Message from the Chair

To the Members of the Committee on Banking Law:

I am pleased to send you another quality edition of the Banking Law Committee Journal which will be posted on the Committee website. The formalization of the publication’s title as part of the Newsletter reflects the dedication and hard work that our Editors put into each article. I commend these articles to you and note that they address many of the important topics discussed in our Committee meetings. Such as, they provide a link to that portion of our 1600 members who may not be able to regularly attend the meetings of the Committee, the Section of Business Law or even the Annual Meeting of the ABA held each August.

The number of “hits” for each edition seem to confirm that link. The editors who write the majority of these articles provide examples of the knowledge, experience and insights from which we all benefit through interaction with others on the Committee. I invite you to become more active by sharing your knowledge. Write a short article for the next edition and send it to any of the editors listed here. Also, feel free to contact Chris Bellini at cbellini@gibsondunn.com if you want to discuss a proposed article or if you have other material you feel is suitable to be posted on the website for our members.

Featured Articles

The Changing Mortgage Lending Landscape
Charlotte M. Bahin

A number of market, regulatory and legislative developments are working together to reinforce the importance of consumer protection and internal controls in the area of banking and mortgage products. Whether it is mortgage loans, consumer loans, credit cards or other credit products, Congress, state legislatures, federal and state banking authorities and state attorney generals are looking at the products - their terms, disclosures and uses - for compliance with existing consumer protection and other laws. They are looking at the products and the lenders to determine whether enhanced disclosures are needed, whether additional education should be required prior to a consumer taking the product or whether there should be a different standard to determine if the consumer should take the product at all.

For several years, consumer groups and other observers of mortgage lending arena have stepped up the calls for a suitability standard that can be used by mortgage lenders. The mortgage industry is resisting the efforts and instead is promoting a uniform nationwide standard. With the change in the leadership in Congress in January 2007 and the changing interest rate environment, the debate between the two views has increased. The current political climate is not as supportive of a national standard that would preempt state laws as it was in prior years.

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Update II on Watters v. Wachovia

Peter Heyward

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Capital Counts in a Globally Competitive Marketplace

Raymond Natter

Beginning with the implementation of the Basel I Accord in 1989, the world's leading economic countries have applied a uniform risk-based capital standard for internationally active banks. While variances exist among the nations, for all practical purposes these banks are currently competing on a level field. This situation may change in the near future.

In 2004, the Basel Committee adopted a new standard, the Basel II Accord, which more closely aligns capital with risk. The proposed implementation of the Basel II Accord in the United States would subject our banks to higher minimum capital requirements than certain foreign banks. This paper explains why this will adversely affect the competitive position of U.S. institutions.

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Mortgage Fraud at Financial Institutions: Prevention and Response

Travis P. Nelson

Over the last year law enforcement and regulatory agencies have been inundated with reports of mortgage fraud, occurring in an environment marked by substantial growth in mortgage lending markets and an increase in innovative loan products that have expanded consumer access to home finance. Mortgage loan fraud has become a growing risk for financial institutions, as reported by the Federal Financial Institutions Examination Council ("FFIEC"): "Mortgage loan fraud is growing because it can be very lucrative and relatively easy to perpetrate, particularly in geographic areas experiencing rapid appreciation."

This article will examine the phenomenon of mortgage fraud, basic steps that a financial institution can take toward preventing such fraud, and what remedies a financial institution can pursue in responding to mortgage fraud once detected.

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Disclosure of Suspicious Activity Reports: Who Can Disclose It and Where Can It Go?

Thomas P. Vartanian and Chin Pann

The Bank Secrecy Act of 1970 (the "BSA") empowers the Secretary of the Treasury (the "Secretary") to "require any financial institution, and any director, officer, employee, or agent of any financial institution, to report any suspicious transaction relevant to a possible violation of law or regulation." Under this authority, the Secretary installed a new reporting system that required financial institutions, and certain individuals related to those institutions (such individuals and financial institutions collectively referred to herein as "financial institutions"), to file Suspicious Activity Reports ("SARs") with the Financial Crimes Enforcement Network ("FinCEN"). This SAR reporting system provided the government with a valuable pipeline of information concerning dubious financial conduct. Since the inception of the reporting system, these SARs and the wealth of information they represent have been a critical tool in the government's efforts against financial crimes.

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A number of market, regulatory and legislative developments are working together to reinforce the importance of consumer protection and internal controls in the area of banking and mortgage products. Whether it is mortgage loans, consumer loans, credit cards or other credit products, Congress, state legislatures, federal and state banking authorities and state attorney generals are looking at the products - their terms, disclosures and uses - for compliance with existing consumer protection and other laws. They are looking at the products and the lenders to determine whether enhanced disclosures are needed, whether additional education should be required prior to a consumer taking the product or whether there should be a different standard to determine if the consumer should take the product at all.

For several years, consumer groups and other observers of mortgage lending arena have stepped up the calls for a suitability standard that can be used by mortgage lenders. The mortgage industry is resisting the efforts and instead is promoting a uniform nationwide standard. With the change in the leadership in Congress in January 2007 and the changing interest rate environment, the debate between the two views has increased. The current political climate is not as supportive of a national standard that would preempt state laws as it was in prior years.

Against this backdrop, the federal bank regulators are becoming more concerned about the financial stability of the mortgage market and about the increasing rate of foreclosures, especially those foreclosures of subprime or nontraditional mortgage loans originated in the low interest rate environment of the past few years. Further, state legislatures continue to introduce, debate and enact anti predatory lending laws that result in uneven requirements for lenders depending on the organization and charter. The Department of Justice and state attorneys general also have imposed compliance requirements through enforcement. Some of these recent events provide examples of lending activity that will be scrutinized by state and federal regulators.

In the past year, the federal banking agencies have issued guidance to lenders that originate nontraditional mortgages. The Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators have issued joint suggested guidance for state mortgage lenders that is similar to that of the federal banking agencies. In the case of the state guidance, each state must adopt the guidance to make it applicable to state mortgage lenders. The guidance addresses safety and soundness as well as consumer protection concerns that the agencies have about the origination of nontraditional mortgage loans. The guidance generally addresses underwriting of the nontraditional mortgage products and the consumer disclosures. There is a concern that in an economy and housing market that is not as robust as it has been in the past few years and as interest rates rise, consumers will find that they are not able to afford the payments for loans once the interest rates have reset. As this happens, regulators and consumer groups look at what disclosures were given, whether the consumer understood them and whether there should be a suitability standard applied to these loans.
As a follow up to the issuance of the nontraditional mortgage lending guidance, the federal banking agencies have issued additional guidance to address the applicability of the guidance to traditional adjustable rate loans and related products.

