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U.S. Circuit Court of Appeals for the Ninth Circuit Remands FCRA Preemption Case Back to the District Court

On June 20, the United States Court of Appeals for the Ninth Circuit issued its much anticipated opinion in American Bankers Ass'n v. Gould, No. 04-16334 (9th Cir. 2005). The question on appeal was whether the federal Fair Credit Reporting Act ("FCRA") preempts the California Financial Information Privacy Act ("SB1") insofar as it regulates the exchange of information among financial institutions and their affiliates. The U.S. District Court for the Eastern District of California granted summary judgment to the California Attorney General holding that SB1 is not preempted in any respect by FCRA. The Ninth Circuit reversed holding that FCRA preempts at least some part of SB1's affiliate-sharing provisions. Although the Ninth Circuit's reversal of the district court indicates that some parts of SB1 are preempted by FCRA, the decision is disappointing to most financial institutions. Many hoped that the Ninth Circuit would hold that FCRA preempted SB1's restrictions on affiliate-sharing with respect to all types of information.

FCRA primarily regulates the issuance and use of consumer reports. In 1996, Congress added a preemption clause to FCRA providing that no requirement or prohibition may be imposed under the laws of any state with respect to the exchange of information among persons affiliated by common corporate control or common ownership (except for an existing Vermont statute). This preemption provision was scheduled to sunset on January 1, 2004, but Congress enacted the Fair and Accurate Credit Transaction Act of 2003 which removed the sunset provision in FCRA.

In 2003, California enacted SB1, which regulates the disclosure of personal information about California customers by financial institutions doing business in the state. Of particular interest, SB1 provides consumers with the right to prevent their information from being shared with affiliates. Although SB1 exempts affiliates in the same line of business from the restrictions, it effectively restricts the ability of banks to share information with securities and insurance affiliates. Just prior to the July 1, 2004 effective date of SB1, the American Bankers Association, the Financial Services Roundtable and the Consumer Bankers Associations (collectively, the "Associations") brought suit in federal district court, seeking declaratory and injunctive relief against the California Attorney General and other officials responsible for the enforcement of SB1. The Associations contended that the opt-out provisions for affiliate information sharing were preempted by FCRA. The district court granted summary judgment for the Attorney General and the Associations appealed to the Ninth Circuit.

After reviewing the district court's decision and FCRA's preemption clause, the Ninth Circuit concluded that the clause preempted SB1 insofar as it attempts to regulate the communication of "information" as that term is used in section 1681a(d)(1). The Ninth Circuit's analysis indicates its belief that "information" would not include all information about a consumer. The Ninth Circuit instructed the district court to determine whether, applying a restricted meaning of "information," any portion of the affiliate-sharing provisions of SB1 survives preemption.

The decision presents two immediate concerns for financial institutions and their affiliates. First, until the district court addresses the issue, there is continuing uncertainty regarding the types of "information" that can be shared with affiliates without regard to the SB1 restrictions. Although the Ninth Circuit's opinion indicated that "information" as such term is used in the affiliate-sharing preemption clause refers to the information described in the definition of a consumer report, this does not provide much guidance to financial institutions. Furthermore, it may lead to situations where a credit score or other indicia of creditworthiness is shared along other information so that the sharing falls within the scope of the preemption clause. Second, the Ninth Circuit's decision may prompt other states to enact laws that impose various

restrictions on the sharing of information with affiliates. States have closely followed this case and may believe that the Ninth Circuit's decision presents an opportunity for state regulation in this area. This is certainly an issue to follow in the various state legislatures throughout the rest of this year and into next year

Jeffrey Taft, Washington, D.C.

Auditing—and Enforcing—Internal Controls

At a time when the Securities and Exchange Commission ("SEC") and Public Company Accounting Oversight Board ("PCAOB") both recently have released guidance that seems to caution public accountants auditing financial reporting internal controls to take a more lenient approach, the Board of Governors of the Federal Reserve System ("FRB") and the Office of the Comptroller of the Currency ("OCC") continue to pursue various enforcement actions against financial institutions that lack adequate internal controls, including internal controls over financial reporting. Are the approaches of these federal supervisory authorities sending mixed signals? A closer examination reveals that they are not.

