

“The Force Awakens:” Regulatory Enforcement and Bank Operations Updates

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Agenda- The Force Awakens

- Comptroller's Handbook: Deposit-Related Credit.
- New Merchant Category Codes.
- New External Processing Code for Remotely Created Checks.
- Same Day ACH: Moving Payments Faster.
- CFPB Arbitration Study
- Disparate Impact
- FIRREA
- Enforcement Trends
- The Return of the Jedi?

Background- A Long Time Ago . . .

- In 2005, the “Joint Guidance on Overdraft Protection Programs” was issued by the four prudential regulators (OCC, Fed, FDIC, and NCUA). 70 Fed.Reg. 9127 (February 24, 2005).
- This Guidance principally focused on discretionary overdraft programs promoted by financial institutions to consumers.
- Best practices advanced: opt out; do not encourage overdrafts; provide advance notice before consumer overdraws an account; and provide accurate available balance information.

Background

- The Office of the Comptroller of the Currency originally issued proposed guidance on deposit-related consumer credit (“DRCC”) at 76 Fed.Reg. 33409 (June 8, 2011).
- This proposed guidance enumerated supervisory principles applicable to DRCC, including: affirmative request (opt in); program availability and prudent eligibility standards; prudent limitations on product costs and usage; monitoring and risk assessments; management oversight; and account management and chargeoffs.

Background

- In 2013, the OCC abruptly withdrew this proposed guidance regarding DRCC products.
- Contemporaneously, the OCC issued proposed guidance on deposit advance products. 78 Fed.Reg. 25353 (April 30, 2013).
- Final guidance on deposit advance products issued at 78 Fed.Reg. 70624 (November 26, 2013).
- Some financial institutions offering deposit advance products, including Wells Fargo, exited this product due to this guidance.

Background

- The Office of the Comptroller of the Currency unexpectedly issued *Comptroller's Handbook: Deposit-Related Consumer Credit* on February 11, 2015, through a website posting (the "Handbook").
- The Handbook was prepared for use by OCC examiners in examining national banks and federal savings banks.
- Due to concerns voiced by many banks, the OCC withdrew the Handbook on February 20, 2015, indicating that an updated handbook would be published in two weeks.

Background

- As promised, the OCC posted a new handbook, *Comptroller's Handbook: Deposit-Related Credit* on March 6, 2015, through a new website posting ("Handbook 2.0").
- Handbook 2.0 is intended to supplant the Handbook.
- The Handbook originally covered bank services to consumers and businesses: overdraft line-of-credit programs ("LOC"); discretionary overdraft protection ("ODP"); and deposit advance products ("DAP").

Background

- **LOC**: A bank automatically transfers funds from an existing line of credit to a customer's demand deposit account when a check is presented for payment against insufficient funds. This is now called "check credit" ("CC") in Handbook 2.0.
- **ODP**: In most cases, a customer meeting a bank's criteria may be enrolled in this automated overdraft protection service. This service is sometimes called "courtesy overdraft protection" or "bounce check protection."

Background

- For ATM and one-time debit card transactions by a consumer, an opt-in is required under Regulation E section 1005.17(b), effective July 1, 2010. Notice of the opt-in right must be provided, and the consumer's affirmative consent is required. 74 Fed.Reg. 59033 (November 17, 2009).
- **DAP**: A type of small-dollar, short-term, fixed-fee credit product offered to customers maintaining a deposit account, a reloadable prepaid account, or similar deposit-related relationship at a bank.

Background

- The bank provides a credit feature allowing the customer to take out a small loan, to be repaid through the customer's next direct deposit.
- The bank cannot condition approval of this credit on the consumer agreeing to repay the loan by means of preauthorized electronic fund transfers at substantially regular intervals. Regulation E section 1005.10(e).
- OCC guidance on DAP at OCC Bulletin 2013-40, *Deposit Advance Products: Final Supervisory Guidance*.

Risks associated with deposit-related consumer credit

- In the Handbook, the OCC defined eight categories of risks for bank supervision purposes: credit; interest rate; liquidity; price; operational; compliance; strategic; and reputation.
- The DRCC product has the following primary risks: strategic; credit; compliance; and operational.
- Other risks include reputation and liquidity risks.