The additional guidance has been issued for comment and discusses the criteria and factors that an institution should assess in determining a borrower’s ability to repay subprime loan. The regulators refer to a number of prior issuances, including the Expanded Subprime Lending Guidance issued in 2001 and the Real Estate Lending Guidelines issued in 1992. The proposed statement clarifies that the agencies are concerned about adjustable rate mortgage products that are marketed to subprime borrowers with certain characteristics including:

- Offering low initial payments based on a fixed introductory rate that adjusts to a variable index rate plus a margin;
- Approving borrowers without appropriate documentation of income;
- Setting high or no limits on how much the payment amount of interest rate may increase;
- Containing products features likely to result in frequent refinancing to maintain an affordable monthly payment;
- Including substantial prepayment penalties; and/or
- Providing borrowers with inadequate information about the product features.

The draft guidance would place new restrictions on these types of loans. Lenders are urged to underwrite subprime mortgages by looking at the borrower’s ability at final maturity to pay the mortgage at the fully indexed rate, assuming a fully amortizing repayment schedule. The guidance also would require that borrowers be qualified on their debt to income ratio. The regulators specifically mention their concern that lenders may not take the tax and insurance payments into account when approving a loan. For higher risk loans, lenders should verify income, assets and liabilities. Stated income and reduced documentation loans are not appropriate for higher risk loans unless the lender can look to mitigating factors.

The draft guidance addresses necessary consumer protection requirements. The agencies also note the risk of marketing these loans and reminds institutions about the risks of violating the Federal Trade Commission Act’s section 5 prohibition against unfair and deceptive practices. Finally, the requirement that internal controls be adequate is addressed.

In addition to other risk management practices including underwriting standards, consumer protections and internal controls, the agencies also identified predatory lending considerations as a concern. The draft guidance refers to the predatory lending practices discussed in the agencies’ Expanded Subprime Lending Guidance and lists three elements, at least one of which is found in a predatory loan.

- Making mortgage loans based predominately on the foreclosure or liquidation value of the borrower’s collateral rather than on the borrower’s ability to repay the mortgage according to its terms;
- Inducing a borrower to repeatedly refinace a loan in order to charge high points and fees each time the loan is refinanced; or
• Engaging in fraud or deception to conceal the true nature of the mortgage loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

As is sometimes the case, a look at an enforcement order issued by one of the federal banking agencies provides an example of how the agencies will enforce a rule or guidance. Several days after issuing the proposed subprime guidance, the FDIC issued an order against Fremont General Corp. and Fremont Investment & Loan. The order reiterates how lenders underwrite subprime mortgages and how to police third party brokers. The FDIC has provided an example of how the agency would like to see the proposed guidance implemented by lenders.

The FDIC clarifies that the analysis of the borrower’s ability to afford the loan must include real estate taxes, hazard insurance, private mortgage insurance and homeowner association fees. Fremont may make assumptions about these fees when calculating the fully amortizing rate for the loan. The order states that the amount should not exceed 50 percent of the borrower’s income. This is more stringent than the proposed guidance, which is not as specific.

The order also requires that subprime loans to borrowers who are in distress be restructured, if such restructuring can be done consistent with safe and sound underwriting. Finally, the FDIC requires Fremont to oversee third party brokers. This oversight includes due diligence, a selection process for brokers that evaluates the integrity of the broker, a mechanism for ensuring that brokers are not rewarded for persuading borrowers into taking unsound loans, and a system that disciplines problem brokers.

Although the issues addressed are different, another instructive enforcement action is an agreement reached by Countrywide Home Loans and then New York Attorney General Eliot Spitzer late in 2006. This settlement not only looks at alleged discrimination but the remedy has the beginnings of a suitability standard.

After a review of the Home Mortgage Disclosure Act data relevant to lending in New York, the Attorney General asserted that Countywide was more likely to originate high priced loans to Latino and black customers. The Attorney General maintained that, based on a statistical analysis, the differences could not entirely be explained by legitimate factors, such as borrower credit scores and debt ratios. Countrywide has agreed to establish a program that includes education for borrowers, additional monitoring of pricing and other discretionary decisions, additional monitoring of mortgage broker pricing decisions, compensation to the borrowers who improperly received a higher priced loan and additional consumer disclosures. In addition, Countrywide has agreed to provide additional fair lending training for loan officers and provide regular reports to the Attorney General.

This settlement is an example of some of the pitfalls of the expanded HMDA disclosures. Each of the federal banking agencies is reviewing the data carefully and they have all announced that they are concerned about some of the findings. In the current political environment, it is possible that there will be Congressional attempts to revise the reporting requirements to include additional data elements.
Mortgage lending has been a profitable business line for many lenders in the past years and many consumers have benefited from the development of new loan products and low interest rates. However, the federal and state regulatory environment is changing and the compliance risks of subprime lending programs that offer an array of products are great. As is seen in the proposed guidance and the Fremont order, it is not just compliance, the agencies are also looking at supervisory risks and the adequacy of internal controls. As the debate continues, the call for a suitability standard for mortgage lenders will continue. Both the Countrywide and the Fremont order provide useful guidance about some of the areas of concern to monitor in the area of mortgage lending.
March 13, 2007

Update II on Watters v. Wachovia

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As most Banking Law Committee members are aware, Watters v. Wachovia pits Michigan’s Commissioner of Insurance and Financial Services against Wachovia Bank and its mortgage lending subsidiary regarding the extent, if any, to which a State may regulate a national bank’s operating subsidiary doing business within its borders. Michigan sought to apply laws requiring Wachovia's mortgage lending subsidiary, Wachovia Mortgage, to register as a mortgage lender and pay annual registration fees as a condition of doing business in the State; submit annual financial statements; and retain certain records for examination by the Commissioner. The Michigan laws would also permit the Commissioner to investigate a complaint against Wachovia Mortgage if it were not being pursued adequately by the Comptroller of the Currency.2

The District Court granted summary judgment to Wachovia when it challenged the application of these laws to Wachovia Mortgage,3 holding that the State laws in question were preempted by regulations of the Comptroller of the Currency implementing the “incidental” powers of national banks under Section 24(7) of the National Bank Act and the Comptroller’s exclusive visitiorial authority with respect to

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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 of any of its clients.

2 See MICH. COMP. LAWS § 445.1651 et seq., MICH. COMP. LAWS § 493.51 et seq.

national banks under 12 U.S.C. § 484(a). The U.S. Court of Appeals for the Sixth Circuit affirmed.\(^4\)

The case has attracted keen interest in the banking industry, while causing concern in some quarters, as a result of the Supreme Court’s grant of *certiorari* in June 2006. In view of the unanimity of lower federal courts in finding State laws to be preempted in similar cases, the Court’s action inevitably suggested that at least four Justices were inclined to reverse, creating a nightmare scenario in which national banks’ operating subsidiaries might have to observe consumer protection laws and other legal requirements in every State in which they operate.

Developments in the last few months have not been reassuring for the partisans of preemption. In particular, the Justices’ questions in the oral argument on November 29, and the fact that the Court has not issued a ruling since then,\(^6\) can be interpreted as reinforcing the inference that a majority of the Court will hold that the OCC’s exclusive visitorial authority over national banks, and the resulting broad preemption with respect to State regulations deemed visitorial in nature, does not extend to national banks’

\(^4\) Section 484(a) provides:

> No national bank shall be subject to any visitorial powers except as authorized by Federal law, vested in the courts of justice or such as shall be, or have been exercised or directed by Congress or by either House thereof or by any committee of Congress or of either House duly authorized.

