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COMMUNITY BANKING ADVISOR

FEDERAL COURT: FINANCIAL INSTITUTION LIABLE FOR ACH FRAUD LOSSES

Know your risks
FAQS ABOUT SELLING MORTGAGES ON THE SECONDARY MARKET

STAYING ATOP THE NEW-AND-IMPROVED CRA RULES

BANK WIRE

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In a recent case — *Studco Building Systems US, LLC v. 1st Advantage Federal Credit Union* — the U.S. District Court for the Eastern District of Virginia held a credit union liable for more than $500,000 in fraudulent ACH payments deposited into a member's account and quickly withdrawn. The payments were the result of a business email compromise scam. There was little or no evidence that the credit union had actual knowledge of the scam. But the court found that such knowledge was imputed to the credit union based on real-time alerts from its anti-money laundering system and various red flags indicating that the account was being used for fraudulent purposes.

COMPROMISED EMAIL SCAM

The plaintiff in *Studco* was a manufacturer of commercial metal building products. A supplier informed the plaintiff that it would be sending a change in banking instructions. However, a third party, which had gained access to the plaintiff's email system, prevented the plaintiff from receiving the legitimate email from the supplier with the new banking instructions. Instead, the third party sent the plaintiff a spoofed email, purportedly from the supplier, instructing it to direct future payments to a personal account at the defendant credit union. Neither the plaintiff nor its supplier had accounts at the credit union.

Over the next few weeks, the plaintiff made four ACH deposits — totaling $558,869 — that named its supplier as beneficiary but listed the account number for the personal account created by the scammers. The individual owner of that account quickly dispersed all the funds. Although the credit union declined to make attempted international wire transfers from the account — based on Office of Foreign Assets Control alerts — it didn't otherwise stop activity into or out of the account.

The credit union's computer system automatically generates warnings for ACH transactions when, as in this case, the identified payee doesn't exactly match the name of the receiving account holder. However, the system generates "hundreds to thousands" of these warnings per day, the majority of which aren't significant, so the credit union's personnel doesn't actively monitor them.

COURT DECISION

The court said, under the Uniform Commercial Code (UCC) as adopted by Virginia, the plaintiff had the right to recover the fraudulent ACH deposits received by the credit union if it showed that the credit union "'[knew] that the name and [account] number' of the incoming ACHs from [the plaintiff] 'identif[ied]

WHAT OTHER COURTS HAVE SAID

Before *Studco* (see main article), most courts have focused on a bank's state of knowledge at the time an ACH payment is credited to the recipient's account. They point to language in the Uniform Commercial Code regarding misdescription of the beneficiary: "If the beneficiary's bank does not know that the name and number refer to different persons, it may rely on the number as the proper identification of the beneficiary of the order. The beneficiary's bank need not determine whether the name and number refer to the same person." As the comments to this provision explain, "It is possible for the beneficiary's bank to determine whether the name and number refer to the same person, but if a duty to make that determination is imposed on the beneficiary's bank the benefits of automated payment are lost."

In *Shapiro v. Wells Fargo Bank*, a case with similar facts to *Studco*, the 11th U.S. Circuit Court of Appeals found that it wasn't unreasonable for Wells Fargo to allow its automated payment system to ignore a potential name mismatch and rely on the number as the proper identification.

different persons.'" According to the UCC, "know" means "actual knowledge," defined as follows:

> Actual knowledge of information received by the organization is effective for a particular transaction from the time it is brought to the attention of the individual conducting that transaction and, in any event, *from the time it would have been brought to the individual's attention if the organization had exercised due diligence.* [Emphasis added]

The UCC further provides that an organization exercises due diligence if it "maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routines."

In *Studco*, the court held that the credit union would have discovered the mismatch between the intended payee and the recipient if it had exercised due diligence. Evidence at trial showed that the credit union failed to do so. Among other things:

- The credit union allowed the recipient to open the account even though it triggered an "ID verification warning," stating that the system was unable to verify the address provided.
- The credit union failed to establish a reasonable routine for monitoring suspicious activity alerts. It wasn't reasonable to ignore those alerts because of their sheer volume. The credit union could have implemented a system to "escalate pertinent alerts of high-value transactions."
- It was unreasonable for the credit union to allow the deposits into the personal account, which was a new account that had a small starting balance followed by multiple high-value transactions.