Key supervisory principles for DRCC programs under the Handbook

- **Affirmative request (opt-in)**: Enrollment should occur only after the customer has received appropriate disclosures, has made an affirmative request for the product, and has agreed to conform to the product's terms. Applied to DRCC, including ODP.
- **Ability-to-repay determination**: The OCC expected banks to implement policies and procedures to determine an applicant's creditworthiness and ability to repay the amount of any funds that may be made available to a customer under the program.

Key supervisory principles for overdraft programs

- “An appropriate degree of [credit] analysis should be conducted before the DRCC product request is approved to determine whether the customer is able to manage and repay the credit obligations arising from the product while still meeting other financial obligations.” *The Handbook* at p. 9.
- **Product fees:** “While permitting appropriate returns, fees should be reasonably correlated to the actual costs of offering, underwriting, and servicing the product as well as associated risks.” *Id.*

Key supervisory principles for overdraft programs

- Cf. 12 C.F.R. 7.4002(b)(2)(ii): “The deterrence of misuse by customers of banking services.”
- Curiously, at 78 Fed.Reg. 33400, 33410, footnote 3, under the proposed guidance on DRCC products issued by the OCC on June 8, 2011, with regard to fees for a DRCC product, the proposal provides: “Fees should be based on safe and sound banking principles,” citing 12 CFR 7.4002.

Risk management and control systems

- Risk management and control systems: an account using a DRCC product should be monitored regularly to ensure that changing customer circumstances have not adversely affected credit risk.
- Identify excessive usage of the product.
- DRCC products should be reported in regulatory reports as loans; FDIC assessments will apply.
- Uncollected overdraft balances should be charged off after 60 days.

New development: the Handbook 2.0

- As promised, on March 6, 2015, the OCC posted Handbook 2.0 on its website.
- In this new Handbook 2.0, the OCC addresses deposit-related credit (“DRC”), not DRCC.
- The OCC identifies three groups of DRC products: check credit (“CC”), overdraft protection (“ODP”), and deposit advance products (“DAP”).
- Handbook 2.0 is a significant improvement from the original Handbook.

New development: the Handbook 2.0

- The four major beneficial revisions are noted: (1) a customer is no longer required to opt in to ODP services; (2) a bank is not required to underwrite ODP customers, only CC and DAP customers; (3) the requirement to assess a customer's financial capacity no longer applies to ODP; and (4) overdraft fees are no longer required to be reasonably correlated to actual costs.

New development: the Handbook 2.0

- However, Handbook 2.0 adopted the following as foreshadowed by the original Handbook:
- The retitling of the examination manual from “Deposit-Related Consumer Credit” to “Deposit-Related Credit” seems to make it clear that it applies to both consumer and commercial accounts.
- Consistent with the 2005 Joint Guidance. 70 Fed. Reg. 9127, 9128.

New development: the Handbook 2.0

- Handbook 2.0 requires that all customers (both consumers and business customers and both new and existing customers) are to be afforded the *right to opt out* of DRC services at any time and that customers are to be given a clear notice of this option.
- However, Handbook 2.0 does not address the manner in which customers are to be given notice of this right and the process under which this right is to be implemented.

New development: the Handbook 2.0

- Banks are expected to (i) establish ODP eligibility standards and (ii) define and document dollar limit decision criteria.
- Further study will need to be done to determine how detailed these standards and criteria need to be and the extent to which a bank's current procedures meet these requirements.

New development: the Handbook 2.0

- Banks are expected to monitor DRC activity to look for changing circumstances of the customer so that credit risk is not adversely affected.
- For ODP customers, accounts are to be monitored for excessive usage and banks are to inform customers incurring excessive overdrafts of alternative credit options.
- The Joint Guidance to be applied, no longer arguably a best practice. Handbook 2.0, p. 3.

New Merchant Category Codes

Unlawful Internet Gambling Enforcement Act of 2006

- The Act (Pub. L. No. 109-347, 120 Stat. 1884; 31 U.S.C. 5361-5367) and Regulation GG issued under it (12 C.F.R. Part 233, effective January 19, 2009) requires, inter alia, participants in designated payment systems to identify and block “restricted transactions.” Regulation GG section 233.2(y).
- For credit and debit card transactions, a participant may employ a code system to identify and block suspected restricted transactions.
- Initially, networks blocked on behalf of issuers MCC 7995, with cardholder not present transaction identifier.
- MCC 9399 (April 1, 2014) for state governments.

