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Recent Developments

AmeriDebt Settles FTC's Charges of Unfair or Deceptive Practices

On January 9, AmeriDebt, its founder, Andris Pukke, and DebtWorks Inc. (another of Pukke's companies) entered into a consent agreement with the Federal Trade Commission (FTC) to settle the FTC's charges that the defendants had engaged in unfair or deceptive practices while promoting and offering credit counseling and debt management plans (a system under which consumers make one consolidated monthly debt payment to an administrator who then disburses payments to the consumer's creditors).

AmeriDebt advertised that it was a nonprofit credit counseling firm and urged consumers to call to speak to "credit counselors," who were in fact customer service representatives, about how to "handle credit in the future." The customer service representatives were trained to sell debt management plans (DMPs) to consumers, and they received compensation based on how many customers they enrolled. Once a consumer agreed to enter into a DMP, the employee pressured him or her to submit the first monthly payment immediately in order to be formally enrolled in the program. Often, the defendants kept the consumer's first payment as an up-front fee for participating in the DMP and did not

disburse any of it to creditors. The DMP contract mentions the up-front payments, but they are referred to as “voluntary” contributions. However, consumers were never made to feel they had the choice of whether or when to pay the fee.

After enrolling the customer in a DMP, AmeriDebt sent the file to its servicing company, DebtWorks, which earned monthly fees of between \$20 and \$70 per customer, depending on the number of accounts covered under the customer’s plan. According to the FTC, AmeriDebt described itself as a nonprofit company, when its primary purpose was to funnel profitable servicing business to DebtWorks. For these reasons, the FTC charged them in 2003 with (1) misrepresenting their up-front fees; (2) deceptively omitting notice that the company retains most, if not all, of a customer’s first payment as an up-front fee; (3) misrepresenting that the company teaches consumers how to handle credit; and (4) misrepresenting AmeriDebt as a nonprofit entity.

While the defendants did not admit liability for any of the practices alleged in the FTC’s complaint, they did agree to settle the claims by entering into a consent order that, among other things, bars them from ever again engaging in or participating in credit counseling, credit education, or debt management. The defendants are also required to pay \$172 million in monetary relief, which the FTC will hold in a trust for consumer victims.

ChoicePoint Settles Allegations That It Failed to Protect Consumer Information

ChoicePoint Inc. is a consumer reporting agency that collects and maintains personal identifying information about individuals and furnishes it to subscribers for a fee. A person can become a subscriber by submitting an application along with documentation that the applicant is a legitimate business with a reasonable business purpose for purchasing consumer data. The Federal Trade Commission (FTC) alleged that ChoicePoint permitted il-

legitimate businesses or persons to become subscribers, which led to at least 800 cases of identity theft.

The FTC alleged that ChoicePoint failed to authenticate the identities and qualifications of its applicants, which in some cases were false or misleading. In addition, the FTC alleged that ChoicePoint failed to identify unauthorized activity by subscribers even after law enforcement authorities issued subpoenas alerting the company to fraudulent accounts, or when its own encounters with a subscriber should have reasonably led it to suspect fraudulent activity (such as an apartment leasing subscriber claiming to need a large number of consumer reports, in a short period of time, that significantly exceeded the total number of rental units in the subscriber’s application). The FTC claimed that these practices violated sections of the Fair Credit Reporting Act and the FTC Act.

Without admitting the truth of, or liability for, these allegations, ChoicePoint agreed to settle the charges with the FTC by entering into a consent order that requires it to pay a civil penalty of \$10 million, in addition to a \$5 million payment for consumer redress. Furthermore, the company is prohibited from furnishing consumer reports to anyone without a legitimate business purpose for obtaining them. Even for subscribers with a legitimate need for the consumer reports, ChoicePoint is directed to maintain procedures to limit the number of reports that are furnished to any one subscriber.

ChoicePoint is also required to establish and implement a comprehensive information security program that identifies internal and external risks to the confidentiality of consumer information. The company must also submit to biennial assessments for 20 years from a qualified third party that will evaluate the company’s compliance with the information security program requirements.