An OCC regulation provides:

> Unless otherwise provided by Federal law or OCC regulation, State laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank.

12 C.F.R. § 7.4006.

\(^5\) *Wachovia v. Watters*, 431 F.3d 556 (6th Cir. 2005).

\(^6\) Justice Thomas recused himself, leaving eight Justices to decide the case. Knowledgeable Court observers have indicated that a 4-4 affirmance or a ruling that *certiorari* should not have been granted in the first place (never very likely), would probably have been issued by now.
operating subsidiaries. Based on a review of the transcript, this article will offer some tentative predictions of the outcome.

“You are really trying to have your cake and eat it, too.”

It seems clear that Chief Justice Roberts and Justices Scalia and Stevens were inclined to reject the extension of the exclusive visitorial authority of the OCC to operating subsidiaries. Chief Justice Roberts was obviously troubled by the notion that a national bank could reap the benefits of operating through a State-incorporated mortgage lending subsidiary, while avoiding the burdens of State corporate status. When Justice Ginsburg suggested to Michigan’s counsel, John Blanchard, that he was advocating “the worst of all possible regulatory worlds, so that they’ve got two equally competent regulators, and they have to meet requirements of both,” Justice Roberts came to Mr. Blanchard's aid, interjecting: “And if they don’t want to, they don’t have to set up a separate subsidiary, right? They can do this business directly as a national bank and they’re not going to be subject to any visitation?” 7 Later, he observed to Wachovia’s counsel: “You are really trying to have your cake and eat it too . . . you want to be able to operate through a subsidiary and yet not be subject to the same rules that apply to other people.” 8

Justice Scalia, too, made clear his reservations about Wachovia’s position, commenting to Wachovia’s counsel: “If you are an affiliate of a national bank, you have the same immunity that the national bank has. That’s not what the statute says.” 9 He

7 Tr. at 13.
8 Tr. at 30.
9 Tr. at 32.
made much the same point in an exchange with the Assistant to the Solicitor General representing the United States, as amicus curiae, supporting Wachovia and the OCC rule: “What troubles me . . . is the core function of a banking regulatory agency is the visitation power, and the Banking Act makes it very clear there is visitation power to national banks and makes it very clear that there is not for subsidiaries. And here is a regulation which under the guise . . . of defining the powers of the national bank simply eliminates that distinction. And it seems to me that perhaps goes beyond what an agency regulation is allowed to do.”

Justice Stevens was also openly skeptical of the bank’s position. Echoing a point made by the Chief Justice, he noted that Wachovia could operate through branches if it chose, but elected the operating subsidiary structure to obtain protection from liability or for other reasons. Later, he pointedly asked the Assistant to the Solicitor General how many additional personnel the OCC had hired to handle the exclusive regulatory functions taken over from State supervisors as a result of its assertion of exclusive visitorial authority with respect to operating subsidiaries.

From the questions at the argument, it is harder to find the two additional votes needed for reversal in Watters. But given that at least four Justices voted to grant certiorari, there must have been at least one Justice in addition to Justices Roberts, Scalia and Stevens who was similarly disposed. And, as noted above, if there were only four

10 Tr. at 48.

11 Tr. at 26–67.

12 Tr. at 45. I note, also, that Justice Stevens was one of only two dissenters from the Supreme Court’s decision in Fidelity Federal Savings & Loan Association v. De La Cuesta, 458 U.S. 141 (1982), that lodestar of federal thrift preemption, holding that California’s restriction on the enforceability of mortgage due-on-sale clauses was preempted by a regulation of the Federal Home Loan Bank Board authorizing such clauses.
votes for reversal after oral argument, the Supreme Court might have been expected to issue its decision by now.\textsuperscript{13} Therefore, it seems reasonable to assume that there are at least five votes for some decision on the merits. The two most likely additional votes for reversal may belong to Justices Breyer and Alito. This inference is based on the admittedly inconclusive evidence provided by their questions to the litigants, along with the fact that Justices Ginsburg, Souter and (to a somewhat lesser extent) Kennedy seemed inclined to side with Wachovia and the OCC.

Justice Breyer at first seemed to assume that Wachovia was asserting that Michigan’s laws were preempted only under a “conflict” preemption theory,\textsuperscript{14} suggesting that he was not disposed to agree with the broader visitorial, or "field" preemption, protection claimed by the bank based on OCC regulations. And, once it was established that the bank was indeed relying, at least in part, on conflict preemption, he did not seem to get the clear answer he was seeking from Wachovia’s counsel as to what that conflict might be.\textsuperscript{15}

Justice Alito, who said little during the oral argument, also seemed inclined to analyze the case in terms of conflict preemption rather than exclusive visitorial powers. His one question, addressed to Wachovia’s counsel, asked for concrete examples of how Michigan’s laws might “impair or impede the operations” of Wachovia Mortgage.\textsuperscript{16} As with Justice Breyer, one may ascribe to him an inclination to vote against the broader claim of preemption asserted by Wachovia and the OCC because of his apparent interest

\textsuperscript{13} It will be recalled that Justice Clarence Thomas has recused himself from the case.

\textsuperscript{14} Tr. at 30-31.

\textsuperscript{15} Tr. at 31.

\textsuperscript{16} Tr. at 29.
in conflict preemption criteria and the lack of a clear response to his questions about the actual conflict between Michigan’s laws and Wachovia Mortgage’s operations.

“Can you think of any reason that Congress would have contemplated the scheme that you are defending?”

On the other side, Justices Ginsburg and Souter seemed sympathetic to the view that it would be inherently burdensome, and hence contrary to the federal scheme of national bank regulation, to impose even Michigan’s relatively unintrusive regulatory scheme on Wachovia Mortgage. Justice Souter reinforced Justice Ginsburg’s concern that subjecting an operating subsidiary to the jurisdiction of both the OCC and local authorities would be “the worst of all regulatory worlds.” He asked Michigan’s counsel to “give me any reason to think that Congress would have contemplated this system of potentially more restrictive State legislation when a national bank in a given instance decides to . . . exercise its Federal banking power through a subsidiary rather than directly? Can you think of any reason that Congress would have contemplated the scheme that you are defending?”17 He went on to note: "Regulation costs the entity something. It is a burden on them."18

Justice Kennedy, for his part, seemed untroubled by the possible preemption of any Michigan laws purporting to regulate the bank-related activities carried on by Wachovia Mortgage. He seemed concerned only to establish that the OCC was not infringing on the State's right to regulate matters of corporate housekeeping and the like. After indicating that he would understand (and presumably agree with) Wachovia's taking the position that a Michigan law limiting the consumer lending activities of an

17 Tr. at 23.

18 Id.
operating subsidiary would be preempted, he asked Michigan's counsel whether Wachovia was making a broader claim: "But just to see if the corporation had a meeting that year, has duly elected its officers under State law, do the respondents take the position you have no authority to visit the corporation to determine that?"19 Later, he observed: "This is just a standard preemption case. When the OCC has regulations that control, then the State has no authority to add to those regulations or to have contrary regulations. But if it's something that doesn't have to do with banking at all, then I suppose they would say . . . the State has authority to regulate."20 Despite a later question to counsel for Wachovia hinting at a possible concern that only Congress could define the extent of field preemption of the kind asserted by Wachovia, Justice Kennedy seemed, on balance, to be leaning in favor of affirmance.