On May 16, the PCAOB and SEC separately released guidance for public companies and their auditors on how to report on and audit internal controls over financial reporting, in response to widespread corporate criticism over the costs of complying with Section 404 of the Sarbanes-Oxley Act of 2002, which requires public companies and their external auditors to review and certify as to the adequacy of their financial controls. The guidance suggests that companies and auditors employ a risk-based approach to internal controls over financial reporting, tailoring control measures according to the nature, size, and complexity of the company to which they relate. In other words, the guidance cautions that auditors should not apply a "one-size-fits-all" approach in developing and carrying out an audit methodology. While the guidance may result in less onerous and costly audits for smaller companies with less complex and risky activities, it does not constitute either a change in position for the SEC and PCAOB or a broad statement that companies and their auditors should take a more casual approach toward financial reporting.

In the first five months of 2005, the FRB and the OCC pursued formal enforcement actions against twenty-one institutions that were deemed to have inadequate internal controls that, at least in part, caused various violations of law and unsafe and unsound banking practices. The majority of these institutions were sanctioned for deficiencies related to the Bank Secrecy Act and anti-money laundering procedures. Six institutions, however, were found to have inadequate internal or external audit functions or inadequate internal controls relating to accounting and financial reporting.

These enforcement actions should come as no surprise. Ensuring adequate internal controls always has played a role in the supervisory approach of the OCC and the FRB. According to both the Comptroller's Handbook and the FRB's Commercial Bank Examination Manual, adequate internal controls provide bankers and regulators assurance that bank operations are efficient and effective, recorded transactions are accurate, financial reporting is reliable, risk management systems are effective, and that the bank complies with banking laws and regulations, internal policies, and internal procedures. Moreover, examiners are instructed to identify the internal controls relevant to the bank, department, business line, or product, considering the consolidated risk profile of the bank, its subsidiaries, and its affiliates.

While Sarbanes-Oxley applies only to banking organizations that are publicly traded, even nonpublic institutions have general internal control obligations that go beyond the requirements of Section 404, and nonpublic federally insured institutions with $500 million or more in total assets are required to comply with the auditor independence requirements of Sarbanes-Oxley. Moreover, in May 2003, the FRB, the OCC, and the Office of Thrift Supervision explicitly stated that a banking institution's policies and procedures for corporate governance, internal controls, and auditing will be assessed during the supervisory process, and the banking agencies may take appropriate supervisory action if there are deficiencies or weaknesses in these areas that are inconsistent with sound corporate-governance practices or safety-and-soundness considerations. Furthermore, the banking agencies encouraged nonpublic banking institutions to periodically review their policies and procedures relating to corporate governance and auditing matters for the purpose of ensuring that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance and remain appropriate in light of the institution's size, operations, and resources.

The standard adopted by the SEC and PCAOB guidance—that internal control auditing should be appropriate in light of the company's size, operations, and resources—is the same standard that banking agencies have been applying in their oversight of federally regulated banking institutions. This approach is not novel, nor should it be construed as a more lenient standard, as demonstrated by the formal number of enforcement actions taken by the FRB and the OCC in 2005 alone. Hopefully, however, a more flexible approach to auditing internal controls for financial reporting will result in more efficient audits that are not needlessly costly to companies whose Chevrolet risk profiles do not justify Cadillac auditing.

Gregory Feder, Washington, D.C.

Bankruptcy Code Overhaul Addresses Netting and Ancillary Proceedings

After at least seven attempts to pass legislation overhauling the Bankruptcy Code, on April 20, 2005, President Bush signed into law the "Bankruptcy Abuse Prevention and Consumer Protection

Act of 2005" (the "Act"). The Act is the most significant change to the Bankruptcy Code since 1978. Although most of the provisions of the Act represent changes to the manner in which consumer bankruptcies are handled, there are several changes that are directed at financial institutions. Netting and ancillary proceedings, two of the most significant of these changes for financial institutions, are discussed below.

