

The Conventional Riba-Based Banking System

THE BANKING SYSTEM OF THE UNITED STATES

The United States has developed the most sophisticated and highly dispersed banking network and system in the world. The American banking system, when it was developed, benefited from the accumulated body of human experience over history, including many religious values, human experiences, and documented and sophisticated solutions to problems faced while developing the system in the United States and other systems in Europe. The system was and continues to be built using the most capable minds, accounting methods and standards, mathematical tools, and analyses available in the world. It is a project in progress. We are reminded that it would be embarrassing to write about the American banking and financial system after what happened in 2008, when the system failed miserably. It is believed that when the lessons learned from the worst crisis since the Great Depression are applied and the system is modified, it will be better: well-designed, well-positioned, and ready for a better future, not only for the United States, but for the rest of the world. History has shown that a country can have the most sophisticated system in the world, but if some people, who are part and parcel of the system, do not respect it and instead indirectly try to sabotage it by trying to get around the laws, that system is doomed. The United States functioned well with its banking system when Americans at all levels believed in it, respected it, and implemented it, and when we Americans lived within our means.

This chapter covers the U.S. banking regulations, which are considered the most sophisticated banking regulations ever developed in the history of the world. These regulations are included in this book to underline two

important facts: (1) These regulations are intended to make sure that every citizen in the United States is treated fairly, and that the money deposited in the depository institutions is protected and safe. This is important, because those who are involved in RF banking and its development need not reinvent the wheel; we can use these regulations as a foundation for future efforts, improving upon or adding to this system of regulations in our effort to develop the RF banking and finance system. The United States' banking regulations are built on a huge body of human experience that was meticulously designed and documented. And (2), many of these regulations have Judeo-Christian-Islamic roots. These roots were tied in with the banking regulations. In addition to the banking regulations, this section attempts to familiarize the reader with the process of regulating and supervising banks. This chapter will focus on the process used by the U.S. Treasury Department's arm responsible for regulating national banks—the Office of the Comptroller of the Currency (OCC)—and how its “Examination of Safety and Soundness” of the national banks is conducted, including my personal perspectives from firsthand experience running the Bank of Whittier, NA, starting in July 2003. The role of the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve System will also be discussed. Additionally, the role of the Securities and Exchange Commission (SEC) in regulating the investment banking industry will be explained. The goal is to help the reader understand the processes used by the SEC to ensure that the financially uneducated and unsophisticated citizen is not conned out of his/her precious savings and that the process of selling securities (shares of companies, mutual funds, and bonds) is closely scrutinized by the government through the SEC.

To give a historic foundation for our discussion of how banks work and how Judeo-Christian-Islamic values can be applied to them, we need to know how financial institutions in the United States were built, their contributions to encourage community savings and investments, and their contributions to the lifestyle and the economy in the United States. With nearly 99,160 branches¹ and 415,321 automated teller machines (ATMs), the U.S. banking system is the largest in the world. As of the end of 2007, U.S. banks had \$13.4 trillion in assets and \$7.996 trillion in total loans. U.S. banking is more diverse than in most Western countries. Despite ongoing consolidation, vigorous competition exists within the vast banking community, which includes financial holding companies that operate nationwide, dominant regional banks, and smaller independent banks.

In my many personal communications and meetings with finance and banking officials and bankers in the world, especially in the United States, Europe, the former Soviet Bloc countries, and the developing countries of Africa and Asia, I was amazed to learn that officials outside the United

States are not aware of the real engine of the United States economy: the highly dispersed community-owned (shareholders and board members are from the local community) and operated network of community-based state and national banks, which make it easier for local communities to safekeep their savings and to use these savings to reinvest in the community. Most of the rest of the world is more familiar with branches of a larger bank that serve local communities.

The American banking system is based on a “bottoms-up” approach as compared to that of the rest of the world, which is designed and built based on a “top-down” approach. This basis, in itself, signifies the ideal of the United States banking system, which espouses the democracy of capital distribution. These, along with the many regulations in the system, aspire to make capital available for those who need it. This in itself is a basic Judeo-Christian-Islamic goal. Compare this to many of the countries in Europe and the developed world, which have huge capital resources but have not yet been able to make it trickle down to the masses despite claims, sometimes made by their governments, that they are applying the values of the faith.

It is interesting to report here the results of a survey made by a popular television channel in the Arab world, in which they asked if “Islamic” banks catered to the rich or served the poor and the needy. More than 70% of the respondents said that Islamic banks only cater to and serve the needs of the rich. In fact, most banks in the developing world, including Islamic banks, not only cater to the needs of the rich but also invest large sums of their capital and deposits in projects that are outside their countries. It is sincerely hoped that the United States’ banking regulations are studied by the regulators, the religious scholars, and the politicians in these countries in order to make a real difference in the fortunes of the future generations at all levels of the social ladder. This can be done through real economic development, prosperity, social justice, and equal opportunity in obtaining credit and in making sure that the huge fortunes accumulated from the sale of the natural resources are invested back in the local communities through a healthy (and hopefully a riba-free) banking industry that believes making credit available to all people is a basic human right.

TYPES OF BANKING SERVICES IN THE UNITED STATES

The American banking system evolved with the emergence of the United States after the Civil War. There are two types of banks in America: State chartered banks, which are chartered by the state banking department of each state in the Union, and national banks, which are chartered and

authorized to operate by the federal government through the U.S. Department of Treasury. One of the reasons Congress created a banking system that issued national currency was to finance the Civil War. Although national banks no longer issue currency, they continue to play a prominent role in the nation's economic life. It is important to understand that banks, be they state chartered or national, are empowered to issue credit facilities that carry the same effect of issuing currency, but only in terms of credit and in the form of a promissory note against the borrowers, as discussed in Chapter 5.

National Banks

Congress has established a number of long-range goals of for the national banking system in America. These are:

- Supporting a stable national currency
- Financing commerce
- Acting as private depositories
- Generally supporting the nation's economic growth and development

The realization of these goals required a type of bank that was not just safe and sound, but whose powers were dynamic and capable of evolving so that national banks could perform their intended roles, well beyond the Civil War. Key to these powers is language set forth in 12 U.S.C. § 24 (Seventh), which provides that national banks are authorized to exercise:

. . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes.

The national banking system demonstrates the value of applying nationwide standardization by introducing uniform national banking standards to banking activities and products.

State Banks

After the establishment of the United States, each state of the union kept a state-run banking system that was supervised by the individual state banking department. These state banking laws and regulations do not necessarily coincide and are not necessarily similar to the national banking system.

However, the state banking laws and regulations are essentially the same as those of the national banks. State banks are usually small in size compared to national banks; however, there are national banks that are small, with capital of as little as \$5 million and total assets of as little as \$25 million, and state banks that are large, with capital that can exceed \$20 million and assets that may exceed \$100 million. It is important to note that state banks can, in general, only operate in the state where they are chartered, while national banks can operate, within regulations, in all states.

To avoid the potential of a conflict that would arise from a particular state regulating a national banking institution that is regulated by the federal government, a dual banking system was invented:

It has been a bedrock precept of our [the United States'] constitutional law for more than 180 years, since the Supreme Court's decision in M'Culloch v. Maryland in 1819, that states cannot constitutionally control the powers of entities created under Federal Law. Courts have consistently applied this principle over the years to national banks, holding a variety of state laws inapplicable to national banks, and finding that the federally authorized powers of national banks are not subject to state supervision and regulation.²

In 1861, Secretary of the Treasury Chase recommended the establishment of a system of federally chartered national banks, each of which would have the power to issue standardized national bank notes based on United States bonds held by the bank. In the National Currency Act of 1863, the administration of the new national banking system was vested in the newly created *Office of the Comptroller of the Currency*, or OCC, and its chief administrator, the *Comptroller of the Currency*.³ The law was completely rewritten and re-enacted as the National Bank Act.⁴ That Act authorized the Comptroller of the Currency to hire a staff of national bank examiners to supervise and periodically examine national banks for safety and soundness. The Act also gave the Comptroller authority to regulate lending and investment activities of national banks.

