully scrutinize the lending programs, including policies and procedures, and risk management processes relative to these types of lending products. The agencies will look for an effective risk management function and will expect institutions to implement the guidance.
The consumer protection aspects of the proposed guidance are important elements of what the agencies are trying to accomplish and are an indication of how important the consumer provisions are. The current form of the guidance is a proposal and the agencies have asked a number of questions as part of the comment process.

**Principal Elements of the Proposed Guidance**

The agencies focus attention on the necessity of maintaining sound loan terms and underwriting standards in any program. The proposal urges institutions to assess what is currently in place and being followed and to implement any necessary changes. The proposed guidance addresses the following underwriting standards:

- Appropriate borrower repayment analysis, including consideration of the comprehensive debt service in the qualification process;
- The potential for collateral-dependent loans which could arise when the borrower is overly reliant on the sale or refinancing or the property when the amortization occurs;
- Mitigating factors that support the underwriting decision in circumstances involving a combination of nontraditional mortgage loans and reduced documentation;
- Below market introductory interest rates;
- Lending to subprime borrowers; and
- Loans secured by non owner occupied properties.

The proposed guidance describes appropriate portfolio and risk management practices for institutions that offer nontraditional mortgage products. The policies and internal controls should address product attributes, portfolio and concentration limits, third-party originations, and secondary market activities. As part of developing risk management practices, the agencies proposed that institutions:

- Maintain performance measures and management reporting systems that provide warning of potential or increasing risks;
- Maintain an allowance for loan and lease losses at a level appropriate for portfolio credit quality and conditions affecting collectibility;
- Maintain capital levels that reflect nontraditional mortgage portfolio characteristics and the effect of stressed economic conditions on collectibility; and
- Apply sound practices in valuing the mortgage servicing rights of nontraditional mortgages.

Finally, an important factor in the proposed guidance is the discussion of the possible consumer protection concerns raised by nontraditional mortgage loan products, particularly if consumers do not fully understand the terms of these products. There is a concern that the complexity of the products relative to the traditional fixed rate and ARM products presents a greater risk of payment shock. The agencies urge institutions to ensure that consumers are provided clear balanced information about the relative benefits and risks of the products at the time during which consumers are making decisions on which mortgage loan they should obtain.

**Consumer Protection Issues**
The proposed guidance includes a separate section on consumer protection issues. The agencies are concerned that consumers may entering into transactions for these types of loan products without understanding the terms. The marketing for these types of loans uses advertising and promotional materials that frequently focus on the near-term monthly payment affordability. The agencies are concerned that consumers are not encouraged to select nontraditional mortgage products based on the lower monthly payments that such products permit compared with traditional types of mortgages. In addition to describing the benefits of these products, the agencies urge institutions to ensure that consumers have been alerted to the risks of the products, including the likelihood of increased future payment obligations. The agencies also urge institutions to provide timely and sufficient information for making a sound product selection decision.

These products can carry risks of significant payment shock that may not be planned for by the consumer. The increases can be the result of a “recast” of the payment option ARM or the end of the interest only period. The increases can be affected by the expiration of promotional interest rates, increases in the interest rate index, and negative amortization. In the event the consumer wishes to refinance the loan, any negative amortization may result in the reduction or elimination of home equity even if property values have appreciated. The agencies urge institutions to provide clear, balanced, and timely communication about the risks of the products. The proposed guidance reinforces that the information must be provided at the point when consumers are making decision or shopping for loans. The proposed guidance also reminds institutions about their legal obligations under the Truth in Lending Act, section 5 of the Federal Trade Act, the Real Estate Settlement Procedures Act and the fair lending laws for ensuring accurate and timely disclosures. Recommended practices for communications with customers as well as developing control systems and policies to ensure that the practices are being followed.

Requests for Information

The agencies ask several questions about the actual practice of institutions that offer these products. The preamble to the proposed guidance seeks input on particular aspects of the proposal in an effort to determine industry standards. For example, the agencies ask whether proposed guidance that provides that the analysis of borrower’s repayment capacity should include an evaluation of the ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. Other questions ask commenters to provide information on the kinds of information that institutions should review for reduced documentation loans. Information is also sought on qualification standards for borrowers for these types of loans.

Conclusion

It is important for lenders that originate these types of loans to look at the guidance carefully. While it is not a regulation, the proposal establishes the standard that the agencies will use to supervise institutions making these loans. The comment period will be important as industry information that is provided will enable the agencies to make adjustments. The ultimate
goal is for any final guidance to be reasonable and to permit the continued offering of these products as they serve an important need in the mortgage market for lenders and consumers.