Banking Legislation & Policy

January - March 2002

Volume 21, Number 1

HIGHLIGHTS

Recent Developments

Enron Bankruptcy Stimulates Legislative Activity

The controversy surrounding Enron and Arthur Andersen has stimulated many legislative proposals that could affect a wide range of companies, including banks. This issue of *Banking Legislation and Policy* reviews one of these bills: the Comprehensive Investor Protection Act of 2002 (see page 5). This bill touches on a number of issues that have become focal points of the Enron-related reform efforts: auditor independence, analyst conflicts of interest, and oversight of the accounting industry.

Rep. LaFalce Introduces Optional National Insurance Charter Legislation

On February 14, 2002, Rep. LaFalce introduced the Insurance Industry Modernization and Consumer Protection Act (H.R. 3766). This bill proposes, among other things, a system of optional national chartering for insurance companies.

Today, the insurance industry is regulated almost entirely at the state level. Each of the 50 states has its own insurance commissioner who regulates companies practicing in that state. But increasingly, the insurance business has become a national one, with insurers offering their products nationwide. The passage of Gramm-Leach-Bliley in 1999 removed barriers that kept banks, securities firms, and insurers from affiliating with one another. Some insurance companies argue they operate at a competitive disadvantage compared to banks and brokerage houses, which are regulated at the federal level. For example, introducing a new life insurance product nationwide could require separate regulatory approvals in every state.

The Insurance Industry Modernization and Consumer Protection Act would offer the alternative of a national charter, with corresponding federal oversight and regulation. The bill would also establish minimum standards for market conduct that would apply to all insurers (whether chartered at the national or state level). The bill would also extend federal antitrust law to the insurance industry. For a detailed summary of the bill, see **Summary of Federal Legislation.**

Citibank Reaches Settlement Over The Sale of Its Customer Lists to Telemarketers

On February 27, 2002, Citibank reached an agreement with 26 states, closing a two-year investigation into the practices of telemarketers who were sold customer lists by Citibank. It was alleged that these telemarketers were charging customers for services they did not purchase and charging customers (without any notification) automatically at the end of free trial periods for services.

Citibank agreed to verify that companies using its customers' information are not doing so in a misleading or deceptive manner and to pay $1.6 million for attorney's fees and other costs. In future contracts with telemarketing firms, Citibank will be required to review all scripts and materials that are used to ensure they are not deceptive. Telemarketers that refer to Citibank in their solicitations must clearly state they are not affiliated with Citibank.

Future contracts would require telemarketers to describe the product or service being offered, the terms of any trial offer, any fees, information about any automatic renewal, and the method for canceling. They must inform customers they may obtain a full refund if they cancel within six months of the original purchase. A toll-free number must be made available for consumers to cancel a product or service. Telemarketers would also be required to send customers a written notice of an upcoming renewal for which they will be charged.

Court Rules That Banks Can Be Sued for Alleged Bait-and-Switch Tactics

On February 8, 2002, the United States Appeals Court for the Third Circuit reinstated a claim alleging that Fleet National Bank was engaging in a bait-and-switch game by imposing an annual fee after issuing a card advertised as having no annual fee. The case, *Rossman v. Fleet Bank (R.I.) National Association*, (3rd Cir., No. 01-1094), was originally dismissed by a district court on the grounds that Fleet's disclosures did not violate the Truth in Lending Act (TILA), which is the basis for the plaintiff's suit.

The case stems from a "no-annual fee" credit card the plaintiff received from Fleet in 1999. The initial credit card solicitation and the required "Schumer Box" (which contains important consumer information on the back of the solicitation) both advertised the credit card as having "no-annual fee." However, both the solicitation and the subsequent cardholder's agreement that came with the card stated that Fleet did "reserve the right to change the benefit features associated with your card at any time." In May 2000, Fleet sent a letter to the plaintiff stating its intention to impose a $35 annual fee because of "the Federal Reserve steadily increasing interest rates" over the past several months. It then charged the fee in July to the plaintiff's credit card.

This case hinged on the "no-annual fee" provision of the credit card solicitation and whether Fleet violated TILA by subsequently charging an annual fee. The district court dismissed the case, saying that TILA required the bank's disclosures to be accurate only on the actual day consumers receive their card. In the unanimous decision by the appeals court, the three judges ruled that TILA was designed to protect consumers, and therefore credit card disclosures should accurately reflect future actions.

Until this case, bait-and-switch cases like this one were usually handled in state courts. The decision by the appeals court to reverse the district court's dismissal and remand the case back to the district court could lead to future litigation against credit card issuers who change the terms of an account shortly after it is opened.

SUMMARY OF FEDERAL LEGISLATION

Enacted Legislation

1. Higher Education Act of 1965 Amendment (S. 1762). Introduced by Sen. Johnson (D-SD) on December 4, 2001.

Status: Signed into law by the President on February 8, 2002. Public Law 107-139.