Distinctions between the national banking system and the state banking system are rooted deep in constitutional principles and the history of the United States. These distinctions are essential to the vitality of the dual banking system and are encouraged.

The OCC booklet⁵ on the dual system states that each component of the dual (state and national) banking system makes different, positive contributions to the overall strength of the U.S. banking system. In defense of the value and contribution of the *state banking system*, state bank supervisors

rightly assert that a separate system of state banks “allows the states to serve as laboratories for innovation and change, not only in bank powers and structures, but also in the area of consumer protection.” State banks’ supervisors argue that state banks put in action the “smaller is better” model of business. State banks are in general geographically closer to state bank regulators. This provides state banks with greater access to state regulators and gives state regulators greater familiarity with the banks they supervise.

National banks are required by law to become members of the Federal Reserve System. Banks chartered by the states are divided into those that are members of the Federal Reserve system (state member banks) and those that are not (state nonmember banks). State banks are not required to join the Federal Reserve system, but they may elect to become members if they meet the standards set by the Board of Governors of the Federal Reserve System. As of 2007, of the nation’s approximately 8,441 commercial banks, approximately 2,459 were members of the Federal Reserve System. Member banks must subscribe to stock in their regional Federal Reserve Bank in an amount equal to 6 percent of their capital and surplus, half of which must be paid in while the other half is subject to call by the Board of Governors of the Federal Reserve System. The holding of this stock, however, does not carry with it the control and financial interest conveyed to holders of common stock in for-profit organizations. It is merely a legal obligation of Federal Reserve membership, and the stock may not be sold or pledged as collateral for loans. Member banks receive a 6 percent dividend annually on their stock, as specified by law, and vote for the Class A and Class B directors of the Reserve Bank. Stock in Federal Reserve Banks is not available for purchase by individuals or entities other than member banks. The Federal Reserve is responsible for supervising and regulating the following segments of the banking industry to ensure safe and sound banking practices and compliance with banking laws: (1) bank holding companies, including diversified financial holding companies formed under the Gramm-Leach-Bliley Act of 1999 and foreign banks with U.S. operations; (2) state-chartered banks that are members of the Federal Reserve System (state member banks); (3) foreign branches of member banks; (4) edge and agreement corporations, through which U.S. banking organizations may conduct international banking activities. Details of the Federal Reserve system are found in Chapter 5.

Credit Unions

There is yet another type of depository institution in the United States that is very close to savings cooperatives. These are called *credit unions*. These are associations of members of a community that are bound together either

because they live in the same neighborhood, work in the same company, or worship at the same place of worship. These institutions usually gather assets by selling shares in the credit union and lending to its members at a spread over the dividends paid back to the members. The spread is usually lower than that of larger banks which yield higher dividends for depositors (credit union shareholders). This is because of the smaller size of most credit unions, the lower overhead, and the very low loan losses, because the community knows each other and is close to each other.

Investment Banks

Another important arm of banking in the United States is a category called *investment banks*. They differ from, but complement, the role of depository institutions (i.e., banks). An important role of the investment banks is that they gather funds that are “excess liquidity in the hands of the public and other institutions, like pension and retirement plans” and reinvest them prudently on behalf of the public, mainly in the United States, but also to capture business opportunities worldwide. It is very important to understand this role, because most of the Islamic *riba*-free banking discussions, especially concerning attempts to operate in the West, mix the roles of depository institutions—banks—and investment banks together. This has been a major source of confusion and a major problem in developing RF banking and finance services in most if not all the developed Western world. The lack of an active, sophisticated investment banking institution and investment bankers who understand the intricacies of reinvesting surplus funds in local economies prudently is an important reason for the flight of capital away from many developing countries. Investment banks are regulated by another U.S. government entity, the Securities and Exchange Commission (SEC), to make sure that the financially uneducated and unsophisticated citizen is not conned out of his/her precious savings, that the process of selling securities (shares of companies, mutual funds, and bonds) is closely scrutinized, and that these activities abide by government rules and regulations.

Licensing a Commercial Bank in the United States

In both types of banks—national and state—an application to start a new bank must detail why there is a need for a banking service in a particular area and the area of service on which this bank will be focusing its services. This area is called the *assessment area*. The bank charter application should include a detailed outline of the business plan, a description of the capital that will be raised and how it will be raised, and the identities of the bank’s board of directors and key operating staff, with details on their experience, personal and professional backgrounds, and how they will contribute to the bank’s mission of serving the banking and financial needs of the

community. The feasibility study should also include a thorough and detailed analysis of the competition and a well-thought-out business plan that justifies the chartering of the bank and demonstrates how the community will be better off chartering and opening the services of this bank. State banks are chartered and authorized to operate by the state regulators, while national banks are chartered and licensed by the federal government through the Department of Treasury of the United States. In case a group wants to buy a controlling interest in a bank—more than 9.9% of the outstanding shares—the group must apply to the regulators for permission to make a change in the control of the bank.

Bank regulators not only review the application in great detail but also perform a detailed check on the background, the police and Justice Department records, and other civil records of all involved to ensure that those who sit on the board or run the bank have a crystal clean reputation before being entrusted with peoples' deposits and assets. It is preferred that the bank's board members come from diverse backgrounds so that they will be able to reflect the different viewpoints of the community. Board members are expected to have received proper training through attending special seminars on banking in general and on how to properly fulfill their responsibilities within the law and the banking regulations in particular. Bank executives and staff members are expected to attend regular training programs to familiarize themselves with all aspects and updates of bank operations and banking regulations. Examples of these training programs will be discussed in Chapter 12. Each board member is required by regulations to risk his or her own money by purchasing at least \$1,000.00 worth of stock in the bank. Many will be surprised to know that members of the Board of Directors are not highly paid – in most cases – for their services. The Board fees range between \$300 to \$2000 (depending on the size of the bank) for each Board of Directors meeting they attend. Members of the Board of Directors not only are responsible for supervising bank operations to make sure that the bank is safe and sound but also are responsible before the law for any lapse in performing their duties of oversight and supervision. The details of all these aspects are not the subject of this book. Only a few samples of the important features of a bank structure are mentioned here, in the hope that such features will be studied, improved upon (if needed), and implemented by RF bankers to build on what is available and to achieve a better future for all.

GOVERNMENT SUPERVISION OF THE BANK

National banks are supervised and regulated by the OCC, which is an arm of the United States Department of Treasury. The OCC regulates and

supervises all national banks and federal branches of foreign banks in the United States. These facilities account for nearly two-thirds of the total assets of all U.S. commercial banks.

The OCC's nationwide jurisdiction over banks—from modest-sized community banks to some of the largest banks in the world—also contributes to the agency's ability to develop and maintain highly expert credit examination and risk management capabilities that benefit all banks in the national system. The OCC has a nationwide reach, which enables it to take actions to protect customers regardless of the state in which they reside. The OCC's efforts to combat unfair or deceptive practices and its focused approach to customer privacy issues have had nationally recognized consumer benefits.

The Office of the Comptroller of the Currency⁶

The OCC charters, regulates, and supervises all national banks. It also supervises the federal branches and agencies of foreign banks. Headquartered in Washington, D.C., the OCC has four district offices plus an office in London to supervise the international activities of national banks.

The OCC was established in 1863 as a bureau of the U.S. Department of the Treasury. The OCC is headed by the Comptroller, who is appointed by the President of the United States, with the advice and consent of the Senate, for a five-year term. The Comptroller also serves as a director of the Federal Deposit Insurance Corporation (FDIC) and a director of the Neighborhood Reinvestment Corporation. The OCC's nationwide staff of examiners conducts onsite reviews of national banks and provides sustained supervision of bank operations. The agency issues rules, legal interpretations, and corporate decisions concerning banking, bank investments, bank community development activities, and other aspects of bank operations.