Netting. Title IX of the Act significantly changes the ability of counterparties to financial contracts to exercise contractual self-help rights upon the insolvency of their counterparties. This section of the law was originally titled the "Financial Contract Netting Improvement Act." These changes amend several important laws, including the Bankruptcy Code, the Federal Deposit Insurance Act ("FDIA"), the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") and the Federal Credit Union Act ("FCUA") (for the most part, changes to the FCUA closely track changes to the FDIA). The primary purpose of these self-help rights is to enable market participants to settle significant positions and thereby reduce systemic risk to the financial markets and banking systems that could be caused by the ripple effect emanating from the insolvency of a significant marketplace participant.

While these changes are important, they are best described as evolutionary. The changes in the Act: (i) clarify areas of uncertainty since the provisions were adopted; (ii) harmonize similar provisions in the Bankruptcy Code, FDIA and FDICIA; and (iii) update the provisions to encompass developments in the financial markets since their adoption.

The provisions apply to numerous financial contracts, including swaps, options, repurchase agreements, commodity contracts (including futures contracts) and forward contracts. The contractual rights referred to as "self-help" rights against an insolvent counterparty include the right to terminate, accelerate or close out all outstanding financial contracts, to net all payment obligations and to foreclose on all pledged collateral. Exercise of some or all of these rights is generally permitted under each of the aforementioned —the Bankruptcy Code, FDIA, and FDICIA notwithstanding the insolvency of a counterparty or imposition of a stay. However, the provisions in the pre-revision Bankruptcy Code, FDIA and FDICIA raised uncertainty regarding the scope of some of the provisions, as well as the interplay between the provisions of the Bankruptcy Code and FDIA on the one hand, and the provisions of FDICIA on the other hand.

The Act makes numerous important changes to these provisions, including: (i) expanding and clarifying the definitions of covered financial contracts and providing sufficient flexibility to cover future developments in those markets; (ii) extending the protections for financial contracts to related security documents; (iii) expanding the scope of protected counterparties by conforming these categories to certain Federal Reserve and SEC definitions and creating a new definition of "financial participant"; (iv) clarifying the ability of counterparties to net payments across different categories of financial products by defining "Master Netting Agreement" in the Bankruptcy Code for the first time; (v) making "walkaway clauses" unenforceable under FDIA; (vi) limiting the ability of a conservator or receiver under FDIA to "cherry-pick" among an insolvent financial institution's qualified financial contract obligations to the same circumstances under which such conservator or receiver can transfer a qualified financial contract; (vii) strengthening the liquidation and acceleration rights for qualified financial contracts under the Bankruptcy Code; (viii) clarifying under FDIA that a counterparty cannot immediately exercise its rights under an ipso facto insolvency clause; (ix) clarifying that the Bankruptcy Code's protective provisions apply to ancillary proceedings and municipal bankruptcies; (x) clarifying the effect of an order under the Securities Investor Protection Act, or a judicial or regulatory order under the Bankruptcy Code, on the exercise of self-help contractual rights; (xi) clarifying the date from which damages from termination, acceleration or liquidation of a qualified financial contract are measured; and (xii) expanding the list of institutions to which the Federal Deposit Insurance Corporation can transfer qualified financial contracts from depository institutions to include brokers, dealers, foreign financial institutions and bridge banks.

Certain related issues were not addressed in the Act. For example, a proposed new "safe harbor" for asset-backed securitizations was not included. This provision would have provided that a transfer of assets as part of a securitization was conclusively not part of the debtor's estate so long as the transfer met the specified criteria.

Ancillary Proceedings. Section 801 of the Act deletes the former Section 304 of the Bankruptcy Code and substitutes a new Chapter 15 entitled "Ancillary and Other Cross-Border Cases." Chapter 15 incorporates into federal bankruptcy law the Model Law on Cross-Border Insolvency drafted by the United Nations Commission on International Trade Law ("UNCITRAL") into the Bankruptcy Code. This change will bring federal ancillary proceedings in line with the those of numerous other industrialized countries.