Related Bills: H.R. 2781.

This new public law amends the Higher Education Act of 1965 (HEA) by establishing fixed interest rates for student loans and extending current law with respect to special allowances for lenders. A change to the formula for calculating the interest rates for borrowers and lenders of student loans was set to take place on July 1, 2003. Student lenders and school groups had been urging Congress to make this amendment because of the belief that the system after 2003 would have been too volatile and would force lenders out of the industry.

This law extends the current interest rate structure until a new fixed interest rate system takes effect on July 1, 2006. Until then, new borrowers will pay an annually adjusted interest rate equal to the bond-equivalent of a 91-day Treasury bill plus 1.7 percent (or 2.3 percent during repayment). Lenders will receive an interest rate 2.3 percent higher than what the borrower pays (2.6 percent higher in the case of Federal Direct PLUS and Consolidation loans), which is subsidized by the federal government.

After June 30, 2006, all Federal Direct Stafford Loans and Unsubsidized Stafford Loans will have a fixed interest rate of 6.8 percent. Federal Direct PLUS loans will have a fixed interest rate of 7.9 percent. Federal Direct Consolidation loans will have a fixed interest rate of the lesser of 8.25 percent or the weighted average of the interest rates on the loans consolidated (rounded to the nearest one-eighth of one percent).

New Legislation

1. A Bill to Amend the Small Business Act Microloan Program (H.R. 3646). Introduced by Representative Hilliard (D-AL) on January 29, 2002.

Status: Referred to the House Committee on Small Business.

This bill would increase the maximum amount for which a loan can be made under the Microloan Program from $35,000 to $50,000. The Microloan Program provides very small loans to start-up, newly established, or growing small-business concerns.

2. ATM Consumer Protection Act (H.R. 3662). Introduced by Representative Rothman (D-NJ) on January 29, 2002.

Status: Referred to the House Committee on Financial Services.

This bill would establish security measures for automated teller machines to ensure their convenience and safety. The bill would require ATM operators to establish a security program to help identify persons committing crimes against one of their ATMs (or the users of the ATMs) and designate one security officer per ATM to be responsible for compliance with these standards. The bill would allow the security officers to take measures they feel appropriate to prevent crimes in the vicinity of the machine. Additional requirements for ATM operators would include a surveillance camera capable of viewing the ATM and the three-foot area surrounding it; an alarm system that would notify the nearest law enforcement office in case a crime is being committed; and adequate lighting in the area of the ATM.

3. Federal Deposit Insurance Reform Act of 2002 (H.R. 3717). Introduced by Representative Bachus (R-AL) on February 12, 2002.

Status: Reported out of the House Committee on Financial Services on April 17, 2002.

Related Bills: S. 1945.

This bill would reform the Federal Deposit Insurance System by altering the way the insurance funds are managed and the insurance coverage is priced. Currently, banks and savings associations pay their insurance assessments into separate funds, and these funds provide coverage for depositors depending on the type of institution.

This bill would combine these two funds, the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF), into one fund called the Deposit Insurance Fund (DIF). The bill would also address the amount of deposit insurance coverage offered by the FDIC. In particular, the bill would increase the insurance coverage from $100,000 to $130,000 per account while indexing this coverage level to the rate of inflation (adjusting the coverage level every 10 years). The bill would raise the deposit insurance coverage limit to $260,000 per account for deposit accounts in regular IRAs, which are held at depository institutions.

The bill would remove the current fixed designated reserve ratio (DRR) of 1.25 percent and replace it with a reserve range from 1.00 percent to 1.50 percent. The FDIC would have to designate a target for the DRR prior to each calendar year and publish this target for public comment. The bill would require that when the amount of reserves in the Deposit Insurance Fund exceeds 1.5 percent of the estimated insured deposits, the FDIC rebate funds until this amount reaches the target level set by the FDIC. If the reserves in the DRR exceed 1.4 percent and are less than 1.5 percent, the bill would leave to the discretion of the FDIC whether or not to rebate or credit any amounts until the reserves reach the target level.

Deposits made by a municipality in an office or branch of an insured depository institution in the same state would be insured in an aggregate amount (across all municipal deposits) not to exceed the total equity capital of the depository institution. Currently, municipal demand deposits (in the aggregate) are insured up to $100,000, and municipal time and savings deposits (in the aggregate) are insured up to $100,000.

Finally, the bill would permit the DIF to invest in U.S. government or agency obligations, securities guaranteed by the U.S. government, and other securities with the approval of the Secretary of the Treasury. Currently, BIF and SAIF can invest only in U.S. government obligations and obligations guaranteed by the U.S. government.

4. Insurance Industry Modernization and Consumer Protection Act (H.R. 3766). Introduced by Representative LaFalce (D-NY) on February 14, 2002.

Status: Referred to the House Committee on Financial Services.