SUMMARY OF FEDERAL LEGISLATION

Enacted Legislation

1. Deficit Reduction Act of 2005 (S. 1932). Introduced by Sen. Gregg (R-NH) on October 27, 2005.

Status: Signed by President George W. Bush on February 8, 2006, and became Public Law No. 109-171.

The deficit reform bill contains two measures of importance to the banking industry. First, the Federal Deposit Insurance Reform Act of 2005 constitutes one section of this broad and lengthy bill (see *Banking Legislation and Policy*, October-December 2005). The bill merges the Bank Insurance Fund and the Savings Insurance Fund into one Deposit Insurance Fund (DIF) into which all future assessments will go.

The bill requires the deposit insurance amount to be recalculated every five years, adjusting for inflation and rounding to the nearest \$10,000. In cases where an adjustment causes a decrease

in deposit insurance coverage, no adjustment is made until the next scheduled five-year adjustment that does not result in a decrease. Deposit insurance coverage for retirement accounts will increase from \$100,000 to \$250,000. This amount is adjusted every five years to account for inflation. The adjustment is calculated in the manner described above and would also be rounded to the nearest \$10,000. The bill extends deposit insurance to provide pass-through coverage for deposits of employee benefit plans. Institutions that are not adequately capitalized are not permitted to accept deposits of employee benefit plans.

The FDIC board of directors will designate a reserve ratio each year. The ratio must fall within the range of 1.0 to 1.5 percent. In determining the ratio, the board of directors will consider the DIF’s risk of losses and current economic conditions and should seek to prevent sharp swings in the assessment rates. If the reserve ratio exceeds 1.5 percent, the FDIC will give cash dividends equal to the excess amount to depository institutions. If the reserve ratio is between 1.4 and 1.5 percent, the FDIC will

give cash dividends equal to half of the amount in excess of 1.4 percent.

In addition to including the Federal Deposit Insurance Reform Act, the Deficit Reduction Act also contains a number of student loan provisions that, among other things, shift borrower interest rates to a 6.8 percent fixed rate, increase loan limits, and reduce insurance amounts for lenders.

2. Federal Deposit Insurance Reform Conforming Amendments Act of 2005 (H.R. 4636). Introduced by Rep. Oxley (R-Ohio) on December 18, 2005.

Status: Signed by President George W. Bush on February 15, 2006, and became Public Law No. 109-173.

While this law is mostly devoted to making technical and conforming amendments that are necessary to implement the Federal Deposit Insurance Reform Act of 2005 (see above), it also requires the comptroller general of the Government Accountability Office (GAO) to conduct a study of the potential effects that the new Basel II regulations may have on the U.S. financial system. (See *Banking Legislation and Policy*, July-September, 2004, for more information about Basel II.) The GAO will examine not only the effects of the new Basel II regulations but also the effects of the proposed revisions to current reserve requirement regulations for non-Basel II banks. The GAO's report must include whether there will be a reduction in capital requirements, whether Basel II could hinder the enforcement of laws and regulations, and the potential implications any changes in capital requirements may have on the safety and soundness of the U.S. financial system.

The GAO will also investigate the costs of Basel II for financial institutions and regulators, the feasibility and appropriateness of the regulation's statistical models, and regulators' ability to oversee capital requirement operations of financial institutions. In addition, the GAO will study whether financial institution regulators have the ability to attract and retain sufficient expertise among specialists and examiners and whether they have the ability to conduct the necessary oversight of capital and risk modeling required under Basel II.

The GAO is required to report its results to the Senate Committee on Banking, Housing, and Urban Affairs and to the House Committee on Financial Services within one year.

Pending Legislation

1. Financial Services Regulatory Relief Act of 2005 (H.R. 3505). Introduced by Rep. Hensarling (R-Texas) on July 28, 2005.

Status: Passed the House; Referred to the Senate Committee on Banking, Housing, and Urban Affairs.

This bill's many provisions are aimed at relieving the regulatory burdens of banks, thrifts, and credit unions. The bill repeals the prohibition against depository institutions' crossing state lines by opening branches, except if a state banking supervisor determines that a depository institution is controlled, directly or indirectly, by a commercial firm, in which case the institution may not acquire,

establish, or operate a branch in the state. Also, every five years federal banking agencies will be required to review and streamline the procedures for filing "reports of condition."