New merchant category codes

- New MCCs, effective April 17, 2015, issued by the International Standards Organization:
 - MCC 7800 (Government-Owned Lotteries)
 - MCC 7801 (Government-Licensed Casinos, only for cardholder not present)
 - MCC 7802 (Government-Licensed Horse / Dog Racing), pari-mutuel gaming activity (wagering through pools).
- Issuers must adopt blocking protocol, as networks will not block as they blocked MCC 7995.

Account agreement

- Updates to account agreement terms.
- **“Illegal Activities.** You will not use your account to conduct transactions relating to unlawful internet gambling or any other illegal activity. **We may refuse any gambling transaction, whether lawful or not.** We may also refuse any transaction that we reasonably believe may involve illegal or suspicious activity.”
- As to card transactions bearing one of these new MCCs, what risks are involved in blocking them?

New External Processing Code for Remotely Created Checks

ANSI and remotely created checks

- ANSI X9.100-160-2-2014, *Magnetic Ink Printing (MICR), Part 2: EPC Field Use*, approved November 24, 2014; effective November 24, 2015. (Replaces X9.100-160-2-2009.) ANSI is the American National Standards Institute.
- New Clause 5.6 assigns a character “6” in the External Processing Code (“EPC,” Region 5F, called position 44) field as an identifier for remotely created checks. On a business check, the EPC field is between the “Auxiliary On Us Field” and the “Routing Number Field.”

NAME OF COMPANY
STREET ADDRESS
CITY, STATE

101

0047890000

DATE 12-5-09

PAY TO THE
ORDER OF

Payee's Name

\$ 123.45

One hundred twenty-three and 45/100 Dollars

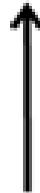
Financial Institution Name

Street Address
City, State

Memo _____

Authorized by Drawer

⑆00000101⑆ 6⑆000067894⑆ 12345678⑆



Business Size
Check



RCC Identification



Not Signed by Drawer

NAME OF COMPANY
STREET ADDRESS
CITY, STATE

101

00-6789-0000

DATE 12-5-09

PAY TO THE

ORDER OF

Payee's Name

\$ 123.45

One hundred twenty-three and 45/100

Dollars  SECURITY PAPER
FURNISHED
BY THE U.S. GOVERNMENT

Financial Institution Name

Street Address
City, State

Memo _____

Authorized by Drawer MP

6 00006 7894 1 2 3 4 56 78

Regulation CC definition of “substitute check”

(aaa) *Substitute check* means a paper reproduction of an original check that—

- (1) Contains an image of the front and back of the original check;
- (2) Bears a MICR line that, except as provided under ANS X9.100-140 (unless the Board by rule or order determines that a different standard applies), contains all the information appearing on the MICR line of the original check at the time that the original check was issued and any additional information that was encoded on the original check's MICR line before an image of the original check was captured;
- (3) Conforms in paper stock, dimension, and otherwise with ANS X9.100-140 (unless the Board by rule or order determines that a different standard applies); and
- (4) Is suitable for automated processing in the same manner as the original check.

Substitute check created from a paper check

Regulation CC section 229.51:

(a) *Legal equivalence.* A substitute check for which a bank has provided the warranties described in §229.52 is the legal equivalent of an original check for all persons and all purposes, including any provision of federal or state law, if the substitute check—

(1) Accurately represents all of the information on the front and back of the original check as of the time the original check was truncated; and

(2) Bears the legend, “This is a legal copy of your check. You can use it the same way you would use the original check.”

Impact of Regulation CC section 229.51(a)(1) on this substitute check:

- Also see Regulation CC, commentary 229.51(a)-3, providing that the MICR line must be accurately reproduced in the substitute check.
- However, since ANS X9.100-140 allows a “4” in the EPC field for forward collection substitute check, the use of “6” was viewed as permissible.

Substitute check created from a remotely created check

- Generally, most checks are collected electronically.
- However, if a depository bank creates a substitute check for forward collection from a remotely created check, the substitute check would bear a "4" in the MICR line even if the original check has a "6" in the EPC field.

Substitute check created from a remotely created check

- Generally, most depository banks create a substitute check to provide to their customers in the event a deposited check is returned checks.
- Similarly, the substitute check created from the returned deposited check would bear a "4" in the MICR line even if the original check has a "6" in the EPC field.

011500120
01/04/2002
8587408979

This is a LEGAL COPY of your check.
You can use it the same way you
would use the original check.