Section 304 permitted a foreign representative to originate an ancillary proceeding in the United States courts if outside the United States there existed a more comprehensive foreign proceeding involving the debtor. Among the powers granted by Section 304 to U.S. judges were the powers to turn over the assets of a debtor located in the United States for adjudication as part of a foreign proceeding. Section 304 specified certain factors for a judge to review in deciding whether to grant a petition from a foreign representative; comity to the laws and proceedings of a foreign state was perhaps the most important of those factors. United States creditors also were given the ability to show that they would be disadvantaged by the approval of a foreign representative's petition.

The procedural and substantive application of Chapter 15 should not differ significantly from the application of the former Section 304, in that Chapter 15 is largely based on the principles of Section

304. Section 1515 permits a foreign representative to file a petition for recognition. Once a petition is filed, a United States court can stay execution on the assets of a debtor, entrust administration of the debtor's U.S. assets to the foreign representation or grant other specified relief. Once a foreign proceeding is recognized, Section 1521 provides for greater relief to the foreign representative, including imposition of a stay and providing for the examination of witnesses and taking of evidence. However, pursuant to Section 1522 the U.S. court cannot grant relief under Section 1521 unless "the interests of the creditors…are sufficiently protected."

Separately, Chapter 15 appears to answer conclusively the open question of whether U.S. branches and agencies of foreign banks may be subject to petitions under Section 304. This issue is the subject of current litigation that is about to be heard by the Second Circuit on appeal from an order on June 11, 2004 by Judge Rakoff of the Southern District of New York. *See In re Agcy. For Dep. Ins., Rehab. Bankr. and Liquid. of Banks v. Superintendent of Banks*, 310 B.R 793 (S.D.N.Y. 2004), *recon. den*. 313 B.R. 561 (S.D.N.Y. 2004). Under the pre-revision Bankruptcy Code, it was unclear whether claims by foreign representatives to the U.S. assets of such entities could be entertained by U.S. courts. Section 109 of the pre-revision Bankruptcy Code made clear that such entities could not be debtors under the Bankruptcy Code. However, Section 304 was silent on the issue. Chapter 15 appears to settle the point. Section 1501(c) states that "[t]his chapter does not apply to—(1) a proceeding concerning an entity…identified by exclusion in section 109(b)." The newly revised Section 109(b) of the Bankruptcy Code now excludes from the bankruptcy code "a foreign bank…that has a branch or agency (as defined in section 1(b) of the International Banking Act of 1978) in the United States." However, this exclusion now raises additional questions, such as whether anyone has standing to oversee the disposition of assets or property of a foreign bank located outside of a State in which it has a licensed branch or agency.

These changes will provide financial institutions and those parties transacting business with them some additional degree of helpful certainty in their transactions with financial markets' counterparties. Whether the Act will raise new issues for financial institutions, however, remains uncertain given the very recent nature of these provisions.

Douglas Landy, New York

Federal Court Upholds OCC Regulation Preempting Application of State Law to Operating Subsidiaries of National Banks

The Office of the Comptroller of the Currency's ("OCC") preemption of state law as it applies to operating subsidiaries of national banks continues to generate controversy. Recently, a federal court determined that operating subsidiaries of national banks are not subject to a Maryland law that restricts the activities of state-licensed mortgage lenders because the law is preempted by the OCC's regulations. The court took into account similar decisions reached by federal courts in Connecticut and Michigan last year and in California two years ago.

[Editor's note: On July 11, the United States Court of Appeals for the Second Circuit upheld the District Court for the District of Connecticut's determination that federal law preempts state regulation of a national bank operating subsidiary to the same extent that it preempts regulation of the parent national bank. See Wachovia Bank, N.A. v. Burke, No. 04-3370-cv (2nd Cir. July 11, 2005).]