National banks may declare and pay dividends in any year in an amount not to exceed the net income of the bank in the current year, plus the retained income for the two preceding years, minus any transfers required by the Office of the Comptroller of the Currency (OCC). Federal branches or agencies of foreign banks will be required to keep extra deposits, investment securities, and other assets on deposit in order to protect depositors and investors. The amount of these additional deposits will be stipulated by the OCC, but it cannot be less than what is required for a state-licensed branch of a foreign bank located in the same state.

The bill makes many amendments to the laws for savings associations, including permitting them to invest in activities that promote public welfare, such as enhancing the welfare of low- and moderate-income communities by providing housing, services, and jobs. The Office of Thrift Supervision (OTS) will determine the amount any savings association may invest in one project and the aggregate amount thrifts may invest under this program. Aggregate investment amounts cannot exceed 5 percent of the thrift's capital stock actually paid in and unimpaired and 5 percent of the thrift's unimpaired surplus, unless the OTS determines that the thrift is adequately capitalized or the OTS believes that exceeding the limit would not present a significant risk to the thrift.

Thrifts will be permitted to make additional investments in small business investment companies, with the limit being increased to 5 percent of the thrift's capital and surplus. The aggregate amount of a thrift's nonresidential real estate loans may equal up to 500 percent of its capital when the thrift is found to have safe and sound operating procedures. The law also increases the limit on real estate loans to a single borrower, allowing thrifts to grant real estate loans of up to \$500,000. In addition, thrifts will be permitted to invest in and sell auto loans.

Thrifts will be permitted to merge with nondepository institution affiliates, provided that the resulting institution does not engage in activities that are prohibited for savings associations.

Community banks with less than \$1 billion in total assets will be eligible for an 18-month examination schedule. The bill also stipulates that the Small Bank Holding Company Policy Statement on Assessment of Financial and Managerial Factors will apply to bank holding companies with less than \$1 billion in consolidated assets. (Currently, the streamlined exam applies to bank holding companies with less than \$250 million in assets.) Furthermore, the limit on small bank holding companies' allowable debt-to-equity ratio in order to remain eligible to pay a corporate dividend and to remain eligible for expedited application processing procedures under Regulation Y will be increased from 1:1 to 3:1.

New Legislation

1. Internet Gambling Prohibition Act (H.R. 4777). Introduced by Rep. Goodlatte (R-Va.) on February 16, 2006.

Status: Referred to the House Committee on the Judiciary.

This bill prohibits Internet gambling and transmission of information over the Internet that assists in the placing of bets. Violators of this bill will face paying a fine or imprisonment for up to five years. The bill also prohibits gambling businesses from accepting credit and debit card payments or electronic fund trans-

fers for online wagers. The bill makes an exception for bettors who are physically in the same state as the facility at which they are placing bets when the state permits this type of gambling and has an effective procedure for verifying the age of the bettor.

SUMMARY OF FEDERAL REGULATIONS

Board of Governors of the Federal Reserve System

Electronic Fund Transfers (1/10)

The Board of Governors of the Federal Reserve System (the Board) issued a final rule that requires merchants to receive a customer's authorization each time they initiate an electronic fund transfer (EFT) on behalf of the customer. The rule defines EFTs as the transfer of funds through an electronic terminal, telephone, or computer, including point-of-sale transfers, automated teller machine transfers, direct deposits or withdrawals of funds, and transfers resulting from debit and credit transactions, whether or not they are initiated through an electronic terminal.

When a check or point-of-sale purchase can be processed as a one-time EFT from a consumer's account, the consumer must be notified that the check may be processed as an EFT, and he or she must authorize the transaction. A merchant must also inform the consumer that the transaction "may" result in funds being debited from the consumer's account more quickly and that the check may not be returned to the consumer's financial institution after processing. In addition, automated teller machine operators must post notices on their machines that fees may be imposed for EFTs and balance inquiry services.

This final rule became effective on February 9. For more information, see 71 *Federal Register*, pp. 1638-64.