National bank examiners supervise domestic and international activities of national banks and perform corporate analyses. Examiners analyze a bank's loan and investment portfolios, funds management, capital, earnings, liquidity, sensitivity to market risk, and compliance with consumer banking laws, including the Community Reinvestment Act. They review the bank's internal controls, internal and external audits, and compliance with applicable laws and regulations. They also evaluate the bank management's ability to identify and control risk.

In regulating national banks, the OCC has the power to:

- Examine the banks.
- Approve or deny applications for new charters, branches, capital, or other changes in corporate or banking structure.
- Take supervisory actions against banks that do not comply with laws and regulations or that otherwise engage in unsound banking practices.

The agency can remove officers and directors, negotiate agreements to change banking practices, and issue cease and desist (C and D) orders, as well as civil money penalties.

- Issue rules and regulations governing bank investments, lending, and other practices.

The OCC's Objectives The OCC's activities are predicated on four objectives that support the OCC's mission to ensure a stable and competitive national banking system. The four objectives are:

- To ensure the safety and soundness of the national banking system
- To foster competition by allowing banks to offer new products and services
- To improve the efficiency and effectiveness of OCC supervision, including reducing regulatory burden
- To ensure fair and equal access to financial services for all Americans

OCC Funding The OCC does not receive any appropriations from Congress. Instead, its operations are funded primarily by assessments on national banks. National banks pay for their examinations, and they pay for the OCC's processing of their corporate applications. The OCC also receives revenue from its investment income, primarily from U.S. Treasury securities.

Insurance of Bank Deposits by the Federal Deposit Insurance Corporation (FDIC)

The FDIC insures the deposits in all member banks in the United States. The basic insurance amount was \$100,000 per depositor, per insured bank until it was increased to \$250,000 in response to the 2008 financial meltdown. This was done on a limited temporary basis (until 2013) to prevent customers of "shaky" banks from creating runs on those banks (when depositors withdraw their deposits from the bank to avoid incurring great losses of their capital). The FDIC insurance amount applies to all depositors of an insured bank. For more information, the reader is invited to visit the FDIC's Web site: www.FDIC.gov. One of the FDIC rules requires that every bank should have a clear Advertisement of Membership.⁷

UNITED STATES BANKING REGULATIONS

This section covers in detail some of the U.S. bank regulations, which are considered to be the most sophisticated bank regulations ever developed in

the world. These regulations are included in this book to underline two important facts: (1) These regulations are intended to make sure that every citizen in America is treated fairly, and that the money deposited in the depository institutions is protected and is safe. This is important, because those who are involved in RF banking and its development need not reinvent the wheel; the existing regulations are built on a huge body of human experience, and it is hoped that RF banks' development efforts can begin by using such regulations as a base for further growth. (2) Many of these regulations have Judeo-Christian-Islamic roots.

In addition to the banking regulations, this section attempts to familiarize the reader with the process of regulating and supervising banks.

Consumer Compliance Management

Every bank in America is required to manage the entire consumer compliance process using an overall *compliance management system*. The system includes a compliance program and a compliance audit function, sometimes referred to as compliance review or self-assessment. The *compliance program* consists of the policies and procedures that guide employees' adherence to banking laws and regulations.

The *consumer compliance audit function* is an independent testing of the bank's transactions to determine its level of compliance with consumer protection laws, as well as the effectiveness of, and its adherence to, its own policies and procedures.

Board of Directors and Management Supervision and Administration

Compliance with U.S. banking laws and regulations at every bank is managed as an integral part of the bank's business strategy. The bank's board of directors and management recognize the scope and implications of laws and regulations that apply to the bank. The *compliance management system* should be designed to ensure that the bank's clients and customers are treated fairly and justly, according to the highest ethical standards, laws, and regulations, to protect the bank. Bank resources are expected to be used effectively to minimize any disruptions in daily activities due to compliance issues.

To ensure an effective approach to compliance, the board and management must take the business of compliance very seriously and make it a top priority. The participation of senior management in the development and maintenance of a compliance program is the pillar of the process. The board and senior management should periodically review the effectiveness of its

compliance management system. This review includes reports that identify any weaknesses or required modifications due to changes in laws, regulations, or policy statements. Prompt and capable management response to those weaknesses and required changes is the final measure of the compliance system's effectiveness. The bank's senior management is required to assign a well-qualified staff and the necessary resources to properly implement and administer the compliance program. Participation in the compliance management system at all levels is important to its success.

Compliance Program

Each bank is expected to aspire to have in place a carefully devised, implemented, and monitored program that will provide a solid foundation for compliance. The bank's management will continually evaluate its organization and structure and modify its existing program to ensure that the compliance program meets its specific emerging new needs.

A *compliance committee* is appointed by the board and is headed by a *chief compliance officer*, who has specific responsibilities and authorities.

Compliance Committee

The board is required to organize the committee, which is chaired by the chief compliance officer. A typical committee in a small community bank would include the following members:

- Chief credit officer (deputy committee chairman)
- Chief operations and private banking manager (deputy committee chairman)
- Chief financial officer (deputy committee chairman)
- Manager of loan administration and credit analysis
- Technology coordinator

The bank compliance committee may have the following subgroups, which will focus on specific compliance activities:

- New Accounts, Customer Service, and Information Security and Technology Compliance
- Credit Operations Compliance
- Financial and Accounting Operations Compliance

The committee is expected to meet periodically (e.g., quarterly) or on an as-needed basis.

Duties, Responsibilities, Authorities, and Accountability of the Compliance Committee The consumer compliance committee will be responsible for the following tasks:

- Design, implement, test, proctor, and certify the program
- Develop and continually update all bank policies and procedures
- Develop a continual training and educational program to train the staff, management, and directors on issues pertaining to compliance within the bank training program
- Develop an internal audit program to self-audit different aspects of the compliance functions
- Perform a semiannual risk-based audit program to identify areas of the bank operations that need auditing and the frequency needed to perform the audit
- Develop the compliance audit scope in light of a *risk-based audit program*, and screen outside independent auditors who can perform the audit
- Make recommendations to the board of directors regarding the auditor(s) and scope of each audit; the board of directors has final approval
- Perform internal auditing of the compliance of each subgroup in a *certification program* to ensure that each department has external oversight (e.g., the credit group would audit the operations group; the operations group would audit and certify the financial and accounting group; and the financial and accounting group would audit and certify the credit group)

Clearly, the formality of the compliance program will increase in direct proportion to asset size, complexity, or diversity (including geographic) of operations of the bank. The board of directors and upper management should discuss these needs as they develop and should promptly take action to meet these needs.

Internal Controls

Internal controls are the systems through which the bank provides and ensures continuing compliance. These generally consist of sound organizational structures, comprehensive policies and procedures, and adequate training.

Organizational Structure The ability of the compliance committee to implement the compliance program, administer it, and institute effective corrective action depends on that committee's authority, independence, and role, as

perceived by other employees, as well as on the support provided by the board and senior management. The compliance committee should be able to:

- Perform audits across departmental lines
- Access all operational areas
- Ensure that line management implements corrective action/changes in policies and procedures

Policies and Procedures An effective compliance program includes compliance policies and procedures. Policies provide the framework for the bank's procedures and a source of reference and training for the bank's personnel. Comprehensive and fully implemented policies communicate clearly with all bank personnel the board's and senior management's commitment to compliance. Procedures must be developed to implement the bank's policies. Generally, the degree of detail, specificity, and formality will vary according to the complexity of the issues or transactions addressed by such procedures. Policies and procedures at the bank must be designed to provide personnel with enough information to complete a normal transaction, to the best of management's abilities and taking in consideration the size of the bank. These policies and procedures may include appropriate regulation definitions, sample forms and instructions, and—where appropriate—directions for routing, review, retention, and destruction of the transaction documents.