This bill would establish the Office of National Insurers (ONI) within the Department of the Treasury. The Office of National Insurers would be led by a director, who would be appointed to a four-year term by the President. The Office of National Insurers would conduct annual on-site financial examinations and market conduct examinations of all national insurers. The bill gives the director the power to revoke the license of a national insurer that is "engaging in conduct involving an undue risk of loss to the national insurer's policyholders" and for other reasons. The bill also grants broad enforcement powers to the director over national insurers, establishes divisions of consumer affairs and fraud within the ONI, and permits the director to undertake international efforts to promote bilateral and multilateral cooperation with respect to insurance regulation.

The bill contains provisions that allow for the chartering and regulation of national insurers. The director would be required to take into account the following factors for parties that wish to be nationally chartered: 1) the character and competency of the parties seeking the charter; 2) the financial resources and future prospects of the proposed national insurer; and 3) whether the chartering of the insurer is likely to be hazardous to the insurance-buying public.

This bill provides initial regulations and calls upon the director to formulate additional regulations for nationally chartered insurance companies regarding adherence to specified accounting principles and auditing standards; investment requirements and limitations; specified standards regarding asset and liability valuation; risk-based capital standards; annual actuarial reporting requirements; and standards for the payment of dividends to shareholders.

The bill details the powers of national insurance companies. These include the ability to enter into legal contracts and guarantees; to acquire and own assets; to engage in the underwriting and sale of insurance; to establish and maintain separate accounts; to form and maintain protected cell companies (protected cells are a pool of assets and liabilities of a national insurer segregated and insulated from the remainder of the national insurer's assets and liabilities); and to exercise all such incidental powers that are necessary to their insurance operations.

The bill allows national insurers to merge or consolidate with or acquire another insurer if the transaction's resulting party is a national insurer. In such cases, the national insurer is subject only to the approval of the director. If the transaction's resulting party is a state insurer, then the transaction is subject to the relevant state law. The director can require notification of such transactions and promulgate regulations concerning notification procedures, but the director has no authority over these transactions.

The bill makes the business of insurance subject to federal antitrust laws to the same extent as any other line of business. Insurance companies would still be exempt under two specific circumstances. First, insurance companies would be permitted to share historical loss data among insurers, but they would not be allowed to share trending data (trending is a process used to determine future insurance rates based upon future expected costs). Second, the exemption would continue to apply for those activities insurers are required to engage in under state law, which are designed to make insurance available to those unable to normally obtain insurance coverage.

The bill stipulates that no state law can interfere with the ability of a nationally chartered insurance company to engage in any activity that the provisions of the bill allow. But nationally chartered insurance companies would be subject to state laws involving taxes, workers' compensation, rate regulation, and others. Nationally chartered insurance companies would also be subject to the corporate governance laws of the state in which their main office is located (which is designated by each of these insurance companies and listed on their national charter) or the state in which their holding company is located.

The bill contains various provisions intended to regulate the sales and marketing practices of insurers, ranging from the prevention of unfair and deceptive practices to unfair discrimination. National and state insurers would have to abide by the market conduct regulations of this bill. States would not be prohibited from legislating or enforcing any statute that would provide greater protections to insurance consumers.

The director would be responsible for chartering and licensing reinsurers at the federal level. The director would be responsible for formulating rules for how transfer of risk in a reinsurance contract is reflected on an insurance company's balance sheet. This law would also preempt state law for federal reinsurers and state-chartered insurers that are purchasing a risk-transfer product from a federal reinsurer.

Internationally, the ONI would be responsible for ensuring that no federal regulation of reinsurers imposes a substantial competitive disadvantage on the United States operations of reinsurers. Also, the director would be responsible for promoting the development of internationally accepted accounting standards for reinsurance.

The U.S. Bankruptcy Code does not apply to domestic insurance companies; on the contrary, state insurers have been subject to receivership proceedings under state insolvency laws. This bill would create a receivership system for national insurers. Unlike state insurers, where insolvency proceedings are handled in state court, this bill would require insolvency proceedings be held in the United States District Court or U.S. court of any territory. Policyholders would be given a higher priority in the distribution scheme for national insurer receiverships than unsecured general creditors.

The bill provides certain protections for policyholders in the case of an insolvent national insurer. To conduct business, nationally chartered and licensed insurers would be required to become members of qualified state guaranty associations in each state in which they operate. A guaranty association is an arrangement that provides protection for policyholders in the event of insolvency of any insurer doing business in the state. If a state does not have a qualifying guarantee association, as determined by the director, national and state-chartered insurers in that state would be required to become members of either the National Life Insurance Guaranty Corporation or the National Property and Casualty Insurance Guaranty Corporation.

5. Comprehensive Investor Protection Act of 2002 (H.R. 3818). Introduced by Representative LaFalce (D-NY) on February 28, 2002.

Status: Referred to the House Committee on Financial Services.

Related Bill: H.R. 3763

Bills Related to Auditor Independence: S. 1896, H.R. 3693, H.R. 3736, S. 2004, and S. 2056.