Payroll Cards (1/10)

The Board of Governors of the Federal Reserve System (the Board) issued an interim final rule that stipulates that Regulation E governs payroll card accounts. Payroll card accounts can be set up either directly or indirectly by employers on behalf of employees. The accounts receive electronic fund transfer infusions of an employee's salary, wages, or other compensation. They are managed by the employer, a third-party payroll processor, a depository institution, or another entity.

The rule does not require financial institutions to furnish periodic statements for payroll card accounts, as long as the institution provides the consumer with a telephone number that he or she can call to receive the account's balance. The institution must also provide a website at which the consumer can access at least a 60-day history of the account's transactions. At the consumer's request, an institution must also provide a written history of transactions occurring in the preceding 60 days.

This interim final rule will become effective on July 1, 2007, and comments on it were due March 13, 2006. For more information, see 71 *Federal Register*, pp. 1473-83.

BHC Capital Adequacy Guidelines (2/28)

The Board of Governors of the Federal Reserve System (the Board) issued a final rule that raises the asset threshold for bank holding companies (BHCs) to be eligible to take on additional debt to acquire new banks or other companies. Currently, only BHCs with a threshold of up to \$150 million in consolidated assets are eligible to take on more debt in order to acquire new subsidiaries. The proposed rule would raise the asset-size threshold to \$500 million, enabling more small BHCs to acquire new subsidiaries by taking on additional debt.

Small BHCs would be required to meet several additional criteria in order to qualify. A small BHC must not: (1) engage in significant nonbanking activities, either directly or through its subsidiaries; (2) conduct significant off-balance-sheet activities; or (3) have a significant amount of outstanding debt that is held by the general public. A qualifying BHC can use debt to finance up to 75 percent of the purchase price of a new acquisition (meaning its debt-to-equity ratio is 3:1). The proposed rule would require subordinated debt to be included when calculating the debt-to-equity ratio, following a transition period of five years, during which time BHCs can modify their debt structures.

This final rule became effective on March 30. For more information, see 71 *Federal Register*, pp. 9897-03.

Cash Processing (3/17)

The Board of Governors of the Federal Reserve System (the Board) announced changes to its cash services policy that could affect approximately 150 to 225 depository institutions with high-volume currency operations. Currently, the Board believes some depository institutions rely too heavily on Federal Reserve Banks to process currency, and it would like to see institutions recirculating fit currency to their own customers and process only unfit currency through the Reserve Banks.

The cash services policy will change in two ways. First, a custodial inventory program will permit depository institutions to transfer a percentage of the \$10 and \$20 notes in their vaults to the books of the Federal Reserve, allowing the institutions to reduce the size and frequency of their deposits of currency to and orders from the Reserve Banks. In addition, if institutions deposit fit \$10 and \$20 notes with the Reserve Banks and order more than a minimum amount of the same denomination during the same business week, they will be charged a fee.

The Reserve Banks will begin accepting requests to participate in the custodial inventory program in May, and they expect

the program to begin in July. The Banks plan to begin assessing fees about one year after implementing the custodial inventory program, or in July 2007.

For more information, see the announcement at www.federalreserve.gov/BoardDocs/Press/other/2006/20060317/default.htm.

International Banking (3/20)

The Board of Governors of the Federal Reserve System (the Board) issued a final rule that requires branches, agencies, or representative offices of foreign banks operating in the United States to establish Bank Secrecy Act compliance programs with the approval of their board of directors or a delegate who is appointed by the board of directors. The rule clarifies that the requirement does apply to Edge Act corporations (companies chartered by the Fed to engage in international banking) but does not apply to federal branches, agencies, or state-chartered branches that are insured by the Federal Deposit Insurance Corporation.

This final rule became effective on April 19. For more information, see 71 *Federal Register*, pp. 13934-7.

Office of the Comptroller of the Currency

Commercial Real Estate Lending (1/13)

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (together, the Agencies) issued a proposed guidance that helps to identify institutions with commercial real estate (CRE) loan concentrations that may be subject to greater scrutiny. The guidance focuses on CRE loans that are especially vulnerable to cyclical commercial real estate markets, such as CRE exposures where the source of repayment primarily depends upon rental income or the sale, refinancing, or permanent financing of the property. In addition, the Agencies are also concerned about loans to real estate investment trusts (REITs) and unsecured loans to developers.