Training Education of the bank's personnel is essential to maintaining a sound compliance program. All personnel should be generally familiar with the consumer protection laws and should receive comprehensive education in the laws that directly affect their jobs. They must also be trained in the policies and procedures adopted by the bank to ensure compliance with those laws. The faculty of the training program consists of bank board members, senior management, and invited guest trainers from auditing and training organizations. The training program may use videos and training materials obtained from different sources, such as the American Bankers Association (ABA) and BankersOnline. The training program is detailed in Chapter 12.

Compliance Audit Function The other component of a comprehensive compliance management system is a *compliance audit function*. It enables the board and senior management to monitor the effectiveness of the compliance program. The audit function tests the bank's compliance with consumer protection laws and adherence with policies and procedures. An effective compliance audit function should address all products and services offered by the bank, all aspects of applicable operations, and all departments and branch locations. Our team at the Bank of Whittier has

developed a pioneering risk-based audit analysis computer program, which we use to identify the frequency of each audit in each area of bank operation, based on the many factors that may impact bank operations such as the economy, oil prices, inflation, political developments, and the like.

SUMMARY OF FEDERAL BANKING REGULATIONS IN THE UNITED STATES⁸

The following pages summarize some of the important U.S. banking regulations. These regulations are intended to make sure that the financial system in the United States is streamlined to prevent any excesses or mismanagement and that financial services are performed in a universal and standardized regulatory fashion to regulate the banking business in the states of the United States, which in fact resemble 50 different nations. These regulations are improved on a continual basis in the United States, as we have seen, in response to unfortunate experiences of excess and malpractice. The regulations are built on a vast body of human experience over the years since the dawn of history. As we read in the Qur'aan about justice, discrimination, and fair dealing among people:

55:9 weigh, therefore, [your deeds] with equity, and cut not the measure short!

10:47 NOW every community has had an apostle; and only after their apostle has appeared [and delivered his message] is judgment passed on them, in all equity; and never are they wronged.

11:85 Hence, O my people, [always] give full measure and weight, with equity, and do not deprive people of what is rightfully theirs, and do not act wickedly on earth by spreading corruption.

16:90 BEHOLD, God enjoins Justice, and the doing of good, and generosity towards [one's] fellow-men; and He forbids all that is shameful and all that runs counter to reason, as well as envy; [and] He exhorts you [repeatedly] so that you might bear [all this] in mind.

42:42 blame attaches but to those who oppress [other] people and behave outrageously on earth, offending against all right: for them there is grievous suffering in store!

One of the purposes of including some of the important U.S. banking regulations in this book is to introduce the respected government officials and RF (Islamic) banking and finance scholars, executives, and practitioners

to such regulations. It is hoped that they will be motivated to study these regulations carefully and learn from them. If we want to develop a specialized set of regulations for an RF (Islamic) banking and finance system, we will not have to start from scratch. Some of these regulations are also included to draw the attention of the eminent scholars to the fact that it is definitely not enough to “devise a financing model” and issue a *fatwa* (an edict) pronouncing that the model is Shari’aa-compliant. Many more aspects of the real spirit of the RF system are based on Judeo-Christian-Islamic values, many of which are catered to by these regulations.

Regulation B: Equal Credit Opportunity

The *Equal Credit Opportunity Act* (ECOA) states that creditors (including banks, retailers, finance companies, and bankcard–credit card companies) that regularly extend credit to customers should evaluate candidates on creditworthiness alone, rather than other factors (such as, for example, race, color, religion, national origin, or sex). Discrimination on the basis of marital status, welfare recieption, or age is generally prohibited (with exceptions), as is discrimination based on a consumer’s good faith exercise of their credit protection rights. This regulation is a manifestation of the values of all faiths, including the Judeo-Christian-Islamic faith system, and it forms the foundation of real belief in God. It helps achieve the ultimate goal of the Judeo-Christian-Islamic value system, which requires that credit be a basic human right.

This Equal Credit Opportunity Act must be translated into a policy of fair lending by the board of directors of each bank in the system. Each bank is required to post a special logo that tells all customers that the bank implements the Equal Credit Opportunity Act.

Fair Lending Policy The bank should extend (and service) all types of credit consistent with safe and sound operational practices. The bank should also originate loans in such a way as to help meet the credit needs of the communities, including low- and moderate-income neighborhoods. All credit decisions must be based on adequate investigation and the application of sound judgment supported by verified facts. The application of credit guidelines and policies must be uniform for all persons and organizations and never based on race, sex, sexual orientation, color, national origin, religion, age, marital status, disability, or any other prohibited basis. This policy is an integral part of each bank’s fundamental mission of providing quality financial services to existing and prospective customers.

Banks must realize that in granting credit, they also build customer relationships, and it is only through these relationships that the banks can achieve sustained, long-term success. A bank must be committed to the

principle that every applicant for credit receives fair and equal treatment throughout the credit application and approval process. This principle is embodied in the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHA).

General Policy Statement Banks must commit to not discriminate with respect to any aspect of a credit decision on the basis of race, color, religion, national origin, sex, marital or familial status, disability, age (provided that an applicant has the capacity to enter into a binding contract), receipt of income from any public assistance program, sexual orientation, military status, or the good faith exercise of any rights under the federal Consumer Credit Protection Act. Every bank in the system is required to fully commit to the principle that all credit decisions should be made without regard to race or any other discriminatory basis that is prohibited by law. Each bank should recognize that affirmative steps must be taken to ensure that this policy is applied consistently and continuously through all aspects of its credit operations, including product design, marketing and advertising, and application and underwriting processes. Each bank is required to regularly monitor its lending activities to make certain that they comply with this policy. When internal and external reviews suggest that a deviation from the policy may have occurred, the bank is expected and required to act expeditiously to investigate and, if necessary, institute corrective measures.

Advertising Each bank should commit not to engage in advertising practices that would discourage on a basis prohibited by law the making or pursuing of an application for credit and should comply with the requirements of applicable laws relating to the nondiscriminatory advertising of credit. Where required, all advertising, press releases, and marketing materials for the bank's lending activities must include a facsimile of the equal housing lender logotype and legend.

Applications and Information Gathering Oral or written statements that tend to discourage potential applicants on a basis prohibited by law must not be employed with regard to oral or written inquiries and applications. The application process must be neutral in nature and of a type applicable to every applicant desiring the same kind and amount of credit. Credit analysts, private bankers, and other bank employees involved in the loan origination process may not ask prohibited questions regarding:

- A spouse or former spouse
- Marital status
- Familial status
- Military status

- Sex
- Alimony, child support, or separate maintenance income
- Child bearing
- National origin
- Race
- Color
- Religion
- Sexual orientation

Application Processing and Evaluation and Loan Application Second Review Process A bank must not use any information it obtains to discriminate on a prohibited basis. No loan application submitted to the bank will be declined unless the decision to decline is supported by sufficient documentation.

Credit Extension A bank must commit that it will not discriminate on a prohibited basis in the extension or denial of credit.

Notification A bank is required to provide notices of action taken on loan applications in accordance with the provisions of the ECOA and Federal Reserve Board Regulation B, described above.

Record Retention A bank is required to maintain the following information, as required by law:

- Application form
- Written or recorded information used in evaluating an application
- Written or recorded information regarding any action taken concerning a new or existing extension of credit, including a copy of any statement of specific reasons for adverse action
- Information obtained for purposes of government monitoring
- Any claim or accusation of alleged discrimination or other violation of law submitted by an applicant or existing customer

Unless a shorter retention period is permitted by applicable law, the information listed above must be maintained for a minimum of 12 months (non-consumer) or 25 months (consumer) after the date on which the bank notifies an applicant of action taken on an application or of incompleteness of an application.