Bills Related to the Establishment of a Public Accounting Board: H.R. 3795, S. 2004.

Bill Related to Analyst Disclosure: S. 1895.

This bill is an attempt to reform the accounting practices as well as other securities laws for the purpose of protecting investors. Many of the topics in this bill are addressed individually by other pieces of legislation, which are listed above as related bills.

The bill would prohibit auditors from providing the following services to an audit client: 1) bookkeeping; 2) financial information systems design; 3) valuation services and fairness opinions; 4) internal audit services; 5) managerial services; and 6) broker-dealer, investment advisor, or investment banking services. Auditors would still be permitted to offer tax-related services to their audit clients.

The bill would force companies to change auditors every four years. Audit companies would be allowed to seek a one-time extension for an additional four-year term. Accountants who are with the same client for more than the allotted time will not be considered independent for the purposes of certifying the clients' financial statements. The bill also includes corporate governance reforms that provide the audit committee with more responsibility. Audit committees would be given the power to hire and fire their auditors. Also, an audit committee would be required to meet quarterly with its auditors without the presence of the corporate managers.

The bill would create a public regulator, which would have oversight over accountants. A seven-member board would be chosen from the public and have a chairman chosen by the SEC and the Comptroller General. The board, which would be self-funded through assessment fees, would have the power to make its own rules (subject to review by the SEC).

Duties of the board include establishing quality standards for audits, performing individual quality reviews of individual audits, conducting inspections of audit firms, setting independence standards, and establishing ethical standards. The board will have a full range of disciplinary and investigative powers, including the power to subpoena documents and compel testimony.

The bill also addresses the potential for conflict of interest among equity research analysts. It would: 1) ban analysts from holding stock in the companies they cover; 2) prohibit analysts' compensation from being based wholly or in part on investment banking revenue; 3) require analysts' compensation to be based principally on the quality of their research; and 4) require the New York Stock Exchange and National Association of Securities Dealers to establish criteria for evaluating analysts' research quality.

6. Financial Services Regulatory Relief Act of 2002 (H.R. 3951). Introduced by Representative Capito (R-WV) on March 13, 2002.

Status: Referred to the House Committee on Financial Services.

The bill would update many laws that govern the financial services industry with the objective of reducing regulatory burden for depository institutions.

Banks. The bill would remove current restrictions on interstate branching by state and national banks. The bill would allow banks to establish interstate branches on a de novo basis, regardless of the state law. Next, the bill would eliminate state-mandated capital requirements. The bill would expressly permit financial holding companies to cross-market the products of nonfinancial firms in which their merchant banking subsidiaries have invested. The bill would amend the National Bank Act to allow more national banks to seek S Corporation status and its favorable tax treatment. Finally, the bill would remove certain reports that banks must file concerning loans made to insiders of the bank.

Thrifts. Banks are currently exempted from the SEC's broker-dealer registration requirements (although this exemption is due to be revoked by an SEC interim rule that takes effect on May 12, 2002). This bill would exempt thrifts as well. Second, the bill would permit the merger and consolidation of a thrift institution with one or more of its nondepository subsidiaries or affiliates. Third, thrifts would be allowed to make investments that are designed to promote the public welfare, such as investments that would aid low- and moderate-income families with housing and other services. Currently, national and state member banks are permitted to make these public welfare investments, like investing in a small business investment company (SBIC). Thrifts would be permitted to make these types of investments under this bill.

Credit Unions. Credit unions would be allowed to exclude loans they make to nonprofit religious organizations from the amount of their total business loans. The bill would allow privately insured credit unions to become members of a Federal Home Loan Bank. Current law permits only federally insured credit unions to become members.

Finally, the bill would allow credit unions to invest in their service organizations up to 3 percent of the sum of shares and undivided earnings. Service organizations are any firm that provides services associated with the routine operations of a credit union.

SUMMARY OF FEDERAL REGULATIONS

Board of Governors of the Federal Reserve System

Capital Maintenance: Nonfinancial Equity Investments (1 / 25 / 2002)

The FRB, together with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, issued a rule establishing regulatory capital requirements for equity investments made in nonfinancial companies. The rule would apply to financial holding companies, bank holding companies, Edge and agreement corporations, and banking organizations. The rule does not apply to small business investment company (SBIC) subsidiaries, so long as a banking organization's total investment in the SBIC does not exceed 15 percent of Tier 1 capital.

The rule establishes a set of charges against Tier 1 capital based on the total adjusted carrying value of covered equity investments in nonfinancial companies. There would be a capital charge of 8 percent for investments that account for less than 15 percent of an institution's Tier 1 capital. A capital charge of 12 percent would apply to all investments in excess of 15 percent, but less than 25 percent, of the institution's Tier 1 capital level. A capital charge of 25 percent would apply to all investments exceeding 25 percent of the institution's Tier 1 capital.