The guidance provides a formula for determining whether an organization has a concentration of CRE exposures that would make it subject to heightened risk management practices. If an organization's total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total capital, or if the institution is rapidly approaching this threshold, it is considered to have a concentration in CRE construction and development loans. In this case, it would be required to have heightened risk management practices that are appropriate for the level of risk in the portfolio.

If an institution's total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land represent 300 percent or more of its total capital, the institution should further analyze its loans and calculate the dollar amount of the loans that meet the guidance's definition of a CRE loan. The bank is also required to have heightened risk management practices that are appropriate for the level of risk in the portfolio.

The guidance explains that heightened risk management

practices include: (1) having additional management and board oversight; (2) having a policy for CRE lending in the institution's strategic plan; (3) updating underwriting standards to reflect the level of risk associated with the institution's CRE loan portfolio; (4) establishing risk assessment and monitoring programs for CRE loans; (5) ensuring that the institution's management information system tracks the risks associated with the CRE portfolio; and (6) performing market analysis to identify potential risks to the CRE portfolio. In addition, institutions that have greater concentrations of CRE loans must also hold additional capital above the regulatory minimums. The level of capital should be proportional to the level and nature of the risks associated with high CRE exposures.

Comments on this proposed rule were originally scheduled to be due March 14; however, the Agencies extended the comment deadline to April 13. For more information about the guidance, see 71 *Federal Register*, pp. 2302-7. For more information about the comment deadline extension, see 71 *Federal Register*, pp. 13215-7.

External Auditor Liability (2/9)

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the National Credit Union Administration (together, the Agencies) issued an advisory to warn financial institutions not to include provisions in engagement letters that limit external auditor liability in audits of financial statements, internal control over financial reporting, and management's assessment of internal control over financial reporting.

The advisory does not apply to (1) non-audit services that may be performed by financial institutions' external auditors; (2) audits of financial institutions' 401k plans, pension plans, and other similar audits; (3) services performed by accountants who are not engaged to perform financial institutions' audits; or (4) other service providers, such as software consultants or legal advisors.

This advisory became effective on February 9. For more information, see 71 *Federal Register*, pp. 6847-55.

CRA Credit in Hurricane Areas (2/9)

The Office of the Comptroller of the Currency (OCC) issued a guidance to clarify that national banks that engage in activities to help revitalize or stabilize the designated disaster areas related to hurricanes Katrina and Rita are eligible for Community Reinvestment Act (CRA) credit, as long as they have adequately met the CRA-related needs of their local communities.

National banks are typically rewarded with CRA credit for helping to meet the credit needs of their local communities through lending, investments, and services, including community development activities. In 2005, the regulations were revised to expand the definition of community development to include activities that revitalize and stabilize designated disaster areas, such as those affected by the hurricanes. National banks may provide CRA-related activities directly or through a third party. They

may receive positive consideration for activities benefiting people who have been displaced by the hurricanes, including evacuees relocated to other states.

For more information about this guidance, see OCC Bulletin 2006-6 at the OCC's website, www.occ.gov.

Nontraditional Mortgage Products (2/17)

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration (together, the Agencies) announced that they are extending the comment deadline on a proposed guidance that helps institutions assess and manage risks associated with nontraditional mortgage products. The original comment deadline was February 27, but the Agencies extended it until March 29.

The guidance, proposed December 29, aims to help institutions offer nontraditional mortgage products in a safe and sound manner and to provide consumers with sufficient information about the risks involved with these products. Among other things, it instructs institutions to consider a borrower's repayment ability before approving a nontraditional mortgage loan, to avoid using collateral-dependent loans, and to develop clear policies governing the use of low- and no-documentation loans. For a full summary of the proposed guidance, see *Banking Legislation and Policy*, October-December 2005.

Comments on the proposed guidance were due March 29. For more information, see 71 *Federal Register*, pp. 9339-41.

Risk-Based Capital Guidelines (2/22)

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (together, the Agencies) issued a final rule to make permanent and expand a 2000 interim final rule that reduced the capital requirement for cash-collateralized securities borrowing transactions by banks and bank holding companies that have adopted the market risk rule for assessing capital adequacy. (For more information about the interim final rule, see *Banking Legislation and Policy*, October-December 2000.)