What Next?

Assuming that a majority of the Supreme Court holds that the exclusive visitorial provision of the National Bank Act does not accomplish field preemption and automatically shield a national bank's operating subsidiary from all State regulation, reversal of the decision below seems likely but is not inevitable. Even the Justices who were obviously skeptical of visitorial exclusivity with respect to operating subsidiaries seemed to recognize – indeed assumed – that State laws must yield to OCC rules to the extent that they actually prevent or stand as an obstacle to the federally authorized lending activities of a national bank’s operating subsidiary. And none of the Justices seemed interested in establishing any sweeping principle of States' rights to regulate

\[19\text{Tr. at 9.}\]
\[20\text{Tr. at 10.}\]
State-chartered corporations without regard to federal rules, whether under the Tenth Amendment (which was not mentioned in the oral argument) or otherwise.

It therefore seems theoretically possible that the Court, having clarified the limited scope of the visitorial powers clause, will nevertheless (possibly through a majority comprised of different Justices) uphold the result below on the basis that the Michigan laws in question actually conflict with federal purposes to a sufficient extent to be preempted. Concededly, this result might seem at odds with the principle of not deciding questions unnecessarily: Why should the Court reach out to define the scope of the visitorial authority if the lower court's decision should be upheld on other grounds?

Alternatively, the Court might conclude that Michigan's laws do not conflict with the federal scheme, or might remand the case with a direction to develop a fuller record as to whether a conflict exists.

If either of the latter two alternatives comes to pass, national banks that wish to conduct mortgage lending or other consumer lending programs nationwide through operating subsidiaries will face a far more complicated legal environment, in which State laws can not be brushed aside with impunity. National banks will have to weigh the advantages and disadvantages of complying with State requirements and, if the disadvantages seem too great, will need to assess the prospects and costs of a successful legal challenge. The alternative of rolling the lending operations back into the bank itself may not be practical. It is not necessarily a simple matter for a national bank to significantly restructure substantial consumer lending operations that had previously been conducted through an operating subsidiaries in reliance on the OCC’s view of the law.
The implications for thrift institutions may be less dramatic. Long viewed as the beneficiaries of field preemption of state laws, federal savings institutions will not necessarily be affected by a decision limiting the scope of the national bank visitorial powers clause.

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Peter Heyward would be pleased to respond to questions or comments about this article. He can be reached at peheyward@venable.com.
Beginning with the implementation of the Basel I Accord in 1989, the world’s leading economic countries have applied a uniform risk-based capital standard for internationally active banks. While variances exist among the nations, for all practical purposes these banks are currently competing on a level field. This situation may change in the near future.

In 2004, the Basel Committee adopted a new standard, the Basel II Accord, which more closely aligns capital with risk. The proposed implementation of the Basel II Accord in the United States would subject our banks to higher minimum capital requirements than certain foreign banks. This paper explains why this will adversely affect the competitive position of U.S. institutions.

I. The Role of Capital

Bank capital comprises the shareholders’ equity investment and similar accounts that would be the first to absorb unexpected losses. In normal periods losses on loans or other activities simply reduce profits, but in extreme periods capital lessens the risk that a bank would be unable to repay its creditors. It therefore reduces potential losses to the FDIC’s insurance fund in a failure. Capital requirements also control the ability of a bank to borrow and grow. A bank with only minimum required capital may not increase its loans or investments without increasing its capital base.

Capital requirements are specified as ratios. Risk-based requirements compare capital to risk-weighted assets, where riskier assets carry a greater weight than safer assets and consequently require more capital. The leverage ratio requirement compares capital to total assets, where all assets – from U.S. government bonds to speculative real estate loans – all require the same capital support.

II. Capital and Competition

Higher capital requirements adversely affect banks in three ways: it discourages growth in loans or equity investments, it enables competing institutions to gain market share, and it encourages the bank to make riskier loans.

Investors prefer companies that provide the most value for each dollar invested. A higher minimum capital level requires more shareholder investment to support the

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2 Unlike almost all other countries, the U.S. also imposes a leverage requirement that is not adjusted for risk. Under Basel II the leverage ratio will likely become the binding regulatory capital requirement for many of our larger banks.
same assets. Each dollar invested in the bank with the higher requirement will receive a smaller share of earnings than if the same investment were made in a bank with the same assets and a lower requirement. Investment dollars will thus flow to the bank with the lower requirement.

Second, since the bank with lower requirement can hold more loans having the same risk with the same capital base, it can charge a lower rate for each loan, yet still earn the same (or even more) profit than a bank that is constrained by higher requirements. The bank with the lower requirement is also advantaged with respect to bank acquisitions. From the standpoint of that bank, the other bank has “excessive capital” that can be “liberated” through an acquisition. The “excessive capital” results simply from the fact that each bank is under a different regulatory regime, not from any economic difference between the institutions.

Third, a bank with higher capital will be motivated to offset these competitive disparities by increasing its earnings. Typically, this means making riskier loans and investments that provide a higher return but with greater chance of loss.

III. Why Do Most Banks Hold More Capital Than Required?

One argument made for higher capital requirements is that most banks today have more capital than is required by regulation, and therefore an increase in regulatory minimums should not be troubling. However, this argument fails to note the differences between required capital and additional capital that banks maintain.

Required capital is not accessible for business purposes. Dividends may not be paid from required capital, and required capital cannot be used for growth or other business opportunities. In a sense, it is funds that have been “spent” and are no longer available for business operations.

Capital held in addition to required amount serves many purposes. It provides a buffer against the consequences of becoming under-capitalized. It is a ready resource permitting a bank to take advantage of business opportunities, such as an acquisition. It allows a bank to meet unexpected demand for credit due to market developments. Additional capital can be used to fund an increase in dividends or for a share buy back or similar return of equity to shareholders. Unlike regulatory capital, additional capital provides a bank important flexibility and is a source of potential future growth.

IV. Global Impact of Higher Capital Requirements

If the U.S. proceeds to adopt higher minimum capital requirements than those applicable globally, our institutions will be disadvantaged. When competing for business abroad, foreign banks will be able to under price U.S. banks while maintaining their profitability. Domestically, foreign banks operating with U.S. branches will enjoy the
same ability to under price our institutions. Foreign banks that own U.S. bank subsidiaries will also enjoy this competitive advantage, even though the subsidiary will have to comply with U.S. rules. The foreign parent can fund the “excessive capital” held by the U.S. subsidiary bank with debt and as a result be able to more aggressively compete with U.S. institutions both domestically and overseas.