The agencies reserve the right to closely monitor and levy additional capital charges on an institution if the facts and circumstances indicate that higher charges are necessary in relation to the risk of the institution's nonfinancial equity investments.

The final rule is substantially similar to the proposed rule, which is summarized in *Banking Legislation & Policy*, First Quarter 2001. The one significant difference between the final and proposed rule is that the final rule's capital charges apply only to investments made after March 13, 2000. For further information, see 67 *Federal Register*, pp. 3784-3807. (Regulations H and Y).

Home Mortgage Disclosure Act (2 / 15 / 02)

The Board issued a final rule that, among other things, expands the number of nondepository institutions subject to the Home Mortgage Disclosure Act (HMDA) and requires HMDA reporters to include information on interest rates.

Current regulations require a nondepository lender to submit HMDA data if, in the preceding year, home purchase loan originations comprised at least 10 percent of the lender's total number of originations. This rule adds a dollar value threshold to this coverage test. Nondepository lenders whose prior-year home purchase loan originations, including refinancings, equal or exceed $25 million are required to submit HMDA data, even if they did not cross the percentage threshold.

Currently, lenders are allowed to select from among four criteria when deciding whether an obligation is a refinancing (one criterion is that the existing obligation was secured by a lien on a dwelling). This method has generated inconsistent data to the extent that HMDA reporters are choosing different scenarios to report as refinancings. This new rule modifies the definition of the term refinancing with the goal of standardizing data received from all lenders. The regulatory definition of refinancing is redefined to mean a new obligation that satisfies and replaces an existing obligation by the same borrower, where both the existing and the new obligation are secured by a lien on a dwelling.

Current Board regulations define a home-improvement loan as any loan classified by the lending institution as a home-improvement loan and any part of whose proceeds are to be used for the improvement of a dwelling. The rule modifies this definition by defining any loan that is secured by a dwelling and where part of the proceeds are used for home improvement as a home-improvement loan—regardless of how the institution classifies the loan. The rule is unchanged for those loans not secured by a dwelling: these are only considered home-improvement loans if the lender classifies them as such.

The new rule extends reporting requirements to pre-approvals, as long as the lender specifies: 1) the maximum amount of credit that it commits to extend; 2) the period of time the commitment is valid; and 3) that the commitment may be subject to conditions. The final rule requires creditors to report the spread on loans where the annual percentage rate (APR) charged on loans exceeds the yield on Treasury securities of comparable maturity by 3 percentage points for first lien loans and 5 percentage points for second lien loans. Creditors are also required to indicate whether the loan is covered by the Home Ownership and Equity Protection Act of 1994 (HOEPA) or if the loan involves a manufactured home. For further information, see 67 *Federal Register*, pp. 7221-51. (Regulation C)

In a related rulemaking, the Board is

proposing to require institutions to report whether an originated loan is or would be secured by a first lien on a dwelling, secured by a subordinate lien on a dwelling, or not secured by a lien on a dwelling. The Board requests comment on this proposed requirement and whether purchased loans should be subject to these same requirements. The proposed rule would also require lenders to request information on race, ethnicity, and gender during telephone applications. Currently, lending institutions are permitted, but not required, to request such information. The proposal would require lenders to request such information while still informing applicants of their right to not answer the questions. For reporting purposes, applicants who choose not to answer would be simply coded as a telephone, mail, or Internet applicant.

The Board is also seeking comment on the issue of appropriate price thresholds for determining for which loans lenders must report pricing data (for more information see the final rule above). In particular, the Board seeks comment on what is the appropriate date for determining the APR spread (the final rule stipulates that the spread is calculated by the difference between the APR on the loan and the yield on the comparable Treasury note on the 15th of the month previous to the loan being made). Comments on this rule were due April 12, 2002. For further information, see 67 *Federal Register*, pp. 7252-53. (Regulation C)

Equity Investments (2 / 21 / 02)
The Board of Governors of the Federal Reserve System issued a statement on February 21, 2002, permitting state member banks to hold equity securities as a hedge for equity derivative transactions. An "equity derivative transaction" is a contract that provides for the bank to pay or be paid an amount that is based on the total return or price of either a single equity security, a group of them, or an index based on equity securities.

State member banks will be permitted to hold equity securities only for hedging purposes and are prohibited from holding them for speculative or investment purposes. In order to do so, state member banks must have the authority under applicable state law to enter into equity derivative transactions and to purchase equity securities for hedging purposes. They must also seek prior approval from the director of the Division of Banking Supervision and Regulation before acquiring any equity securities. Finally, they may hold a maximum of 5 percent of the stock of any one issuer.

Financial Crimes Enforcement Network

Money Laundering (1 / 31 / 01)
On December 31, 2001, the Financial Crimes Enforcement Network (FinCEN) issued an interim rule, with request for comment, which will amend regulations of the Bank Secrecy Act. The rule adds a section that requires a report to be filed when a person, while conducting a nonfinancial trade or business, receives more than $10,000 in coins or currency. This required reporting also applies to two or more related transactions in excess of $10,000.