In general, the interim final rule permitted banking organizations that use the market risk rule to exclude from their risk-weighted assets all of their receivables that come from posting cash collateral in securities borrowing transactions, subject to four conditions. The conditions require that the transaction be (1) based on securities that are liquid and readily marketable; (2) marked to market daily; (3) subject to daily margin maintenance requirements; and (4) compliant with applicable provisions of the Bankruptcy Code, the Federal Deposit Insurance Act, the Federal Deposit Insurance Improvement Act of 1991, or the Federal Reserve Board's Regulation EE. If a transaction does not meet the fourth requirement, it would still be eligible for exclusion if the banking organization completes a legal review to determine that the securities borrowing agreement is binding and allows the organization to accelerate, terminate, and close out all transactions on a net basis and to liquidate collateral promptly if the counterparty defaults.

This final rule became effective on February 22. For more information, see 71 *Federal Register*, pp. 8932-8.

CRA Guidance (3/10)

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (together, the Agencies) issued a notice that they revised the question and answer section of their guidance relating to the Community Reinvestment Act. The revisions were prompted by the changes to CRA regulations that were passed in August and became effective in September. In particular, the final rule changed the definition of "community development" to include activities that revitalize or stabilize designated distressed or underserved nonmetropolitan middle-income areas or designated disaster areas. (For more information on the final rule, see *Banking Legislation and Policy*, July-September 2005.)

In revisions to the guidance, the Agencies clarify that providing housing for middle- or upper-income individuals qualifies as an activity that revitalizes or stabilizes a distressed nonmetropolitan middle-income area or a designated disaster area if the housing directly helps to revitalize or stabilize the community by attracting or retaining residents or businesses or, in the case of disaster relief, is related to disaster recovery.

The guidance also creates a 36-month period during which banking organizations may receive CRA credit for performing disaster recovery activities in designated disaster areas. The 36-month period commences on the day that the federal government designates an area as a disaster area. The Agencies also announced that they plan to extend the 36-month period for disaster recovery activities in the Gulf Coast areas that were designated as disaster areas because of hurricanes Katrina and Rita.

This guidance became effective on March 10. For more information, see 71 *Federal Register*, pp. 12424-34.

Federal Deposit Insurance Corporation

Changes in Insured Status (2/21)

The Federal Deposit Insurance Corporation (FDIC) issued a final rule requiring institutions to certify to the FDIC when all of their deposit liabilities have been assumed by another institution. The rule is identical to the proposed rule issued in October (see *Banking Legislation and Policy*, October-December 2005). The final rule clarifies that certification is required only when all liabilities are assumed, not for partial assumptions of liabilities (such as when a branch of an institution is acquired), as some institutions previously believed. Institutions in default are not required to certify the assumption of their liabilities when the FDIC is appointed as the receiver of them.

This final rule became effective on March 23. For more information, see 71 *Federal Register*, pp. 8789-92.

Deposit Insurance (3/23)

The Federal Deposit Insurance Corporation (FDIC) issued an interim final rule that would increase deposit insurance coverage for certain retirement accounts and permit the standard deposit insurance coverage amount of \$100,000 per account to

be adjusted for inflation. This rule implements sections of the Federal Deposit Insurance Reform Act of 2005 and the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 that were passed this quarter (see the *Summary of Federal Legislation* section for more information).

First, the rule creates the new term “standard maximum deposit insurance amount” (SMDIA) and defines it as \$100,000 currently but allows the FDIC and the National Credit Union Administration to adjust it for inflation every five years.

The rule also permits pass-through coverage for employee benefit plan accounts at any insured depository institution, even if the institution was technically not permitted to accept the deposit. This will apply to all employee benefit plan deposits, even if they were placed before the effective date of this rule and regardless of whether the deposits would have been eligible for coverage under the former rules. As under former rules, only noncontingent interests of plan participants are eligible for coverage. (A “noncontingent” interest is one that can be determined without the evaluation of contingencies other than life expectancy.)