National City Bank of Indiana ("National City") filed suit in the United States District Court for the District of Maryland seeking declaratory and injunctive relief to enjoin the Commissioner of Financial Regulation of the Maryland Department of Labor, Licensing, and Regulation ("Commissioner") from enforcing a provision of Maryland law that restricts the amount of prepayment fees that mortgage lenders can impose on consumers. *Nat'l City Bank of Indiana v. Turnbaugh*, Civ. Act. No. CCB-04-2719 (D. Md. April 15, 2005). Until January 2005, National City originated residential mortgage loans in Maryland through its wholly-owned operating subsidiaries First Franklin Financial Corporation ("First Franklin") and National City Mortgage ("NC Mortgage"), both of which were licensed by the State of Maryland to engage in mortgage lending. First Franklin and NC Mortgage offered adjustable-rate mortgage loans ("ARMs"), and in some cases each imposed prepayment penalties that conflicted with Maryland law.

The dispute regarding whether the Maryland prepayment penalty restriction was preempted by federal law arose from two consumer complaints filed with the Commissioner in connection with mortgage loans originated by First Franklin. The loans in question were subject to a prepayment penalty. In response to the first complaint, a state financial examiner sent a letter to First Franklin indicating that the prepayment penalty appeared to violate the Maryland prepayment restriction. The examiner asked First Franklin for a list of all Maryland residents that were charged a prepayment penalty within a specific time period. In response to this request, First Franklin offered to waive the prepayment penalty for that particular loan. First Franklin maintained, however, that charging prepayment penalties was permissible under federal law. In response to the second complaint, First Franklin contacted the consumer directly to inform the consumer that charging prepayment penalties was permissible under federal law. Shortly thereafter, National City filed suit to enjoin the Commissioner from taking further action against First Franklin or NC Mortgage to enforce the Maryland prepayment restriction.

Under the National Bank Act, Congress: (i) granted specific banking powers to national banks and all such incidental powers necessary to carry on the business of banking; (ii) determined that

no national bank shall be subject to any visitorial powers except as authorized by federal law; and (iii) granted national banks with the authority to make, arrange, purchase, or sell loans or extensions of credit secured by liens on interests in real estate. *See* 12 U.S.C. § 24 (Seventh). Pursuant to the National Bank Act, the OCC issued regulations: (i) permitting national banks to conduct, in an operating subsidiary, activities that are permissible for a national bank to engage in directly as part of the business of banking or incidental to the business of banking; (ii) indicating that state laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank; and (iii) permitting national banks and their subsidiaries to make, sell, purchase, participate in, or otherwise deal in ARMs and impose fees for prepayments without regard to state law limitations on those activities. *See* 12 C.F.R. §§ 5.34(e)(1), 7.4006, and 34.23.

National City argued that the Commissioner was prohibited from exercising any regulatory or visitorial powers over National City's operating subsidiaries because operating subsidiaries are subject to the exclusive regulatory and supervisory authority of the OCC. The commissioner's exercise of visitorial or regulatory powers over National City's operating subsidiaries would include the enforcement of the Maryland Mortgage Lender Law and the prepayment penalty restriction. The Commissioner contended that the OCC exceeded its authority when it issued regulations indicating that state laws apply to national bank operating subsidiaries to the same extent that they apply to national banks, because the National Bank Act does not expressly make reference to operating subsidiaries.

The OCC, which filed an amicus curiae brief in support of National City, argued that its preemption regulations interpreted laws already passed by Congress. In addition, the OCC contended that the rationale for allowing national banks to charge prepayment fees in connection with ARMs was to provide lenders and borrowers with additional flexibility and to encourage the development of ARMs with relatively slow-moving interest rate indexes and long adjustment periods. Accordingly, the OCC argued that the court should apply the two-part analysis used in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984). The *Chevron* analysis requires the court to determine whether Congress clearly expressed its intent regarding the issue in question and, if so, whether the agency's action is based on a permissible construction of the statute.

The Commissioner argued that the court should follow the approach used by the Supreme Court in *Fidelity Federal Savings and Loan Assoc. v. de la Cuesta*, 458 U.S. 141 (1982), because in the Commissioner's opinion the OCC was not interpreting a statute when it declared that its regulations preempted state law as it relates to operating subsidiaries. Under the *Fidelity* analysis, the court would be required to consider whether the OCC intended to preempt conflicting state law and, if so, whether such preemption is within the scope of the authority delegated to the OCC by Congress.