Government Monitoring Program As required by applicable law, a bank is required to request and maintain information from loan applicants on race,

ethnicity, and sex to allow the government to monitor compliance with nondiscrimination laws.

Fair Lending Training Bank personnel involved in lending are required to receive appropriate training on fair lending laws and regulations periodically from the bank.

Regulation C: Home Mortgage Disclosure Act (HMDA)⁹

The instinct of owning a place in which to live and to produce livelihood is a natural dream for every individual and family.¹⁰ The motor powering economic development throughout history has been the desire to have a place to live and a means of transportation. In today's language, that means owning a house and an automobile. That is why the twin backbones of major developed countries and societies have been the housing and automobile industries. The development of mortgage financing in the United Kingdom, Germany, and the United States has helped propel the economies directly and indirectly:

- Economies are propelled *directly* by increasing demand for the products, industries, and services associated with building homes.
- Economies are propelled *indirectly* by satisfying the citizen's natural instinct for ownership by making him/her feel that he/she owns a house—"a piece of the rock." This feeling of ownership makes the citizen proud of his/her citizenship, deepens the feeling of belonging to the country, and enhances the value of the real estate in general, as owners strive to beautify their owned properties by continually maintaining and improving them. Owning a home strengthens the feeling of responsibility towards the citizens' own families and the community at large.

One of the important parameters used by the U.S. Federal Reserve System, in its decision regarding interest rate and monetary policy, is setting the interest rates (as discussed in Chapter 5) and its impact on the housing and automobile industries.

In an effort by the government to monitor home financing activities in every small town, neighborhood, or city throughout the United States, each home mortgage financing participant—including each bank and mortgage finance company—is required to complete a special government form designed to reveal any implicit or systematic discrimination against any minority when it comes to home financing. This act was designed to eradicate to the best possible ability of the government any discriminatory activity, such as the most well-known scheme (practiced in the 1970s) called *red*

zoning. In this scheme, different areas in a city were *red-zoned* to indicate that such areas were high-risk areas and that lending there would be dangerous because of the ethnic character of those who lived there. This practice, of course, made the low-income and poor neighborhoods suffer. The *Home Mortgage Disclosure Act* (HMDA) was enacted by the Congress in 1975 (as amended) and is implemented by the Federal Reserve Board's *Regulation C* (12 CFR 203). HMDA requires financial institutions to maintain and annually disclose data about home purchases, home purchase pre-approvals, home improvement, and refinance applications involving one- to four-unit and multifamily dwellings. It also requires branches and loan centers to display a special HMDA logo on all its communications, publications, Web site, and advertising materials.

Purpose of the Act The purpose of the HMDA is to provide the public with loan data that can be used (1) to help determine whether financial institutions are serving the housing needs of their communities; (2) to assist public officials in distributing public-sector investment to attract private investment to areas where it is needed; and (3) to assist in identifying possible discriminatory lending patterns and in enforcing antidiscrimination statutes. It was also made very clear in the Act that “neither the Act nor this regulation is intended to encourage unsound lending practices or the allocation of credit.”

Reporting Requirements Financial institutions must report data regarding applications for home purchase loans, home improvement loans, and refinancing, whether originated, purchased, turned down, or canceled. HMDA requires lenders to report information on the following:

- The loan, as to its type, amount, and pricing and whether the loan is subject to the *Home Ownership and Equity Protection Act* (15 USC 1639)
- The property, as to its location and type, and the disposition of the application, including whether it was originated or denied; in case of denial, lenders must report the reason for declining
- The applicant's ethnicity, race, gender, and gross income for mortgage applicants and borrowers
- In case loans are sold, the type of purchaser for mortgage loans that were sold

Denial Reasons and Other Data Financial institutions regulated by the OCC, such as national banks, are required to provide reasons for denials. Providing reasons for denials is optional for financial institutions supervised by the Federal Reserve and the FDIC.

Disclosure As the result of amendments to the HMDA incorporated within the *Housing and Community Development Act* of 1992, an institution must make its disclosure statement available to the public at its home office within three business days of receipt.

Training and Oversight Responsibilities Each loan officer is required to attend HMDA training at least annually.

Regulation Q: Prohibition Against Payment of Interest on Certain Deposit Account Types

Regulation Q prohibits banks from paying interest on *demand deposit accounts* (DDA). Banks, however, may pay interest on *negotiable order of withdrawal* (NOW) checking accounts offered to consumers and certain entities (but not to commercial enterprises, other than sole proprietorships).

This regulation is very interesting for Islamic bankers and RF bankers, because it stipulates *not to pay interest*. I am stating this because in many of the applications made by Islamic bankers to operate in the West, one of the main negotiation issues has been the payment of interest on some deposits and the requirement of many of the Islamic banking eminent scholars to expose the bank deposits to bank profit and loss, with the possibility of losing depositors' money. We will discuss this issue further in Part Two of this book.

Regulation D: Reserve Requirements for Depository Institutions (Banks)

As we discussed in the section on Regulation Q, banks are not allowed to pay interest on their *demand deposit account* (DDA) checking accounts. Regulation D was devised after the introduction of what are known as NOW (*negotiable order of withdrawal*) accounts, which were allowed to earn interest in order to allow banks to compete with investment banks, whose banking products included interest-bearing money market mutual funds that offered interest on invested cash (deposits that are not FDIC-insured). The regulation was devised in an effort to limit frequent withdrawals from these accounts, which may cause the bank to undermine its long-term investment commitment in the community (by keeping a larger percentage of its assets in cash to meet these unexpected withdrawals). Following are the objectives of Regulation D:

- To establish reserve requirement guidelines
- To regulate certain early withdrawals from certificate of deposit accounts

- To define what qualifies as *DDA/NOW* accounts (please see Regulation Q regarding eligibility rules for interest-bearing checking accounts)
- To define limitations on certain withdrawals on savings and money market accounts
- To establish that unlimited transfers or withdrawals are permitted if made in person, by ATM, by mail, or by messenger

In all other instances there is a limit of six transfers or withdrawals per month. No more than three of these transactions may be made payable to a third party (by check, draft, point-of-sale, etc.).

The bank must close accounts where this transaction limit is constantly exceeded.

Regulation O: Loans to Bank Insiders

This regulation was devised to make certain that bank insiders, such as directors, senior management, and/or principal shareholders, are not getting preferential treatment when they deal with the bank (e.g., by obtaining credit at lower rates than the public), are not given preferential credit standards when they apply for credit (e.g., by receiving higher rates on their deposits), do not have access to other customers' private information, and do not "front" others in making business decisions based on their preferred position and insiders' information.

Regulations P and S

Regulation P requires all banks and financial institutions to safeguard all personal financial information given by the customer and not to release any such information to a third party, be it an affiliate, an advertising agency, or even a government agency, unless authorized by that customer. In addition, the financial institution is required to mail all its customers a letter—on an annual basis—detailing the institution's *privacy policy*. A copy of the letter sent by one of the community banks is shown below.¹¹ It is also interesting to note that if a wife opens an account in her name only, her husband cannot get any information about that account without the approval of the owner of the account (the wife).

This regulation is considered to be an important expression of the Judeo-Christian-Islamic value system, which has at its core a fundamental and keen intent to respect and guard private and personal information. In fact, this kind of policy is an important feature of the Law (Shari'aa) that should be highlighted to RF banking scholars, as they expand their efforts to establish a universal set of regulations that will truly express these values

of the Judeo-Christian-Islamic system. Many countries claim they apply Shari'aa as the source of their legal systems or as the foundations of their legal systems, but they have no respect for the private domain of their citizens. In these countries, financial, personal, and corporate information is compromised easily and privacy is violated without a court order or even allowing those whose rights were violated any legal recourse.

Please see Box 7.1 for a sample privacy letter that the Bank of Whittier sends to its customers.