The definition of currency, for the purposes of the proposed and interim rule, includes monetary instruments like cashiers' checks, bank drafts, traveler's checks, and money orders. The interim rule requires reporting of transactions that are almost identical to transactions that must be reported to the Internal Revenue Service (IRS). Comments on this rule were due March 1, 2002. The interim rule became effective January 1, 2002. For further information, see 66 *Federal Register*, pp. 67685-86 or pp. 67680-84.

Information Sharing (3 / 4 / 02)
The Financial Crimes Enforcement Network (FinCEN) published an interim rule, with a request for comment, on March 4, 2002. This rule implements provisions of the USA PATRIOT Act that are intended to prevent money laundering and terrorism.

The rule includes a broad definition of the financial institutions that the rule will cover. In this rule, a financial institution is defined as: 1) an institution that is subject to the reporting of Suspicious Activity Report bulletins (which includes banks, savings associations, credit unions) that is not a money services business; 2) a broker or dealer registered with the SEC; 3) an issuer of traveler's checks or money orders; 4) a registered money transmitter; 5) or an operator of a credit card system that is not in the money services business.

To share information, financial institutions must first certify to the Treasury they will use procedures that ensure the confidentiality of the information and that the information will not be used for unauthorized purposes (this certification must be provided annually). Financial institutions would then be permitted to share information with other qualified financial institutions for the purpose of identifying individuals, organizations, or countries that may be involved in money laundering or terrorist activities.

Financial institutions would not be allowed to use this information other than for the purposes of reporting to law enforcement authorities or determining whether to establish or maintain an account or engage in a transaction. Comments on this proposed rule were due April 3, 2002. For further information, see 67 *Federal Register*, pp. 9879-9887 or pp. 9874-9878.

Information Sharing (3 / 4 / 02)
FinCEN has published a notice of proposed rulemaking in accordance with certain provisions of the USA PATRIOT Act that removed certain barriers to information sharing between financial institutions and federal law enforcement agencies.

The proposed rule would allow FinCEN, at the request of a federal law enforcement agency, to require a financial institution to search its records and determine if it maintains (or had maintained previously) accounts with individuals, entities, or organizations specified by FinCEN.

Additionally, the financial institutions would be required to search for and report on any transactions they have engaged in with the party specified by FinCEN. A federal law enforcement agency requesting such information must certify that the individual, entity, or organization in question is engaged in or reasonably suspected (based on credible evidence) of being engaged in money laundering or terrorist activities. Financial institutions that identify any account or transaction named in the FinCEN request would be required to file a report to FinCEN.

Financial institutions would be prohibited from disclosing information provided to FinCEN to anyone other than FinCEN and the federal law enforcement agency involved in the request. The proposed rule would require financial institutions to maintain adequate security policies to ensure the confidentiality of FinCEN requests for information. Finally, financial institutions could use information provided to FinCEN only to determine whether to establish or maintain an account or engage in a transaction. Comments on this proposed rule were due April 3, 2002. For further information, see 67 *Federal Register*, pp. 9879-9887.

Office of the Comptroller of the Currency

Well-Managed Federal Branches (3 / 4 / 02)
The Office of the Comptroller of the Currency (OCC) issued an interim rule on March 4, 2002, which implements more flexible capital equivalency requirements for well-managed federal branches of foreign banks. Federal branches of foreign banks are required by U.S. law to maintain capital equivalency deposits (CEDs) in trust at other banks. These CEDs must be at least 5 percent of their liabilities and cannot be withdrawn without OCC approval.

The OCC is implementing two changes: First, low-risk branches will be allowed to withdraw excess funds from their CEDs without prior OCC approval. Second, the OCC is amending the way it calculates the CED liability for qualifying branches of foreign banks. International banking facilities, which are arms of a bank that only accept deposits and extend credit to foreign companies and individuals, will be excluded from the liability calculation. The OCC will still require a minimum CED amount of $1 million per branch (even if this amount is greater than the 5 percent) and that the assets in the CED accounts must be free from liens or claims by others. This interim rule became effective January 30, 2002, and comments on it were due April 1, 2002. For further information, see 67 *Federal Register*, pp. 4325-26.

Office of Federal Housing Enterprise Oversight

Prompt Supervisory Response and Corrective Action (1 / 25 / 02)
The Office of Federal Housing Enterprise Oversight (OFHEO) has issued a final rule that implements a prompt supervisory response system and a procedure for taking prompt corrective action. OFHEO is charged with the oversight of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) to ensure that they are adequately capitalized and operated safely. The rule was initially proposed on April 10, 2001.