The court essentially applied a "knew or should have known" standard that's a departure from the "actual knowledge" standard used by many courts. (See "What other courts have said" above.) As the court explained, the credit union couldn't "ignore their own systems to prevent fraud in order to claim that they did not have actual knowledge of said fraud."

STAY TUNED

It remains to be seen whether the *Studco* case is an aberration, or whether it heralds a shift in how courts view financial institutions' responsibility to monitor ACH transactions for potential fraud. The credit union has appealed the decision to the Fourth U.S. Circuit Court of Appeals. ■

Know your risks

FAQS ABOUT SELLING MORTGAGES ON THE SECONDARY MARKET

In an increasingly volatile marketplace, community banks need to be resourceful to take advantage of strategies that can help them maintain profitability and stability over time. Selling mortgage loans that your bank originated to secondary market investors can create a much-needed influx of cash, but it's important to understand and mitigate the risks.

HOW DID WE GET HERE?

Traditionally, community banks that participated in the secondary market were brokers, originating mortgages closed on behalf of larger financial institutions. In 2013, the Consumer Financial Protection Bureau (CFPB) finalized new loan originator compensation rules, which substantially limited the fees a broker could earn.

Since then, many community banks, in an effort to enhance noninterest income, have begun originating mortgages on their own behalf and then selling them to secondary market investors.

WHAT ARE THE RISKS?

Community banks that move away from the broker role and originate their own loans increase their risk exposure. For one thing, they become subject to CFPB rules, including the Ability-to-Repay (ATR) and Qualified Mortgage (QM) rules, which were revised in April 2021 with a mandatory compliance date of October 1, 2022. Even after selling a loan to the secondary market, a bank remains liable under these rules. A bank might even be required to buy back the loan years later if it's determined that it failed to properly evaluate the borrower's ability to repay or to meet qualified mortgage standards.

To mitigate these risks, it's important for banks to develop or update underwriting policies, procedures and internal controls to ensure compliance with the revised ATR and QM rules. It's also critical for banks to have loan officers and other personnel in place with the skill and training necessary to implement the rules.

COMMUNITY BANKS THAT MOVE AWAY FROM THE BROKER ROLE AND ORIGINATE THEIR OWN LOANS INCREASE THEIR RISK EXPOSURE.

Moreover, there's a risk that contracts to sell mortgages to the secondary market will have a negative effect on a bank's regulatory capital. Often, these contracts contain credit-enhancing representations and warranties, under which the seller assumes some of the risk of default or nonperformance. Generally, these exposures must be reported and risk-weighted (using one of several approaches) on a bank's call reports. In turn, this can increase the amount of capital or reserves the bank is required to maintain.

WILL UPDATED BASEL III RULES ADD RISK?

In addition, the Basel III capital rules are currently being updated to reduce operational risk in banks. The update was made in response, in part, to several 2023 regional bank failures largely caused by

inadequate levels of capital. Known as the Basel III endgame, the update is somewhat controversial because some see its requirements as excessively stringent. Currently, the Basel III endgame is scheduled to take effect July 1, 2025, and will phase in the capital ratio impact over three years.

Among other things, the updated rules would reduce banks' ability to use their own models for calculating capital requirements for loans. Banks would instead be required to use standardized measures and models to evaluate loan risks.

STAY VIGILANT

Community banks have much to gain by selling their mortgage loans to the secondary market, but only if they fully understand and take steps to mitigate the potential problems. Staying on top of the latest regulatory updates and developing proper procedures and internal controls will help ensure the rewards outweighs the risks. ■

STAYING ATOP THE NEW-AND-IMPROVED CRA RULES

Final rules to strengthen and modernize the Community Reinvestment Act (CRA) were unveiled by the Federal Reserve, Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC) late last year. Among other things, the new rules strive to adapt the CRA regulations to changes in the banking industry, including the expanded role of mobile and online banking.

At nearly 1,500 pages, the new rules are complex. Fortunately, with the exception of provisions that are similar to current CRA regulations, banks have until January 1, 2026, to comply. All banks should reevaluate their CRA programs in light of the new rules, and prepare for any necessary adjustments.