The court decided to apply the *Fidelity* analysis first and the *Chevron* analysis second to determine whether the OCC's regulations were valid. Noting that federal regulations have no less preemptive effect than federal statutes, the court reviewed the statute and regulations at issue. The court determined that the OCC's regulations were permissible constructions of the National Bank Act under the *Fidelity* and *Chevron* analyses. Under *Fidelity*, it is necessary to determine that the agency's actions are within the scope of the authority delegated to the agency by Congress. Whether Congress explicitly stated that it intended federal law, including any agency regulations promulgated pursuant to a particular statute, to preempt state law is not dispositive under *Fidelity*. The court held that the record amply demonstrated that the OCC's regulations were promulgated within the scope of the OCC's delegated authority. Applying *Chevron*, the court determined that although Congress had not explicitly stated whether operating subsidiaries of national banks should be subject to the exclusive visitorial and regulatory authority of the OCC, the OCC's regulations represent a reasonable policy determination well within the authority delegated to it by Congress under the National Bank Act.

The court disagreed with the Commissioner's contention that the public interest would best be served by upholding the Maryland laws. The court determined that National City would suffer irreparable harm to its business and its federally authorized banking activities if its operating subsidiaries were forced to comply with the conflicting Maryland laws. Furthermore, the court decided that the public interest would be served by enjoining the enforcement of invalid provisions of state law. In addition, the court was not persuaded by the Commissioner's arguments that preempting Maryland law would give NC Mortgage and First Franklin a competitive advantage over other state-chartered licensed lenders. The court recognized that other courts have repeatedly acknowledged that the National Bank Act's preemption of state law may create disparities between the national bank and state bank competitors, and may, in some instances, create a competitive advantage for the national bank.

Conclusion

The OCC's regulations preempting state laws as they apply to operating subsidiaries continue to be upheld. The court's decision in *Nat'l City Bank of Indiana v. Turnbaugh* is consistent with the decisions previously reached by federal district courts in Michigan, Connecticut, and California and the Second Circuit. It is likely, however, that the issue of OCC preemption will continue to be litigated in federal courts across the country because of the fundamental differences of opinion between the state regulatory authorities on the one hand, and the OCC and the national banks on the other hand.

Maya Wilson, Washington, D.C.

Federal Banking Agencies Delay Basel II Rules

In late April, the four federal banking agencies (the Board of Governors of the Federal Reserve System ("FRB"), the Federal Deposit Insurance Corporation ("FDIC"), Office of the Comptroller of the Currency, and the Office of Thrift Supervision ("OTS")), (collectively, the "Agencies") announced that they were postponing the release of a notice of proposed rulemaking ("NPR") regarding the U.S. implementation of the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," also known as the Basel II framework, due to the unexpected results of the fourth quantitative impact study ("QIS4").

In mid-2004, the Basel Committee on Banking Supervision ("Basel Committee") published the Basel II framework, the latest negotiated step in what is intended to be a revision to the 1988 international capital accord ("Basel Accord") that has become outdated as a result of the increased scope and complexity of the banking activities of the international market's largest banking institutions. At the same time, the Basel Committee established common timelines for the international adoption of the Basel II framework. As part of this adoption effort, the Agencies were due to release the NPR in mid-2005, with January 1, 2008, as the target for implementation of the Basel II framework.

Prior to adopting regulations for the implementation of the Basel II framework, the banking agencies are using the QIS4 to study further the likely impact of the Basel II framework on risk-based capital requirements for the U.S. banking industry, at consolidated U.S. institutions, and for specific portfolios. Twenty-six consolidated banking organizations provided the Agencies with their internal estimates of key risk parameters driving capital requirements for credit risk and operational risk under the Basel II framework. The agencies intended to apply the Basel II framework to the risk parameter estimates provided by the banks and to use the results of QIS4 to assess the competitive ramifications of Basel II and to make revisions to the U.S. implementation of the Basel II framework by issuing the NPR.