V. Conclusion

Regulatory capital protects the deposit insurance funds and helps a bank deal with unexpected losses. However, excessive capital mandates reduce profitability, limit growth, and encourages the booking of riskier loans and investments. When similar banks have different minimum capital requirements, a competitive advantage is given to the bank with the lower requirements. This advantage is not based on productivity or management efficiency, but simply created artificially by regulation. The U.S. regulators should conform the U.S. rules to the rules that apply abroad. The Basel II Accord was agreed to by all of the bank regulatory agencies, and there is no reason to diverge from that agreement. The Basel II Accord includes many safeguards including a two-year transition period. These safeguards are sufficient for the rest of the world, and – along with the continuous on-site supervision in place at large U.S. banks – can ensure that U.S. banks remain safe and sound.

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3 U.S. bank holding companies and foreign banks may engage in a broad range of financial activities in the U.S., but only if the U.S. holding company or foreign bank is “well capitalized.” The Fed does not apply the leverage ratio to foreign banks, and Fed staff has stated that foreign country’s version of Basel II will be used for determining whether the foreign bank is “well capitalized,” and therefore able to engage in broader financial activities in the U.S. Domestic bank holding companies will be required to meet both the leverage ratio and the U.S. version of Basel II for the same privileges.
Mortgage Fraud at Financial Institutions: Prevention and Response

By:

Travis P. Nelson

Over the last year law enforcement and regulatory agencies have been inundated with reports of mortgage fraud, occurring in an environment marked by substantial growth in mortgage lending markets and an increase in innovative loan products that have expanded consumer access to home finance. Mortgage loan fraud has become a growing risk for financial institutions, as reported by the Federal Financial Institutions Examination Council (“FFIEC”): “Mortgage loan fraud is growing because it can be very lucrative and relatively easy to perpetrate, particularly in geographic areas experiencing rapid appreciation.”

This article will examine the phenomenon of mortgage fraud, basic steps that a financial institution can take toward preventing such fraud, and what remedies a financial institution can pursue in responding to mortgage fraud once detected.

The Nature of Mortgage Fraud

Mortgage loan fraud can generally be divided into two broad categories: fraud for property and fraud for profit. Fraud for property generally involves material misrepresentation or omission of information with the intent to deceive or mislead a lender into extending credit that would likely not be offered if the true facts were known, and is generally committed by home buyers attempting to purchase homes for their personal use. Typical fraud for property schemes include: asset fraud (where a borrower misrepresents their actual assets), occupancy fraud (where a borrower misrepresents that the property is sought as a primary personal residence rather than for investment purposes), employment and income fraud, debt elimination fraud, identity theft, and straw borrowers. Conversely, fraud for profit is motivated by money, committed with the complicity of industry insiders such as mortgage brokers, real estate agents, property appraisers, and settlement agents (attorneys and title examiners). Typical fraud for profit schemes include: appraisal fraud, fraudulent flipping, straw buyers, and identity theft.

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4 Id.

5 Other schemes include: silent second trust, mortgage warehousing, builder bailout, equity skimming, and false down payment.
Though mortgage fraudsters can defeat even the most comprehensive anti-fraud programs, some institutional lapses can also contribute to mortgage fraud, for which regulators have brought enforcement actions, such as for inadequate internal controls, and compliance failures in the areas of customer identification, data security, BSA/AML, and identity theft.

**Preventative Measures**

In implementing any fraud prevention program, a financial institution should provide all relevant employees with the following:

- Clear directives as to their responsibility when they suspect fraud.
- An awareness of the major types of fraud.
- An understanding of red flags and their use in the application review process.
- A list of resources available to them to detect and investigate fraud.

In structuring the anti-fraud program, the following five points are core global measures that should guide the program:

- **Collecting Data:** Applications must require complete data, which can be used to identify the individual or company during the approval process.

- **Validating Data:** Since personal IDs are sometimes unreliable, and corporate organizing documents can be forged, application data must be validated against credit reports and other trusted third-party sources.

- **Correlating Data:** This process compares various pieces of data with other data on the application, looking for inconsistencies such as an address that does not match the phone number.

- **Detecting Fraud Patterns:** This essential step looks for typical fraud patterns within the application and among third-party information sources. Recently opened credit accounts under the same social security number but different names would be a red flag, suggesting a need for further manual review.

- **Verifying the New Account:** Additional verification to confirm or double-check the individual’s intent in opening the account is the final precautionary measure for which various methods can be used.
The FFIEC has issued a comprehensive report for the banking industry on red flags and best practices for combating mortgage fraud.⁶ Although the report provides specific examples of red flags and best practices on a scheme-by-scheme basis, the following non-specific red flags are appropriate for most fraud prevention programs:

- The application is unsigned or undated.
- Signatures on credit documents are illegible and no supporting identification exists.
- Borrower has high income with little or no personal property.
- Borrower’s age is not consistent with the number of years of employment.
- Borrower has an unreasonable accumulation of assets compared to income or has a large amount of unsubstantiated assets.
- Borrower claims to have no debt.
- Borrower owns an excessive amount of real estate.
- A post office box is the only indicated address for the borrower.
- The same telephone number is used for the borrower’s home and business.
- Patterns or similarities are apparent from applications received from other borrowers.
- Borrower does not guarantee the loan or will not sign in an individual capacity.
- Business income is not consistent with business type.
- Years of education is not consistent with borrower's profession.
- Borrower is buying investment properties with no primary residence.

In addition to establishing systems to monitor for red flags, financial institutions should have programs, as applicable, in place that:

- Establish an employee training program that provides instruction on understanding common fraud schemes and recognizing red flags.

⁶ The Detection, Investigation, and Deterrence of Mortgage Loan Fraud Involving Third Parties: A White Paper, FFIEC, Feb. 2005. Though this paper is primarily intended for examiners, its best practices and internal controls guidance are equally appropriate for financial institutions’ internal fraud investigation units.
• Conduct pre-funding reviews on new production.

• Closely monitor new borrowers. Scorecard criteria can be used to track performance. Typical tracking data includes: default rates, pre-purchase cycle times, loan quality indicators such as underwriting exceptions, and key data changes prior to approval.

• Closely analyze the borrower’s financial information for unusual items or trends.

• Independently verify business information by researching the location and phone number of the business.

• Visit the business location unannounced.

• Employ pre-funding and post-closing reviews to detect any inconsistencies within the transaction.

• Conduct risk based quality control audits prior to funding.

• Ensure that prior liens are immediately paid from new loan proceeds.

• Assess the volume of critical post-closing missing documents.

• Establish a periodic independent audit of loan operations.

• Provide fraud updates/alerts to employees.

• Review patterns on declined loans, i.e., individual social security number, loan officer, etc.

• Establish a fraud hotline for anonymous fraud tips.

• Increase the use of original supporting documentation.