BOX 7.1: A SAMPLE PRIVACY LETTER SENT TO ALL CUSTOMER AT LEAST ONCE A YEAR¹²
BANK OF WHITTIER, NA RIGHT TO FINANCIAL PRIVACY POLICY

BECAUSE YOUR TRUST IS SO IMPORTANT

Your trust is the cornerstone of our relationship. This is why we work diligently to safeguard your privacy. The information that you provide us is kept in the strictest confidence. We have no intention of selling personal information about you, the Customer(s), to any third-party businesses. We are proud to make this commitment to our Customers, because your trust is the foundation of our business. The following privacy policy explains how we use and protect information about our Customers. Please read this very important information carefully.

NOTICE OF CUSTOMER'S FINANCIAL PRIVACY RIGHTS

The terms "we," "our," and "us," when used in this notice, are defined as Bank of Whittier, N.A.

We define our "Customers" or "you" as having a continuing relationship through the following types of accounts with us:

- Deposit account
- Loan account
- Safe deposit box

As the Customer of the Bank, you will be notified of any sources for nonpublic personal information we collect on you. We will notify you as to any measures we have taken to secure the information. We must first define a few terms:

Nonpublic personal information is information about you that we collect in connection with providing a financial product or service to you. Nonpublic personal information does not include information available from public sources, such as telephone directories or government records.

An “affiliate” is a company we own or control; a company that owns or controls us; or a company that is owned or controlled by the same company that owns or controls us. Ownership does not mean complete ownership, but means owning enough to have control.

A “nonaffiliated third party” is a company that is not an affiliate of ours.

THE BANK OF WHITTIER, N.A. PRIVACY PROMISE FOR CUSTOMERS

While information is the cornerstone of our ability to provide superior service, our most important asset is our customers’ trust. Keeping customer information secure, and using it only as our customers would want us to, is a top priority for all of us at Bank of Whittier.

Our promise to our Customers:

We will safeguard, according to strict standards of security and confidentiality, any information our customers share with us.

We will limit the collection and use of customer information to the minimum required to deliver superior service to our customers, which includes advising our customers about our products, services, and other opportunities as well as administering our business.

We will permit only authorized employees who are trained in the proper handling of customer information to have access to your information. Employees who violate our Privacy Promise will be subject to our normal disciplinary process.

We will not reveal customer information to any external organization unless we have previously informed the customer in disclosures or agreements, have been authorized by the customer, or are required by law or our regulators.

We will always maintain control over the confidentiality of our customer information.

Whenever we hire a third party to provide support services, we will require them to conform to our privacy standards and conduct regular audits to ensure compliance.

For purposes of credit reporting, verification, and risk management, we will exchange information about our customers with reputable reference sources and clearing-house services.

(continued)

We will not use or share—internally or externally—personally identifiable medical information for any purpose other than the underwriting or administration of a customer’s account, or as disclosed to the customer when the information is collected, or to which the customer consents.

We will attempt to keep customer files complete, up to date, and accurate. We will notify our customers on how and where to conveniently access their account information (except when we are prohibited to do so by law) and how to notify us about errors, which we will promptly correct.

THE CONFIDENTIALITY, SECURITY, AND INTEGRITY OF YOUR NONPUBLIC PERSONAL INFORMATION

We restrict access to nonpublic personal information about you to only those employees who need to know the information to provide products or services to you. We maintain physical, electronic, and procedural safeguards that comply with federal standards to guard your nonpublic personal information.

THE NONPUBLIC PERSONAL INFORMATION THAT WE COLLECT

We collect nonpublic personal information about you from the following sources:

- Information we receive from you on applications or other forms
- Information about your transactions with us
- Information about your transactions with nonaffiliated third parties
- Information we receive from a consumer reporting agency

THE NONPUBLIC PERSONAL INFORMATION THAT WE DISCLOSE

We do not disclose, nor do we reserve the right to disclose, any nonpublic personal information about our customers or former customers to anyone, except as permitted by law.

Regulation Z: Truth in Lending Act

This regulation is one of the most important consumer protection regulations in the United States, as well as to RF (Islamic) bankers around the

world. Prior to its enactment, banks lent money at a purportedly low interest rate, but they would charge a number of additional fees that, if added up, would result in a much higher implied interest rate. It was imperative to legal experts and regulators to create a standardized “yardstick” by which the consumer could compare various banks’ offers to finance his/her needs. That was the motivation behind Regulation Z, which requires that whenever money changes hands between two persons or entities, the return realized should be expressed in terms of an “implied” interest rate, and that in calculating it, all pertinent fees and costs should be included.

Regulation BB: Community Reinvestment Act (CRA)

The Community Reinvestment Act (CRA) requires banks to define an assessment area that they will be serving. Based on this, the regulators monitor the bank’s lending activities to make sure that:

- The bank’s loan to deposit ratio is at least 50 percent.
- The bank’s loan portfolio has at least 50 percent of its loans extended to entities in the declared assessment area.
- The bank lends to all segments of the community that reside in the assessment area without discrimination and in a way that reflects the demographic nature of the communities residing in these areas.

This is an important regulation that is needed for most, if not all, of the developing countries of the world, including those which have a thriving RF banking industry. One of the most important revelations of God to all of us in all His messages and through all of His messengers, as taught by the Judeo-Christian-Islamic value system, is to reinvest in the communities to which one belongs and from which banks gather their deposits. This regulation is very important, because in my travels throughout the world, both in the developing non-Muslim and Muslim countries, I was sorry to see the public underserved. The banks collected peoples’ savings and reinvested them in financing projects that were only short term in nature; most of the financing was done to facilitate imports-related businesses, rather than long-term development and strategic projects. I also discovered that in most of these countries, most banks’ loan-to-deposit ratio is 50 percent or less. If this happened in a bank in the United States, the bank would be cited by the regulators for not implementing the CRA and would be required to increase its financing activity in the community. If the bank did not comply within a limited time, its license to operate would be revoked.

Another disappointing fact is that banks in many of these countries invest the liquid money left over in their coffers outside the country, which

results in two violations. The first is violating our covenant with the higher authority, God, to reinvest in our communities and to change the fortunes of all people to a better future. The second violation is a violation of the Community Reinvestment Act, CRA. One time, I was visiting a country in North Africa and during a meeting with local bankers, I shared with them the aspects of the CRA applied in the United States. It was a great revelation to them. I told them that in the United States, according to this CRA, all insured depository institutions are required to reinvest in the communities they serve. It was also suggested that government regulators should require banks there to spend documented efforts with measured acceptable results in an effort to increase banking and credit services to all people, including low- and moderate-income areas, communities, and individuals. Insured depository institutions in America must display and make available to the public a CRA notice describing their activities and efforts to serve local communities. To meet that requirement, each bank branch must have a current CRA public file or access to it via the company's intranet. The bank has 10 days to provide the information to any questions on CRA if asked in person or via mail.

Regulation DD: Truth in Savings Act

Regulation DD requires all banks and other depository, savings, and investment institutions to be truthful when they advertise the interest rate they promise to pay the customer who deposits and/or saves with them and the return on investment realized when a customer invests with one of these institutions. Some banks and financial representatives, in their pursuit to attract as many deposits and investments as possible, quote and/or promise higher "interest" or "returns" in their advertising. Regulation DD requires the bank to be complete in advertising the interest rate based on a universal standard format that is used to calculate the interest on deposits, so that the customer can make a fair comparison. This standard will help the consumer make an educated decision when he/she decides to invest or save. For example, the bank must disclose the method it used when it calculated the promised rate—for example, whether the advertised rate was a *compounded* or a *simple* rate.

Fair Credit Reporting Act

This act requires all financial institutions and banks to exercise great care to be accurate and truthful while reporting their customers' credit history and pattern of paying back their debts and commitments to credit reporting agencies. It is a known fact that consumers' credit ratings are of prime importance when a bank decides whether to extend credit to and/or to do business with a customer. That is why the regulation stipulates detailed

methods, ways, and means to ensure protection of the consumer and correction of errors if these errors occur, as well as charging penalties if the report was erroneous—particularly if it was intentional.