To the surprise of the Agencies, however, a preliminary analysis of the QIS4 data demonstrated a substantial reduction in the aggregate minimum required capital for banks participating in QIS4, with a significant dispersion of results across institutions and portfolio types. The cause for these results—a lack of quality data for risk assessment, flaws in the banks' application of the Basel II principles to the data, flaws in the equations used by the agencies to implement the Basel II framework, flaws in the Basel II framework, or some combination of the above—may not even be known after further analysis. While the Agencies may not be able to determine or agree upon the significance of the QIS4 results, there is little appetite for proceeding with an NPR until more is known.

Partially in reaction to the Agencies' postponement, in early May, the House Subcommittees on Financial Institutions and Consumer Credit and Domestic and International Monetary Policy, Trade and Technology held a joint hearing entitled "Basel II: Capital Changes in the U.S. Banking System and the Results of the Impact Study." The hearing was called in part because of perceived disagreements among the Agencies regarding the significance of the QIS4 results and the competitive impact of the Basel II framework on U.S. banking institutions. Many members of Congress present at the hearing expressed concern that the Basel II framework would result in competitive inequalities in the U.S. banking industry, with community banks and other smaller institutions unlikely to convert to the Basel II framework because of the costs. These institutions would be left to either consolidate or engage in risky behavior in order to maintain market share and profitability. There also appeared to be disagreement among the Agencies and economists as to whether the Basel II framework would create competitive disadvantages for non-adopting banks. In particular, the OTS and FDIC expressed concern that Basel II would hurt mortgage, small business and other lending areas of affected banking organizations.

This disagreement among the Agencies led Rep. Spencer Bachus to introduce H.R. 1226, the United States Financial Policy Committee for Fair Capital Standards Act, which would create a committee responsible for unifying the United States' position and reporting to Congress on the impact that changes to the Basel Accord would have on the domestic and global financial systems. There is bipartisan support for the measure.

Some question whether the Agencies have the resources and can work together to address all of these issues on the tight schedule imposed by the Basel Committee's recommended timetable. It is too early to tell whether the Agencies will be able to release the NPR and meet the January 1, 2008 target date for implementation of the Basel II framework. Although FRB Governor Susan Schmidt Bies has stated that the Agencies are on target for a Fall 2005 release of the NPR, FDIC Chairman Donald Powell has expressed a preference for an analysis of the QIS4 data before reconsidering the NPR. The FDIC also is calling for revisions to the Basel Accord to help smaller banks compete against the 20-30 large banks that are expected to adopt the Basel II framework, as well as minimum leverage capital standards, which are lacking in the Basel II framework.

Gregory Feder, Washington, D.C.

Federal Banking Agencies Issue Credit Risk Management Guidance for Home Equity Lending

In response to the exceptionally strong growth in home equity lending over the past few years, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit

Union Administration and the Office of Thrift Supervision (collectively, the "federal banking agencies") issued guidance to promote sound risk management practices at financial institutions with open-end home equity lines of credit ("HELOCs") and closed-end home equity loans. "Credit Risk Management Guidance for Home Equity Lending," May 16, 2005 (the "Guidance").

Under the Guidance, financial institutions are required to ensure that risk management practices keep pace with the growth and changing risk profile of home equity portfolios. As part of this obligation, management must actively assess a portfolio's vulnerability to customer default and any declines in home values. In addition, financial institutions with significant growth or concentrations in higher risk products such as high LTV, "low doc," "no doc," interest-only or third party generated loans are expected to manage their portfolio risks.

The Guidance describes sound credit risk management systems for (i) product development and marketing, (ii) origination and underwriting, (iii) third party originations, (iv) collateral value management, (v) account management, (vi) portfolio management, (vii) operations, servicing and collections, (viii) secondary market activities, and (ix) portfolio classifications, allowances for loan and lease losses and capital.

Product Development and Marketing. In the development of any new product offering, product change or marketing initiative, financial institutions should have a review and approval process that is sufficiently broad to ensure compliance with the institution's internal policies and applicable laws and regulations and to evaluate the credit interest rate, operations, compliance, reputation and legal risks. If mortgage loans are marketed or closed by a third party, the financial institution should have standards that provide assurances that the third party is in compliance with applicable laws and regulations. Management should also have appropriate monitoring tools and management information systems to measure the performance of marketing initiatives.