1800539446
0530001831 01/03/2002

NAME OF COMPANY		101
STREET ADDRESS		00000000
CITY, STATE		
PAY TO THE	DATE <u>12-5-09</u>	
ORDER OF <u>Payee's Name</u>	\$ <u>123.45</u>	
<u>One hundred twenty-three and</u>		<u>45/100</u> Dollars 
Financial Institution Name		
Street Address		
City, State		
_____	Authorized by Drawer	
⑆00000101⑆ 6⑆000006789⑆ 1 2 3 4 5 6 7 8⑆		

⑆00000101⑆ 4⑆000006789⑆ 1 2 3 4 5 6 7 8⑆ ⑆0000012345⑆

↑
IRD
Identification

↑
RCC
Identification

Risk mitigation uses of the EPC field

- In order to monitor remotely created check activity, a depository bank may consider requiring by agreement a customer creating remotely created checks to include a "6" in the EPC field to enable the bank to interrogate the MICR line and identify remotely created checks deposited by that customer.
- Similarly, a paying bank may consider interrogating the MICR line's EPC field and identifying remotely created checks as checks are presented for payment, rather than relying on its account owner to notify it of suspicious or unauthorized transactions.

Accounts Receivable Conversion (“ARC”) and Back Office Conversion (“BOC”) entries

- Many banks offer a treasury management service under which deposited checks are collected through two principal channels: as check images and as debit entries bearing an ARC (NACHA Operating Rules section 2.5.1) or BOC (Operating Rules section 2.5.2) standard entry class code through the Automated Clearing House, depending on the most effective, timely, and cost-efficient channel available.
- Remotely created checks are not eligible for such ARC or BOC check conversion transaction. Operating Rules sections 8.35(c) and (g).
- By requiring commercial customers using such service to identify remotely created checks through the use of the new EPC field character “6,” the bank providing the service will be able to interrogate by automated means the MICR line to identify and to segregate remotely created checks so that such checks may be collected as images rather than as an ACH entry. By so identifying and segregating, an Originating Depository Financial Institution (Operating Rules section 8.65) will be able to maintain the integrity and accuracy of its standard entry class code designations.

Same Day ACH: Moving Payments Faster- Engage the Hyperdrive

Benefits of same day ACH

- The ACH network processes about 71 million ACH payments every business day.
- Same Day ACH addresses needs of end-users:
 - Bill payments and invoices due on that day;
 - Payroll products to better support payroll needs;
 - Billers and banks looking to better manage credit risk;
 - Moving payment-related remittance information on the same day.

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Same day ACH

- Currently, most ACH payments are settled on the next business day or even the second business day.
- However, businesses and consumers could benefit from same day processing.
- Request for comment (RFC) published by NACHA on December 8, 2014; comment period closed February 6, 2015.
- 214 responses received to RFC.
- Final rule announced on May 19, 2015.
- <https://www.nacha.org/content/same-day-ach>

Same day ACH

- Creates new option to originate same-day ACH transactions (99% of all ACH transactions eligible).
- Mandatory participation by RDFIs; optional for ODFI.
- Eligible transactions, all domestic ACH transactions \$25,000 and under (no IAT).
- Non-monetary transactions: Prenote, Notification of Change (NOC), remittance information (using CCD, “corporate credit or debit” and CTX, “corporate trade exchange”), Automated Enrollments (ENR), and Death Notifications (DNE)

Same day ACH

- Non-monetary transactions covered.
 - a Prenotification Entry (or Prenote);
 - Notification of Change (“NOC”) or (“COR”);
 - Zero Dollar Entry conveying remittance information using Corporate Credit or Debit Entry (“CCD”) and Corporate Trade Exchange Entry (“CTX”); and
 - Death Notification Entry (“DNE”), federal gov’t use.

Same day ACH

- RDFIs may use the new same day processing windows to send returns, reversals, and nonmonetary transactions.
- Same day returns and reversals would not be limited to the \$25,000 per transaction limit or the IAT exclusion applicable to forward transactions.
- Same day returns and reversals would also not be assessed the Same Day Entry Fee.