Anti-Money-Laundering Program

To enhance domestic security following the terrorist attacks of September 11, 2001, Congress passed the USA PATRIOT Act, which contained provisions for fighting international money laundering and blocking terrorists' access to the United States and global financial systems. The provisions of the USA PATRIOT Act that affect banking organizations were generally set forth as amendments to the Bank Secrecy Act or BSA, which was enacted in 1970. The BSA requires financial institutions doing business in the United States to report large currency transactions and to retain certain records, including information about persons involved in large currency transactions and about suspicious activity related to possible violations of federal law such as money laundering, terrorist financing, and other financial crimes. The BSA also prohibits the use of foreign bank accounts to launder illicit funds or to avoid U.S. taxes and statutory restrictions. The U.S. Department of the Treasury maintains primary responsibility for issuing and enforcing regulations to implement this statute.

However, the Department of Treasury has delegated to the federal financial regulatory agencies the responsibility for monitoring banks' compliance with the BSA. The Federal Reserve Board's Regulation H requires banking organizations to develop a written program for BSA compliance. During examinations of state member banks and U.S. branches and agencies of foreign banks, Federal Reserve examiners verify an institution's compliance with the recordkeeping and reporting requirements of the BSA and with related regulations, including those related to economic sanctions imposed by Congress against certain countries, as implemented by the Office of Foreign Assets Control or OFAC. It is beyond the scope of this book to detail such regulations.

Bank Examination for Safety and Soundness by Bank Regulators

Every bank in America is examined on a regular basis (if it is a large bank, the OCC would have permanent examiners on site throughout the year) or on a cyclical basis (in the case of smaller banks, the cycle would be from 12 months in the case of banks that need closer supervision to 18 months for banks that are known to have wise management and a proven track record). The following is a typical letter from the regulators to the bank president (in this case, it was me at the Bank of Whittier, NA¹²) to prepare all the documents needed to examine the bank. The reader will appreciate the detailed

nature of the examination as shown in the letter; it is usually conducted by five to eight examiners over a period of two to four weeks—or more, depending on the size and the condition of the bank. After concluding the examination, the bank is rated by the OCC according to each of five important parameters: Capital, Assets, Management, Earnings, and Liquidity (CAMEL). A bank with a rating of 1 or 2 is considered superior, and of medium status if it is rated 3. A bank that is rated 4 or below is required to agree to a *Memorandum of Understanding* (MOU) with the regulators, in which the bank makes promises about how it will operate and fix its problems according to a preapproved time table in the future. Or if the bank is in bad shape, it get a *Cease and Desist* order (C and D), and if not fixed, its charter is revoked. It is also important to note that not all regulations are tested every year and that in some years a particular focus is taken (for example, if there is a high historic risk of flooding, the OCC examination adds a close focus on flooding compliance). It is also interesting here to recommend that compliance with Shari'aa could be a part of this examination process in cases when a bank chooses to include RF banking services as part of their service to the public.

Box 7.2 is a copy of what a bank receives from the regulators in order to prepare for the annual regulatory examination.

BOX 7.2: OCC REQUEST LETTER: FROM THE OCC OFFICE TO THE BANK'S PRESIDENT:

In order for us to prepare effectively for this supervisory activity, we are asking you to provide the information listed in digital format. If this is not practical or becomes inefficient for you, please provide copies of the requested documents. Other large items may be provided in hardcopy form for return to the bank. Please indicate which items should be returned to the bank.

Please make available the following upon our arrival on (date of exam). Please forward any items marked by a check (X) to our Southern California–North Field Office by [*deadline for submitting the requested documents*].

MANAGEMENT AND SUPERVISION

Unless otherwise stated, please provide the most recent information on the following:

- The Board packet. Any information included in the packet and requested below need not be duplicated.

- Current organizational chart.
- If any changes have occurred since the last examination, a list of directors and executive management, and their backgrounds, including work experience, length of service with the bank, etc. Also, a list of committees, including current membership.
- A list of officers' salaries and compensation.
- If any changes have occurred since the last examination, a list of related organizations (e.g., parent holding company, affiliates, and operating subsidiaries).
- Most recent external audit reports, management letter, engagement letter, and management's responses to findings (including audits of outside service providers, if applicable).
- The internal audit schedule for the current year, indicating audits completed with summary ratings, and in process.
- Most recent internal audit reports, including management's responses. Include (20XX) audit reports covering loan administration, funds management and investment activities, Bank Secrecy Act program, risk based capital computations, information processing, and any audit areas that were assigned a less than satisfactory rating.
- Brief description of new products, services, lines of business, or changes in the bank's market area.
- List of data processors and other servicers (e.g., loan, investment). The detail of the list should include:
 - a. Name of servicer.
 - b. Address of servicer.
 - c. Contact name and phone number.
 - d. Brief explanation of the product(s) or service(s) provided.
 - e. Note of any affiliate relationship with the bank.
 - f. For example, services provided may include the servicing of loans sold in whole or in part to other entities, including the service provider. OCC examiners will use this list to request trial balances or other pertinent information not otherwise requested in this letter.
- Minutes of board and major committee meetings (e.g., Audit, Loan, Asset/Liability Management, Fiduciary, and Technology Steering Committee) since our last examination.

(continued)

ASSET QUALITY

Please provide copies of the following [*dated as of XXXX*]:

- List of watch list loans, problem loans, past-due credits, and non-accrual loans.
- List of the ten largest credits, including commitments, made since the last examination and the new loan report for the most recent quarter.
- Concentrations of credit reports.
- Policy, underwriting, collateral, and documentation exception reports.
- List of insider credits (to directors, executive officers, and principal shareholders) and their related interests. The list should include terms (rates, collateral, structure, etc.).
- List of loan participations purchased and sold, whole loans purchased and sold, and any securitization activity since the last examination.
- List of overdrafts.
- Analysis of the allowance for loan and lease losses including any risk rating changes from the most recent quarter.
- List of other real estate, repossessed assets, classified investments, and cash items.
- List of small business and farm loans “exempt” from documentation requirements.
- Latest loan review report, including any responses from the senior lending officer, account officers, etc.
- List of board-approved changes to the loan policy and underwriting standards since the last examination.
- The loan trial balance.
- The bank’s loan policy including a description of the bank’s risk rating system.

FINANCIAL PERFORMANCE

Unless otherwise stated, please provide the most recent information on the following:

- Most recent Asset Liability Committee (ALCO) package.
- Most recent reports used to monitor and manage interest rate risk (e.g., gap planning, simulation models, and duration analysis).
- Most recent liquidity reports (e.g., sources and uses).
- List of investment securities purchased and sold for [20XX] and [20XX]. Please include amount, seller/buyer, and date of each transaction.
- Most current balance sheet and income statement.
- Most recent strategic plan, budget, variance reports, etc.
- Current risk-based capital calculation.
- Securities acquired based upon “reliable estimates” authority in 12 CFR 1.3(i).
- Securities acquired using the bank’s lending authority.
- The pre-purchase analysis for all securities purchased since the last examination.
- A summary of the primary assumptions used in the IRR measurement process and the source.
- Current contingency funding plan.
- Investment portfolio summary trial, including credit ratings.
- The list of board-approved securities dealers.
- List of shareholders and ownership.
- Most recent annual and quarterly shareholders’ reports.
- Most recent Report of Condition and Income (call report).
- List of pending litigation, including a description of circumstances behind the litigation.
- Details regarding the bank’s blanket bond and other major insurance policies (including data processing–related coverage). Provide name of insurer, amount of coverage and deductible, and maturity. Also, please indicate the date of last board review and whether the bank intends to maintain the same coverage upon maturity.
- Summary of payments to the holding company and any affiliates.
- Bank work papers for the most recent call report submitted.