Origination and Underwriting. All factors should be considered when establishing product offerings and underwriting guidelines. Generally, these factors should include a borrower's income, debt levels, credit scores, credit history, collateral value, lien position and property type. Where loans contain variable interest rates, rising rates could subject a borrower to significant payment increases. Therefore, underwriting standards for interest-only and variable rate loans should include an assessment of the borrower's ability to absorb potential rate increases and larger payments.

Third-Party Origination. Financial institutions using third parties to originate loans should have strong control systems to ensure the quality of originations and compliance with all applicable laws and regulations to help prevent fraud. With respect to brokered loans, the financial institution should retain appropriate oversight of all critical loan-processing activities, such as verification of income and employment and independence in the appraisal and evaluation function. With respect to loans originated by correspondents, the financial institution should have systems and controls to provide assurances that the correspondent is appropriately managed, financially sound, and provides mortgages that meet the institution's prescribed underwriting guidelines and comply with applicable consumer protection laws. Financial institutions should perform comprehensive due diligence on all third-party originators prior to entering a relationship. In this regard, monitoring the quality of loans originated is an essential part of the ongoing relationship.

Collateral Valuation Management. Financial institutions should have appropriate collateral valuation procedures that ensure compliance with the "Interagency Appraisal and Evaluation Guidelines" and the federal banking agencies' appraisal regulations. In addition, the financial institution should: (i) establish criteria for determining the appropriate valuation methodology for a particular transaction; (ii) ensure that an expected or estimated value of the property is not communicated to an appraiser; (iii) implement policies to prevent value shopping; and (iv) require sufficient documentation to support the collateral valuation in the appraisal.

Account Management. Financial institutions should have risk management techniques to identify high-risk accounts. Effective account management practices for accounts with high-risk characteristics include refreshing credit scores, using behavioral scoring and analysis, assessing payment patterns, monitoring home values and obtaining updated information on the collateral's value. The frequency of these actions should be commensurate with the risk in the portfolio. Financial institutions should conduct annual credit views of HELOCs to determine whether the line of credit should be continued based upon the borrower's current financial condition. Such an annual review is prudent based upon the risk-based capital requirements pertaining to unused HELOC commitments.

Portfolio Management. Financial institutions should implement an effective portfolio credit risk management process for their home equity portfolios that includes: (i) lending standards that are consistent with safe and sound banking practices; (ii) portfolio management, which clearly communicates growth targets, utilization, rate of return and default and loss expectations; (iii) adequate credit management information systems allowing segmentation of the loan portfolio; (iv) a process for identifying, approving, tracking and analyzing underwriting and exceptions; (v) monitoring high LTV loans; and (vi) performing stress testing for portfolios.

Operations, Servicing and Collections. Effective procedures and controls should be maintained for such support functions as perfecting liens, collecting outstanding loan documents, obtaining insurance coverage and paying property taxes. Credit risk management should oversee these support functions to ensure that operational risks are properly controlled.

Secondary Market Activities. Although secondary market activities can enhance credit availability and an institution's profitability, they

also pose certain risks. An institution's risk management systems should address the risks associated with HELOC securitizations.

Portfolio Classification. FFIEC's "Uniform Retail Credit Classification and Account Management Policy" governs the classification of consumer loans and establishes general classification thresholds based upon delinquency. Portfolios of high LTV loans made to borrowers who exhibit inadequate capacity to repay the debt within a reasonable period of time may be subject to reclassification.

Conclusion. The Guidance is the latest indication of the federal banking agencies' concerns about the residential real estate lending market. In particular, the federal banking agencies are beginning to carefully scrutinize the recently developed mortgage lending products, such as interest-only loans, because many of these new loan products will require refinancing and/or higher monthly payments in the near future. In turn, with these higher future payments, the federal banking agencies are worried about an increase in defaults and foreclosures.

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