While a determined fraudster will find ways to overcome even the most comprehensive best practices programs, following these points should assist a financial institution that is the victim of mortgage fraud in defending against allegations by regulators that systemic failures led to the fraud.

**Mortgage Fraud Through Identity Theft**

With the increase in financial institutions’ surveillance of account activities, and heightened pressure to “know-your-customer” under customer identification program requirements, mortgage fraudsters are turning to identify theft and identify fraud to perpetrate their schemes. A recent report by FinCEN indicates that 1,761 Suspicious Activity Reports (SAR) were filed between January 1, 2003 and March 31, 2006, with the following distributions:
2003 – 69 reports, 2004 – 466 reports, 2005 – 941 reports, and during the first quarter of 2006 – 855 reports. The data reflects that use of identity theft to perpetrate fraud is on the rise.

Under a typical identity theft mortgage fraud scheme, a fraudster will use the internet to obtain confidential personal information such as social security numbers, addresses and other vital data needed to order a credit report, and then apply for a home equity line of credit on a property owned by the victim and have the loan proceeds wired to an account that can be quickly depleted or transferred to other accounts. All this can be done over the internet, without the victim finding out until the money is long gone. Identity theft is distinguished from identity fraud, which refers to the loan applicant’s use of a non-existent social security number or a number taken from the social security death index, along with the use of the borrower’s true personal identifiers (name, date of birth, address). The applicant will then use the social security number to qualify for a loan, either because the borrower does not have a number or because the borrower’s credit rating associated with their true number is inadequate for approval.

In the late 1990’s with the ubiquitous nature of the internet, allowing for the filing of applications for mortgage loans by faceless applicants adrift in cyberspace, and the ease with which fraudsters acquire the tools for identity theft, Congress passed the Identity Theft and Assumption Deterrence Act of 1998 (the “Act”), which for the first time specifically labeled identity theft as a crime. Criminal statutes alone were not sufficient to combat the rise of identity theft, so Congress later required federal banking regulators to establish procedures for the identification of possible instances of identity theft. In July 2006, the federal banking agencies offered proposed red flags, which the agencies define as a pattern, practice, or specific activity that indicates the possible risk of identity theft. Whereas some statutory and regulatory sources, both state and federal, decline to provide for a private right of action for victims of identity theft based on an institution’s failure to comply with identity theft prevention laws, institutions should consider that the identity theft regulations, as with other privacy and information security regulations and guidance, may establish a new standard of care for potential plaintiffs. Consumers damaged by identity theft where the “red flag” system was not operable, up to date, effective or executed properly are likely to add a count to their complaints that the institution failed to comply with applicable standards of care required by law, forming the basis for measuring an institution’s duty of care, a core element in a negligence complaint.

In a recent example of this, on January 17, 2007, retailer TJX Companies, Inc. (“TJX”), announced that its computer network that handles customer transactions for some 2,500 retail stores was hacked into, resulting in the theft of personal credit, debit, and driver’s license information. A week later, on January 24, the Massachusetts Bankers Association reported that fraudulent use of the stolen information had been detected overseas. In response, Alabama-
based AmeriFirst Bank, a TJX customer, filed a lawsuit against TJX,\textsuperscript{10} alleging, among other things: (1) common law claims of negligence, breach of contract, and negligence per se, and (2) failure to adhere to the financial institutions customer records privacy and data security safeguards rule of the Gramm-Leach-Bliley Act (“GLBA”). This complaint presents an inventive approach to data processor liability in its use of the federal data security standards as a benchmark against which to assert a negligence per se claim. Under traditional negligence per se analysis under tort law, a plaintiff must show that the defendant’s conduct constituted a violation of some statute or regulation, and that the harm resulting from such conduct was the type of harm that the statute or regulation was designed to prevent. Although GLBA and its implementing regulations do not provide for a private right of action, and many state data security statutes do not provide for a private right of action based on failure to comply with such established standards, the data security safeguards contained in the regulations certainly present a measurable and widely accepted standard with which many prominent national users of customer information must comply. As this case demonstrates, the regulators’ guidance is having the unintended effect of serving as the basis for supporting common law tort claims against third party providers.\textsuperscript{11}

\textbf{What to Do When Fraud is Discovered}

When an institution first discovers fraud, internal corporate security/fraud prevention personnel should collect and copy all relevant documents that pertain to the transaction. This information should include the supporting documents, any parties involved and their suspected roles, and any instruments used in the disbursement of funds. Care should be exercised in preserving the integrity of the documents for their subsequent use by examiners in reviewing the conduct and the institution’s response, as well as for use in later administrative or judicial proceedings.

In addition to documentation of the fraud, financial institutions should conduct timely interviews of insiders that may have knowledge of the fraud. As the fraud may be on-going or part of a larger fraud scheme, institutions should consult with counsel, a fraud expert, or their regulator in determining the appropriate strategy for conducting interviews. Interviews of people and entities outside of the institution, if necessary, will be conducted by regulatory and law enforcement authorities, nevertheless institutions can aid in this process by maintaining detailed investigation records to assist regulators.

As soon as a financial institution has a reasonable belief that fraud has occurred, it is required to file a SAR in accordance with the SAR regulation and form.\textsuperscript{12} The obligation to file

\textsuperscript{10} AmeriFirst Bank v. TJX Companies, Inc., Case 1:07-cv-10169-JLT, filed 01/29/2007 (D. Mass)

\textsuperscript{11} See also, Patrick v. Union State Bank, 681 So.2d 1364 (Ala. 1995), Huggins v. Citibank, 585 S.E.2d 275 (S.C. 2003), and Eisenberg v. Wachovia Bank, N.A., 301 F.3d 220 (4th Cir. 2002). These cases discuss the application of the common law tort of negligent enablement of imposter fraud, a theory of liability that has met with mixed success in the courts, but should still be considered a viable possibility.

\textsuperscript{12} The Detection, Investigation, and Deterrence of Mortgage Loan Fraud Involving Third Parties: A White Paper, Produced by the October 27, 2003 FFIEC Investigations Symposium, Issued February 2005.
a SAR report is generally triggered where there is actual or attempted perpetration of an act constituting a violation of federal criminal law (e.g., mortgage fraud, identity theft fraud, etc.), against or through a financial institution where the suspicious transaction involves at least $5,000, or where an insider is involved regardless of the dollar amount involved. The following points should be considered when handling and processing SAR reports:

- **Institutions should designate one individual or department to be responsible for completing and filing SAR reports:** Where different departments or divisions within an institution file SAR reports separately, there is increased risk that SAR reports will not be filed under the institution’s uniform Bank Secrecy Act (BSA) compliance program, that SAR reports might be inconsistent or incomplete, and that SAR reports could be duplicative.

- **Confidentiality of SAR reports:** Under most circumstances, the disclosure of the existence of a SAR report is prohibited, and doing so may constitute a violation of federal criminal law – thus possibly requiring the filing of another SAR report. In particular, care should be taken when preparing and filing the SAR report to ensure that the target of the filing is not informed of its existence. This can be difficult where the target is a senior executive officer of the institution.