CONSUMER COMPLIANCE

The consumer compliance examination is being conducted under the authority of 12 USC 481. However, it also constitutes an

(continued)

investigation within the meaning of section 3413 (h) (1) (A) of the Right to Financial Privacy Act. Therefore, in accordance with section 3403 (b) of the Act, the undersigned hereby certifies that the OCC has complied with the Right to Financial Privacy Act, 12 USC 3401, et seq. Section 3417 (c) of the Act provides that good faith reliance upon this certification relieves your institution and its employees and agents of any possible liability to the consumer in connection with the disclosure of the requested information.

Unless otherwise stated, please provide the most recent information on the following:

- A list of approved changes to the bank's compliance policies and procedures since the last examination.
- A description of the bank's training programs and criteria for ensuring that employees receive job appropriate compliance training.

FLOOD DISASTER PROTECTION ACT

Bank's policy and procedures applicable to compliance with the FDPA:

- A copy of bank contract(s) with third parties performing flood determination services.
- Flood maps used to determine whether a property is in a standard flood hazard area (SFHA), if available.
- A copy of flood notices.
- List of all loans located in special flood hazard areas.

EXPEDITED FUND AVAILABILITY ACT

- The bank's Reg. CC policy.
- Copy of your funds availability disclosure.
- Hold reports and/or records from the main office and branch office(s) for the past month.

PRIVACY OF CONSUMER FINANCIAL INFORMATION

- Copies of privacy and information security policies and procedures.
- Describe key internal controls that ensure compliance.

- Copies of privacy notices (initial, annual, revised, opt-out, short-form, and simplified).
- List of affiliates and nonaffiliated third parties to whom the bank discloses nonpublic personal information about consumers, customers, and former customers:
 - Outside of the regulatory exceptions (Sections 13, 14, and 15); and
 - Under Section 13, including joint marketing agreements
- Describe how the bank ensures that nonpublic personal information received from nonaffiliated financial institutions is reused and redisclosed according to regulatory requirements, and describe such sharing activities.
- Any records supporting the bank's categorization of its information sharing practices under Sections 13, 14, and 15, and outside the regulatory exceptions, if available.
- Information sharing agreements and contracts between the bank and its affiliates and between the bank and non-affiliated third parties.
- A list of consumers who have opted out of the disclosure of nonpublic personal information to nonaffiliated third parties.
- Consumer and customer complaints regarding the treatment of nonpublic personal information.
- Nonaffiliated third-party complaint logs, telemarketing scripts, and any other information obtained from nonaffiliated third parties, if available.
- Compliance and audit work papers related to privacy.
- Training program information and materials.

RIGHT TO FINANCIAL PRIVACY ACT

- Policies and procedures on the Act.
- Requests for customers' financial records received from federal government authorities since the last examination.

Bankruptcy Laws¹⁴

One important and often abused privilege of U.S. citizens and businesses is the ability of the person or entity that obtained a credit facility to stand

before a special bankruptcy judge in court to present the reasons why the person or the entity cannot meet their obligations by paying back what he/she owes the bank or the financial institution. These bankruptcy laws are called different names depending on the nature of the problem and the solution. If there is an economic slowdown and demand declines, resulting in lower sales and hence lower net profits, the owner of the business can file for a request to the court to protect him/her and his/her business against foreclosure by creditors. The owner of the business would be requested to present the court with a plan to reorganize that contains a reduction of the monthly payment on a loan and/or partial loan forgiveness as well as a timetable to get out of this dire situation. Another purpose of the bankruptcy laws is to maximize returns under adverse conditions by providing an orderly distribution of assets and debts.

This facility is considered an important development and a fair “safety valve” in the business of giving credit and in financing. Very disturbing situations and penalties have been reported regarding the failure of a borrower to meet his/her obligations to a bank for good and justifiable causes in other countries—including Islamic countries. Borrowers who do not fulfill their credit obligations are systematically jailed by the government, which resorts to throwing the business owner in jail and taking over the facility. In most cases, the facility is pillaged, the employees are laid off, and the facility is sold for next to nothing. Many developing countries practice such painful and unproductive “therapy.” I understand that this action can be condoned, and that this approach should be applied for those who defraud others by lying on an application for credit, intentionally misusing and siphoning funds outside the company or country, and/or outright racketeering. This must be done by following due process according to the law and in the courts of law. On the other hand, the world has seen wonderful, honorable business people end up in jail in one country or another in Africa, Asia, or the Middle East, and their facilities—along with the households of many of their employees—are shut down just because the economy is in decline or a government official wants to settle a political grudge. That is another area that needs pioneering and dedicated work among the RF (Islamic) banking scholars who believe in applying the credible and attractive Judeo-Christian-Islamic value system to the RF banking system that we all aspire to grow. It is strongly recommended that similar provisions be included in Shari’aa guidelines by which RF banks operate.

NOTES

1. Source: American Bankers Association (ABA), Private Communication: As of the end of 2007, there are 42,386 national (commercial) bank branches, 42,895

- state commercial bank branches, 9801 national savings banks, 4067 state saving banks (savings banks used to be called savings & loan associations and financed homes and apartments), and 11 foreign banks.
2. Comptroller of the Currency Administrator of National Banks: National Banks and The Dual Banking System, September 2003.
 3. Ibid.
 4. Ibid.
 5. Ibid.
 6. For more information about the OCC, contact the Office of the Comptroller of the Currency, Communications Division, Washington, DC 20219, via telephone at 202-874-4700, or via the Web at www.OCC.Treas.gov.
 7. As stipulated by the authority of regulation 12 U.S.C. 1818(a), 1819 (Tenth), 1828(a): Part 328 describes the official sign of the FDIC and prescribes its use by insured depository institutions. It also prescribes the official advertising statement insured depository institutions must include in their advertisements. For purposes of part 328, the term “insured depository institution” includes insured branches of a foreign depository institution. Part 328 does not apply to non-insured offices or branches of insured depository institutions located in foreign countries.
 8. Banking regulations are labeled by an alphabetical letter, starting from A to Z and then AA to, say, CC. For a detailed listing and description of these regulations, please visit the U.S. Treasury Department Web site.
 9. Pronounced “Hamda.”
 10. Yahia Abdul Rahman and Abdullah Tug: “Towards a LARIBA (Islamic) Mortgage Financing in the United States Providing an Alternative to Traditional Mortgages,” Harvard University School of Law, October 9–10, 1998 (Presentation).
 11. Privacy letter sent annually by Bank of Whittier, NA. This letter is a copy of the 2007 edition of that letter.
 12. Ibid.
 13. The Request Letter sent by OCC to Bank of Whittier President in March 2008 to request documents that will help in their examination of the bank.
 14. www.uscourts.gov/bankruptcycourts/bankruptcybasics/discharge.html. Chapter 7: The chapter of the Bankruptcy Code providing for *liquidation* (i.e., the sale of a debtor’s nonexempt property and the distribution of the proceeds to creditors). Chapter 9: The chapter of the Bankruptcy Code providing for reorganization of municipalities (which includes cities and towns as well as villages, counties, taxing districts, municipal utilities, and school districts). Chapter 11: The chapter of the Bankruptcy Code providing (generally) for reorganization, usually involving a corporation or partnership. (A Chapter 11 debtor usually proposes a plan of reorganization to keep its business alive and pay creditors over time. People in business or individuals can also seek relief in chapter 11.) Chapter 12: The chapter of the Bankruptcy Code providing for

adjustment of debts of a “family farmer” or “family fisherman” as those terms are defined in the Bankruptcy Code. Chapter 13: The chapter of the Bankruptcy Code providing for adjustment of debts of an individual with regular income. (Chapter 13 allows a debtor to keep property and pay debts over time, usually three to five years.) Chapter 15: The chapter of the Bankruptcy Code dealing with cases of cross-border insolvency.