The first part of the rule establishes a system of prompt supervisory response, which will be used when circumstances at Fannie Mae and Freddie Mac warrant a supervisory review from OFHEO. A prompt supervisory response will be triggered if one of the following five events occurs: 1) OFHEO's national House Price Index for the most recent quarter decreases more than 2 percent from four quarters previously; 2) an enterprise's publicly reported net income for the most recent quarter is less than one-half of its average quarterly net income for any four quarters during the prior eight quarters; 3) an enterprise's net interest margin is less than one-half of its average quarterly net interest margin for any four quarters during the prior eight quarters; 4) the proportion of single-family mortgage loans (owned or securitized by an enterprise) that are delinquent 90 or more days or in foreclosure increased by more than one percentage point compared to the lowest proportion of such loans over the past four quarters; or 5) any other development that OFHEO determines in its discretion presents a risk to the safety and soundness of the enterprise or is a violation of applicable laws or regulations. If any of the aforementioned developments occur at either Fannie Mae or Freddie Mac, the final rule establishes a supervisory response framework that consists of four levels.

The second part of this rule establishes the procedures for OFHEO to take prompt corrective action in response to declines in the capital levels of Freddie Mac and Fannie Mae. The rule sets out two capital classifications schemes that are based on capital thresholds (risk-based capital level, minimum capital level, and the critical capital level): A permanent classification structure that will take effect one year after OFHEO's risk-based capital rule has become effective (September 13, 2002) and an interim capital classification scheme that will be used until then.

OFHEO is required to classify each enterprise four times a year and must provide notice prior to each classification. In these notices, OFHEO is required to describe the proposed capital classification, the information used to base such a classification, and the reasons for the proposed classification. An enterprise has 30 days to submit a written response, providing information they feel is relevant to their capital classification. Finally, OFHEO reserves the right to issue a notice of and undertake the process of capital classification of an enterprise at any time.

The final rule also limits capital distributions by Freddie Mac and Fannie Mae. An enterprise is prohibited from making any capital distribution that would decrease total capital of an enterprise below its risk-based capital level or reduce the core capital of an enterprise below its minimum capital level. An enterprise is prohibited from making any capital distribution that would result in its being classified in a lower capital classification than "adequately capitalized." Finally, an enterprise that is classified as "significantly or critically undercapitalized" is prohibited from making any capital distribution without the prior written approval of OFHEO. The rule became effective February 25, 2002. For further information, see 67 *Federal Register*, pp. 3587-3605.

National Credit Union Administration

Prompt Corrective Action; Requirements for Insurance (3 / 19 / 02)
The National Credit Union Administration (NCUA) issued a final rule on March 19, 2002, that will require all federally insured credit unions to file quarterly financial and statistical reports. Previously, federally insured credit unions with over $50 million in assets had to file these reports, also called call reports, quarterly. Credit unions with less than $50 million in assets previously only had to file these reports semiannually.

The final rule directs the NCUA staff to develop a shorter version of the call report prior to the third quarter of 2002. The rule allows credit unions with less than $10 million in assets to file the shorter version of the call report in the first and third quarters of the year. They still will be required to file the full version of the call report in the second and fourth quarters of the year. The rule is effective July 1, 2002. For further information, see 67 *Federal Register*, pp. 12459-64.

SUMMARY OF JUDICIAL DEVELOPMENTS

On January 22, 2002, the United States Supreme Court announced it had refused to hear two cases that were filed in response to the passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). These two cases, both involving California Federal Bank and the United States government, are among a large number of lawsuits filed against the government after the passage of FIRREA eliminated the use of special accounting treatment for intangible assets granted to the acquirers of failing thrifts.

The first case (*California Federal Bank FSB v. U.S.*, U.S., No. 01-592) was an appeal by the U.S. government on a ruling of damages against it. California Federal Bank was awarded damages of about $23 million by the United States Court of Federal Claims because of the government's "breach of an agreement to allow plaintiff to treat liabilities acquired from failing thrifts as goodwill that satisfied capital requirements." The second case (*U.S. v. California Federal Bank FSB*, U.S., No. 01-698) was an appeal of the Federal Circuit's decision that a contract actually existed between California Federal Bank and the U.S. government. The government contested the presence of a contract between it and California Federal Bank, saying that an exchange of documents between California Federal Bank and financial regulators did not constitute a contractual promise on the part of the United States government.

For further information on the issue of FIRREA and subsequent goodwill litigation, see *Banking Legislation & Policy*, Second Quarter 1999. It summarizes the case of *Glendale Federal Bank, FSB v. The United States* and provides more background information on the passage of FIRREA and the subsequent litigation against the United States government.

On March 1, 2002, the United States Appeals Court for the Ninth Circuit ruled that furnishers of credit information can be sued under the Fair Credit Reporting Act (FCRA) if they distribute disputed credit information without attempting to verify its accuracy. The appeals court took the position presented by the Federal Trade Commission (which appeared as a friend of the court) that furnishers of information (e.g., a mortgage lender) can save themselves from liability by simply investigating a disputed item and reporting their findings to credit reporting agencies (CRAs).