- **Responding to requests for SAR reports:** Institutions should exercise caution in responding to requests for production of a SAR report. Most courts and regulatory interpretations have held that public disclosure of a SAR report is absolutely prohibited. Institutions should consult with bank regulatory counsel to confirm the application of SAR regulations to the specific circumstances of a request for production.

Where suspected mortgage fraud involves third parties, the regulators suggest that institutions contact the appropriate state licensing board (e.g., state appraiser or real estate licensing authorities).

### Responding to Suspicion of Fraud Where Proof Does Not Exist

As part of their internal fraud detection and response programs, financial institutions are increasingly considering their options where they suspect that fraud may be involved in an application, but they do not have documentary evidence of the suspected fraud.

Under regulations promulgated by the Federal Reserve Board in Regulation Z, a creditor on a home equity plan may terminate the plan and demand repayment of the entire outstanding

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13 12 C.F.R. § 21.11 (Office of the Comptroller of the Currency); 12 C.F.R. § 563.180 (Office of Thrift Supervision); 12 C.F.R. § 208.62 (Federal Reserve Board); 12 C.F.R. Pt. 353 (Federal Deposit Insurance Corporation).
balance in advance of the original term if there is fraud or material misrepresentation by the consumer in connection with the plan.\textsuperscript{14} This provision, however, only applies to fraud on the part of the consumer, not to fraud perpetrated by a third party exclusive of the consumer. Regardless the source of the suspected fraud, financial institutions have certain obligations under the Fair Credit Reporting Act (“FCRA”), and the Equal Credit Opportunity Act (“ECOA”) with respect to taking “adverse actions” against consumers. Under the FCRA, a financial institution can reject an applicant where it suspects fraud based on information contained in a consumer report, however as such constitutes an “adverse action,” the institution is required by FCRA to inform the affected consumer of the source of the information and of the consumer’s right to contest the accuracy of the information contained in the consumer report. Similarly, the ECOA requires that where an applicant is denied a mortgage loan, the denying institution must provide a statement as to the “specific reasons” for the denial.\textsuperscript{15}

Where the institution lacks specific indicia of fraud, taking an adverse action against a consumer based on suspicion of fraud creates definite risks for the institution. Where financial institutions choose to take an adverse action against an applicant or existing customer based on suspicion of fraud, such institutions should be mindful of the following attendant risks: regulatory risk, litigation risk, reputation risk, and safety and soundness risk. Some of the more common adverse actions that would trigger these risks include: rejection of the applicant, assessment of a default rate of interest, suspension of access to the account, set-off against funds, and closure of the account.

**Conclusion**

Mortgage fraud, and identify theft in furtherance of mortgage fraud, are equal opportunity crimes – they can affect community banks and large banks. The attendant risks and costs of mortgage fraud reach beyond mere loss on a loan; financial institutions that are the victims of mortgage fraud due to deficient internal controls and prevention and response procedures, may suffer regulatory, litigation, and reputational consequences. In conducting their regular self-assessments of their fraud response programs, institutions should consider not only existing threats, but also the innovative schemes that potential fraudsters are constantly planning. Institutions should constantly identify and monitor potential weaknesses in their fraud prevention defenses – because surely the perpetrators of fraud are doing so.


\textsuperscript{15} 15 U.S.C. § 1691.
Disclosure of Suspicious Activity Reports: Who Can Disclose It and Where Can It Go?

by

Thomas P. Vartanian
Chin Pann¹

The Bank Secrecy Act of 1970 (the “BSA”)² empowers the Secretary of the Treasury (the “Secretary”) to “require any financial institution, and any director, officer, employee, or agent of any financial institution, to report any suspicious transaction relevant to a possible violation of law or regulation.”³ Under this authority, the Secretary installed a new reporting system that required financial institutions, and certain individuals related to those institutions (such individuals and financial institutions collectively referred to herein as “financial institutions”), to file Suspicious Activity Reports (“SARs”) with the Financial Crimes Enforcement Network (“FinCEN”).⁴ This SAR reporting system provided the government with a valuable pipeline of information concerning dubious financial conduct.⁵ Since the inception of the reporting system, these SARs and the wealth of information they represent have been a critical tool in the government’s efforts against financial crimes.⁶

General Prohibition on Disclosure

Important to the usefulness of the reporting system is the general prohibition on disclosure imposed upon financial institutions. These entities are barred from disclosing SARs, or information related to the existence of SARs, to “any person involved in the transaction”

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³ 31 U.S.C. § 5318(g).

⁴ See FINANCIAL CRIMES ENFORCEMENT NETWORK, 1ᵗʰ REVIEW OF THE SUSPICIOUS ACTIVITY REPORTING SYSTEM (SARS) (1998) (stating that the requirement to file SARs is by the Secretary’s authority under the BSA), available at http://www.fincen.gov/sarptfin.html; see generally, 31 C.F.R. § 103 (containing various regulations enacted by the Department of the Treasury (the “Treasury Department”) requiring the filing of SARs with FinCEN). FinCEN is a bureau of the Treasury Department. There are different implementing regulations for different types of financial institutions. For example, 31 C.F.R. § 103.18 concerns banks while 31 C.F.R. § 103.16 concerns insurance companies. While there are differences between these implementing regulations, these regulations are substantively the same for the purposes discussed in this article.


⁶ Id.
reported upon in the SARs. FinCEN guidance explains that “[t]his prohibition effectively precludes the disclosure of a SAR or the fact that a SAR has been filed” to anyone, but the prohibition does not prevent the disclosure of the information underlying the SAR so long as the secrecy of the SAR’s existence is in no way implicated.

The law makes an unauthorized disclosure of SARs or certain related information a criminal violation. In the context of litigation, the federal banking agencies and FinCEN advise financial institutions not to admit or deny the existence of a SAR and not to disclose a SAR in response to any discovery request or subpoena. In cases where a third party is persistent, the banking agencies or the U.S. Attorney may intervene to protect the interests of the United States and urge the court to deny all discovery requests for SARs. Interesting issues arise when the disclosure of a SAR is a fundamental aspect of the case. For example, may a party in a lawsuit state that an institution has filed a SAR, if that is relevant to its case, without violating the non-disclosure provisions of the law?