NACHA Same-Day ACH

A Phased Approach

Functionality	Phase 1*	Phase 2*	Phase 3*
Implementation Date	9/23/16	9/15/17	3/16/18
Transaction eligibility	Credits Only	Credits and Debits	Credits and Debits
Processing Windows	10:30 ET; 3:00 ET	10:30 ET; 3:00 ET	10:30 ET; 3:00 ET
Settlement Times	1:00 ET; 5:00 ET	1:00 ET; 5:00 ET	1:00 ET; 5:00 ET
ACH Credit Funds	End of RDFI's processing day	End of RDFI's processing day	5:00 RDFI's time

Same day ACH-Interbank compensation

- Interbank Same Day Entry fee 5.2 cents/transactions; paid from ODFI to RDFI
 - RDFI can recover costs for enabling and supporting same-day ACH: investment costs, operating costs, and reasonable rate of return – included
 - Opportunity costs – excluded (resulting in 3 cent reduction from originally proposed 8.2 cents)
- Important cost-recovery mechanism
 - Periodic review of the effectiveness of the fee 5, 8, 10 years after implementation
 - Language in final rule: “In no case will the Same Day Entry fee be increased as a result of this review.”

FedACH® SameDay Service

- FedACH SameDay Service Allows ODFI participants to originate same-day payments to RDFI participants that have signed on to the service
- Fewer than 100 depository institutions currently participate (not including Wells Fargo)
- Proposed enhancements to FedACH SameDay Service Would adopt key aspects of NACHA Same-Day ACH rule, including (1) mandatory participation by RDFIs, and (2) introduction of interbank fee of 5.2 cents. See 80 Fed.Reg. 30246 (May 27, 2015).
- Changes to be incorporated into Operating Circular 4

FedACH® SameDay Service

- Effective dates of the NACHA rule are contingent upon written confirmation of the Board's support.
- Board's support is critical because it has been asked to help collect and distribute the interbank fee to RDFIs.

Regulatory Enforcement - the Phantom Menace

The Force Awakens- Enforcement Trends

- More regulation = more enforcement actions
- Data driven enforcement
- Low hanging fruit has been picked: payday lenders, debt collection, credit cards, mortgage lending
- Ripples are spreading beyond traditional financial services
- Growing awareness of new powers and better coordination among state/federal regulators
- Hot areas: minorities, students, older Americans, military, vendors and data security

The CFPB 2015 Arbitration Study

- Lays the groundwork for rule making to broadly restrict the use of arbitration provisions –including class action waivers- in consumer contracts
 - Consumer arbitration clauses are prevalent
 - Consumers do not understand arbitration or opt outs
 - Private class action insufficient to address unfairness
 - Class action waivers are problematic
- Mandated by Dodd-Frank, which also empowers the CFPB to impose conditions or limitations on arbitration provisions if in the public interest and for the protection of consumers

The Reach of the Empire- Disparate Impact

- *Texas Dept. of Housing and Community Affairs v. Inclusive Communities Project, Inc.*, 576 U.S. ____, 2015 WL 2473449 (Jun. 25, 2015)
- disparate impact discrimination claims are cognizable under the FHA
- policies or practices, while not intentionally discriminatory, have a “disproportionately adverse effect on minorities,” and are “otherwise unjustified by a legitimate rationale.”
- typically grounded in statistical evidence of the effects of policies or practices on a protected class.
- First Action: American Honda Finance Corp. (2015 CFPB 14)

Recent CFPB Actions- Old Issues Creating New Problems

- Deposit Processing Discrepancies: RBS Citizens Financial Group, Inc. (n/k/a Citizens Financial Group, Inc.), RBS Citizens, N.A. (n/k/a Citizens Bank, N.A.), and Citizens Bank of Pennsylvania (2015 CFPB 0020)
- Overdraft Fees and Advertising: Regions Bank (2015 CFPB 0009)
- Not policed by class action plaintiffs, significant amounts at issue

FIRREA Enforcement – the Reborn Statute with New Applications

- Financial Institutions Reform, Recovery and Enforcement Act of 1989, 12 U.S.C. § 1833a.
- Civil money penalties for violations of 14 criminal statutes and a 10 year statute of limitations
- DOJ expanded interpretation of FIRREA based on the “self-affecting” application:
 - BNY Mellon, 941 F. Supp. 2d 438 (S.D.N.Y. 2013)
 - Wells Fargo, 972 F. Supp. 2d 593 (S.D.N.Y. 2013)
 - Countrywide, 961 F. Supp. 2d 598 (S.D.N.Y. 2013)
- Driving government investigations and resulting in large settlements

The Return of the Jedi? A New Hope

- The beginnings of a backlash against aggressive enforcement?
 - Criticisms of overzealous tactics of Preet Bharara
- Improved compliance awareness in a more regulated environment and more dedicated compliance resources
- A better sense of the kinds of behavior regulators will address

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