CRA IN A NUTSHELL

The CRA encourages banks to help meet the credit needs of the communities in which they operate — including low and moderate-income neighborhoods — consistent with safe and sound banking operations. To monitor compliance, the federal banking agencies periodically evaluate banks' records in meeting their communities' credit needs and make their performance evaluations and CRA ratings available to the public. The agencies take a bank's CRA rating into account when considering requests to approve bank mergers, acquisitions, charters, branch openings and deposit facilities. A bank's CRA rating may also affect its reputation in the community.

HIGHLIGHTS OF THE NEW RULES

CRA evaluation standards vary depending on a bank's size. The new rules increase the asset size thresholds as follows:

- Small banks are defined as those with less than $600 million in assets (up from $357 million).
- Intermediate banks are those with $600 million but less than $2 billion in assets (up from $1.503 billion).
- Large banks are those with $2 billion or more in assets (up from $1.503 billion).

The final rules create a new evaluation framework that rates a bank's CRA performance based on four tests: 1) a retail lending test, 2) a community development financing test, 3) a community development services test, and 4) a retail products and services test. These new tests, which are more stringent than existing standards, have varying applicability depending on a bank's asset size.

Small banks will be evaluated under the current "small bank lending test," though they may opt into the new retail lending test. Intermediate banks will be subject to the new retail lending test — plus, they'll have the option of having their community development loans and investments evaluated under the existing community development test or the new community development financing test. Finally, large banks will be evaluated under all four new tests.

THE AGENCIES TAKE A BANK'S CRA RATING INTO ACCOUNT WHEN CONSIDERING REQUESTS TO APPROVE BANK MERGERS, ACQUISITIONS, CHARTERS, BRANCH OPENINGS AND DEPOSIT FACILITIES.

RULES MATTER

As before, banks of all sizes will still be able to request an evaluation under an approved strategic plan. The new rules also provide for the evaluation of lending by certain large banks outside traditional assessment areas generated by the growth of new delivery systems, such as online and mobile banking. Staying current with the latest CRA rules will help your bank pass the tests and maintain its good standing over time. ■

BANK WIRE

BNPL LOANS: MANAGING THE RISK

In a recent bulletin, the Office of the Comptroller of the Currency (OCC) offers guidance to community banks on managing the risks associated with buy now, pay later (BNPL) loans. These loans can take many forms, but the bulletin focuses on those that are payable in four or fewer installments and carry no finance charges. Typically, these loans are offered at the point of sale. The lender pays the merchant a discounted price for the good or service and, in exchange, assumes responsibility for granting credit and collecting payments from the borrower. The lender's primary source of revenue is the difference between the total installment payments and the discounted purchase price, though it may also collect late fees from the borrower.

The bulletin warns banks of various risks associated with BNPL loans. For example, borrowers may overextend themselves or not fully understand their repayment obligations; applicants with limited or no credit history may present underwriting challenges; and the lack of clear, standardized disclosure language may obscure the true nature of the loan, creating a risk of violating prohibitions against unfair, deceptive or abusive acts or practices. The OCC offers tips on designing risk management systems that "capture the unique characteristics and risks of BNPL loans." You can find the bulletin at https://www.occ.gov/news-issuances/bulletins/2023/bulletin-2023-37.html. ■

GUIDANCE ON VENTURE LOANS

In another recent bulletin, the OCC offers guidance to banks considering venture lending — that is, commercial lending activities that target high-risk borrowers in the early, expansion, or late stages of development. According to the bulletin, the primary risks associated with venture lending include unproven cash flows, untested business models, difficulty projecting future cash flows, high liquidity needs, high investment spending, and limited refinancing or business exit options.

Typically, these risks are greater for borrowers at an earlier stage of development. The bulletin — which can be found at https://www.occ.treas.gov/news-issuances/bulletins/2023/bulletin-2023-34.html — provides guidance on managing these risks. ■

CFPB PROPOSAL WOULD CLOSE OVERDRAFT LOOPHOLE

The Consumer Financial Protection Bureau (CFPB) recently issued a proposed rule designed to rein in excessive overdraft fees charged by large banks. The proposal would end the exemption of overdraft lending services from the Truth in Lending Act and other consumer protection laws.

Banks would be permitted to extend overdraft loans if they comply with the requirements of these laws or, alternatively, charge a fee to recoup their costs at an established benchmark (as low as $3) or at a cost they calculate (provided they show their cost data). The proposed rule would apply only to insured financial institutions with more than $10 billion in assets, but it may be expanded to smaller institutions in the future. ■

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