There are, however, limited circumstances when financial institutions are required or permitted to disclose such information. One such exception, among others, to this general prohibition is disclosure to an appropriate law enforcement agency or an appropriate supervisory agency. These government agencies may request SARs directly or in the form of certain

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8 FinCEN guidance explains that “[t]his prohibition effectively precludes the disclosure of a SAR or the fact that a SAR has been filed” to anyone, but the prohibition does not prevent the disclosure of the information underlying the SAR so long as the secrecy of the SAR’s existence is in no way implicated.8


10 See 31 U.S.C. § 5318(g); FinCEN guidance explains that “[t]his prohibition effectively precludes the disclosure of a SAR or the fact that a SAR has been filed” to anyone, but the prohibition does not prevent the disclosure of the information underlying the SAR so long as the secrecy of the SAR’s existence is in no way implicated.8

11 See FinCEN guidance explains that “[t]his prohibition effectively precludes the disclosure of a SAR or the fact that a SAR has been filed” to anyone, but the prohibition does not prevent the disclosure of the information underlying the SAR so long as the secrecy of the SAR’s existence is in no way implicated.8 FinCEN guidance explains that “[t]his prohibition effectively precludes the disclosure of a SAR or the fact that a SAR has been filed” to anyone, but the prohibition does not prevent the disclosure of the information underlying the SAR so long as the secrecy of the SAR’s existence is in no way implicated.8

12 See, e.g., 31 C.F.R. § 103.18(e). The implementing regulations in 31 C.F.R. § 103 for the various types of financial institutions are split between the use of supervisory or regulatory in reference to appropriate agencies for disclosure. Some regulations except only law enforcement and supervisory agencies while other regulations except only law enforcement and regulatory agencies. For purposes of this article, references to supervisory agencies include both supervisory and regulatory agencies.
instruments of law enforcement like grand jury subpoenas or National Security Letters. Additionally, financial institutions may provide SARs or related information to appropriate law enforcement and supervisory agencies on their own initiative, even when no agency has requested such information.

**Requirement to Determine Appropriate Agencies**

Upon receiving a request for information related to SARs from government agencies, financial institutions are posed with the task of determining whether the particular requestor is an “appropriate” law enforcement or supervisory agency, a question that can be a bit difficult at times. FinCEN guidance indicates that financial institutions that have received a request are required to disclose to appropriate law enforcement and supervisory agencies the backup that supports the SAR. Even in the absence of any requests for information, financial institutions are allowed and encouraged to “share a Suspicious Activity Report, or the information contained therein, with” these appropriate agencies. FinCEN warns financial institutions to be cautious in determining whether a request is coming from an appropriate entity. Hence, this interplay between the general rule of non-disclosure and the requirement for and allowance of disclosure in the case of appropriate law enforcement or supervisory agencies results in financial institutions having to make determinations of whether particular government agencies are appropriate recipients of SAR information.

**Appropriate Law Enforcement Agencies**

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16 Id. The OTS regulation on sharing with non-federal law enforcement states, for example: “A savings association or service corporation is encouraged to file a copy of the SAR with state and local law enforcement agencies where appropriate.” 12 C.F.R. § 563.180(d)(6).

As noted above, financial institutions must/may disclose some information concerning SARs to appropriate law enforcement agencies, including appropriate state and local law enforcement agencies. But this exception to the prohibition on disclosure does not extend to non-law enforcement entities. FinCEN guidance indicates that “an appropriate law enforcement agency” is any agency that has jurisdiction under federal or state law to investigate or prosecute any person or entity involved in the transaction reported on the Suspicious Activity Report.”18 For example, financial institutions faced with requests for SARs from a state attorney general’s office and a state election commission, both with the typical powers and authority associated with those agencies, would normally consider the former a law enforcement agency, but would need to engage in a more detailed analysis to determine whether that agency is an appropriate one (i.e. has jurisdiction to investigate or prosecute persons or entities involved in the SAR transaction). According to FinCEN, appropriate law enforcement agencies include, among others, the FBI, ATF, state AG’s office or district attorney’s office, the IRS or state tax enforcement agencies, or a U.S. Attorney’s Office.19

Notably, FinCEN’s guidance quoted above includes within its definition of appropriate law enforcement agencies any agency that under federal or state law has the authority to “investigate or prosecute” persons involved in the transaction described in the SAR. This could include a wide swath of state and local agencies. If the definition was limited to prosecutorial authorities, than appropriate law enforcement agencies would be restricted to authorities with the power to seek criminal penalties. However, the inclusion of authorities that “investigate” violations of law allows for a much larger range of entities that might qualify as an appropriate authority for purposes of SAR disclosures. Such determinations of whether a particular government agency has the authority to investigate violations of law, thereby qualifying as an appropriate law enforcement agency, are not always clear-cut. The determination may depend upon considerations such as the language of the law that created the agency, the purpose of the agency, and the powers that the agency is able to exercise.

Appropriate Supervisory Agencies

Whether an entity can properly be considered an appropriate supervisory agency raises its own questions. FinCEN guidance indicates that “[w]hether a supervisory agency is an appropriate requestor generally depends on whether the agency has the authority under federal and state law to examine the financial institution receiving the request for Bank Secrecy Act compliance.”20 In short, this guidance defines appropriate supervisory agencies in terms of examination authority. For depository institutions, for example, such agencies include, as appropriate, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office

18 Id. at 44.
19 Id.
20 Id. at 45.
of Thrift Supervision, the Federal Deposit Insurance Corporation and the National Credit Union Administration.\textsuperscript{21}

But other FinCEN guidance introduces a different consideration in the determination of whether a government agency is an appropriate regulatory agency.\textsuperscript{22} FinCEN guidance for casinos state that “a separate state, local or tribal suspicious activity reporting obligation, or an obligation to provide [SAR] information to state, local or tribal regulators” would also allow the disclosure of SARs or related information to those regulators.\textsuperscript{23} This guidance allows for disclosure upon a state legal obligation to disclose, which may not necessarily coincide with authority to examine. Presumably, this allowance for disclosure due to legal obligations holds true for all financial institutions, not just casinos, and holds true for all legal obligations, not just state law obligations. Additionally, the above FinCEN guidance concerning examination authority states a general, not a bright line rule. Hence, financial institutions, in determining whether a government agency is an appropriate supervisory agency, would be prudent to investigate further. A financial institution’s reliance upon its knowledge of which agencies have examination authority over it may lead to an incorrect determination. Instead, financial institutions, in determining whether a government agency is an appropriate supervisory agency, should be willing to consider other relevant characteristics of that government agency.

\textit{Conclusion}

SARs are an important component of the BSA and are an important tool in the government’s efforts to combat financial crimes. Unauthorized disclosure of SARs related information could result in a financial institution facing questions of criminal liability. Disclosures to appropriate law enforcement and supervisory agencies are one exception, among others, to the general prohibition against disclosure faced by financial institutions. The answers to these determinations are sometimes less than obvious and may require careful consideration. FinCEN guidance indicates that the agency will, however, provide assistance to financial institutions with this determination. FinCEN encourages financial institutions to call its Regulatory Helpline if they have questions concerning whether a particular agency is an appropriate requestor.\textsuperscript{24}

\begin{itemize}
\item \textsuperscript{21} \textit{See Financial Crimes Enforcement Network, 1\textsuperscript{st} Review of the Suspicious Activity Reporting System (SARS) (1998), available at http://www.fincen.gov/sarptfin.html.}
\item \textsuperscript{22} \textit{See Financial Crimes Enforcement Network, Suspicious Activity Reporting Guidance for Casinos 15 (2003), available at http://www.fincen.gov/casinosarguidancefinal1203.pdf.}
\item \textsuperscript{23} \textit{Id.}
\end{itemize}