The case resulted from a mortgage loan from Chase Manhattan Mortgage Company to Mr. Nelson and a co-signatory in 1995. In 1998, the co-signatory filed for bankruptcy while Mr. Nelson continued to make the payments on the mortgage in a timely fashion. Subsequently, Mr. Nelson had difficulties obtaining financing on several occasions, because of a bankruptcy being noted on his credit report. He disputed this claim with two CRAs and with Chase. But the bankruptcy was still noted on his credit report in 1999, at which time he filed suit against Chase for failing to comply with FCRA. The District Court of Nevada dismissed the suit, holding that the applicable section of the FCRA did not allow for private lawsuits. The court of appeals noted that the primary purpose of the FCRA was to protect consumers from inaccurate and incomplete credit reporting. The court concluded that allowing injured consumers such a private remedy would serve this main purpose of the FCRA.

Additionally, the court concluded that Congress had very carefully drafted the FCRA to strike a very delicate balance between consumers, CRAs, furnishers of credit information, and users of credit information. Thus, the court concluded that it could not "introduce limitations on an express right of action where no limitation has been written by the legislature."

On March 14, 2002, the United States Court of Appeals for the Ninth Circuit ruled that banks are prohibited from using directly deposited Social Security and supplemental security income (SSI) benefits to offset overdrafts and overdraft charges. The court ruled that the practice violated federal law that extends protections to Social Security and SSI benefits. The case, *Lopez v. Washington Mutual Bank Inc.*, (9^{th} Cir., No. 01-15303, 3/14/02), was the result of a lawsuit brought by Luis Lopez and other Social Security recipients against Washington Mutual Bank Inc. In the case of each plaintiff, their accounts were debited to cover for overdrafts previously incurred on the account. Notice of this procedure was provided in disclosures that the consumers were given when opening the account. The funds that Washington Mutual used turned out to have been directly deposited Social Security and SSI benefits.

The decision by the court focused on whether the plaintiffs had given consent for Washington Mutual to use their directly deposited Social Security and SSI benefits to cover their account deficiencies. The court noted that the Social Security Act prohibits the use of Social Security and SSI benefits by various methods, including "other legal process." The court found that Washington Mutual had used "other legal means" and violated federal law "because there was no knowing, affirmative, and unequivocal consent by the plaintiffs to such practice." The ruling could be an important one, because it may prevent banks from being able to offer overdraft protection to any recipients of directly deposited Social Security and SSI benefits. This ruling would not impact accounts where those benefits are not received through direct deposit.

In the future, banks would have to gain affirmative consent from Social Security beneficiaries to use their funds for overdraft protection and fees. In this consent, banks would have to explicitly describe to the beneficiaries the protections that the Social Security Act provides them. Customers could then decide whether to allow the bank to use their directly deposited Social Security and SSI benefits to cover overdrafts. However, in the concurrence, Judge Noonan noted that the Social Security Act prohibited assignment of future Social Security benefits by the recipient. If so, the judge noted that congressional legislation may be the only way to solve the conflict between the prohibition in the Social Security Act and convenience of direct deposit.

SUMMARY OF THIRD DISTRICT DEVELOPMENTS

New Jersey

On March 7, 2002, the New Jersey State Senate passed a bill (by a vote of 39-0) that would increase the loan to value ratio for loans eligible for mortgage guarantee insurance. The bill (A.473) passed the Assembly by a vote of 76-0 on February 11, 2002. The bill would allow mortgage guaranty insurance companies to insure 100 percent of the fair market value of the real estate securing the mortgage. Currently, they can insure only up to 97 percent of the fair market value of the real estate securing the mortgage. The bill was introduced on January 2, 2002, by Assemblymen Bateman and Decroce.

The New Jersey Department of Banking and Insurance adopted a final rule on January 4, 2002, that would increase the capital requirements of new depository institutions applying for state charters. The final rule increases the required capital for a new depository institution from $5,000,000 to $6,000,000. Stock institutions must hold at least $3,000,000 of this total in capital stock, which was increased from $2,500,000. The department is not changing the required amount of capital for the establishment of a new limited-purpose trust company; it remains set at $2,000,000.

At the same time, the Department of Banking and Insurance sought to reduce the burden associated with these new increased capital requirements. The final rule amends a mandatory charter condition by reducing the Tier 1 capital-to-assets ratio a depository institution must hold. Previously, a new depository institution had to maintain a capital-to-assets ratio of at least 10 percent for a period of five years. The final rule lowers the ratio to at least 8 percent of the bank's total assets and for a period of only three years. The rule became effective February 4, 2002, and it expires on March 6, 2006.

Federal Reserve Bank of Philadelphia

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Prepared by the Research Department. For further information, contact Deron Green at 215-574-4102 or deron.green@phil.frb.org. To subscribe to this publication please contact the Publications Desk at 215-574-6428 or lois.newell@phil.frb.org.