Finally, the rule also increases the maximum coverage for certain retirement accounts to \$250,000. The eligible retirement accounts include traditional IRAs, Roth IRAs, section 457 deferred compensation plan accounts, self-directed Keogh plan accounts, and self-directed defined contribution plan accounts, such as 401(k) accounts. (The term “self-directed” means that the account’s owner has the right to direct how his or her funds are invested, including whether they are invested at an FDIC-insured depository institution.)

This interim final rule became effective on April 1. Comments on the rule are due May 22. For more information, see 71 *Federal Register*, pp. 14629-31.

Department of Housing and Urban Development

Hurricane Foreclosures (2/27)

The Department of Housing and Urban Development (HUD) announced that it has instructed all FHA-approved lenders to extend HUD’s moratorium on foreclosures of FHA-insured mortgages in the Gulf Coast area for 120 days. The moratorium was set to expire on February 28. The extension applies to all loans in presidentially declared disaster areas eligible for individual assistance as a result of hurricanes Katrina, Rita, and Wilma. To be eligible for the extension, borrowers were to have made a written commitment to work with their lender on a plan to resolve their mortgage delinquency by March 31.

For more information, see HUD’s news release at www.hud.gov/news/release.cfm?content=pr06-022.cfm.

Office of Thrift Supervision

Preemption (3/7)

The Office of Thrift Supervision (OTS) issued a legal opinion to assert that a Maryland law about mortgage lending practices does not apply to federal savings associations because it is preempted by federal law. The Maryland law in question prohibits mortgage loans that (1) include the financing of single premium credit life insurance; (2) have excessive upfront points, excessive

fees, or excessive prepayment penalties; or (3) provide compensation paid directly or indirectly to a person from any source.

The OTS stated in its legal opinion that these provisions are not applicable to federal savings associations or their subsidiaries because they are preempted by the Home Owners’ Loan Act, which occupies the field of lending regulation for federal savings associations to the exclusion of state laws. In particular, the OTS said that its regulations preempt state laws that seek to impose requirements regarding: (1) the ability of creditors to require insurance or other credit enhancements; (2) the terms of credit; and (3) loan-related fees. In addition, the OTS said that it is the only government entity with the authority to examine savings associations or their subsidiaries for violations of, or to enforce, any other provisions of the Maryland law that may be applicable.

For more information, see the OTS’s legal opinion and the news release pertaining to it at www.ots.treas.gov/docs/7/776010.html.

Federal Trade Commission

Accuracy of Consumer Reporting Information (3/22)

The Federal Trade Commission, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, and the National Credit Union Administration (together, the Agencies) issued an advance notice of a proposed rule to implement provisions of the Fair and Accurate Credit Transactions Act (FACTA) that require furnishers of credit information to ensure the accuracy of their information and to reinvestigate disputed information at a consumer’s request. (For more information about FACTA, see *Banking Legislation and Policy*, October-December 2003).

Among other things, FACTA requires the Agencies to establish guidelines that information furnishers can use to maintain the accuracy and integrity of the information they provide to consumer reporting agencies (CRAs). To do so, the law instructs the Agencies to identify patterns, practices, and specific forms of activity that can compromise the accuracy and integrity of information furnished to CRAs. Also, the Agencies must review the methods that are used to furnish the information. In addition, the Agencies must examine the policies and processes that furnishers use to conduct reinvestigations and to correct inaccurate information that has already been furnished to CRAs.

The law also requires the Agencies to identify the circumstances under which a furnisher must reinvestigate a dispute over the accuracy of information included in a consumer report at the request of the consumer. In prescribing their regulation, the Agencies must weigh the benefits to consumers against the costs to furnishers. The Agencies must also consider the effect the regulation will have on the overall accuracy and integrity of consumer reports and determine if direct contact between the consumer and the furnisher would result in the fastest resolution of a dispute.

In issuing this advance notice of proposed rulemaking, the Agencies request comment on these factors they must consider before issuing a proposed rule. Comments on this advance notice of proposed rulemaking are due May 22. For more information, see 71 *Federal Register*, pp. 14419-25.

Court Decisions

A National Bank Is a Citizen of the State in Which Its Main Office Is Located

On January 17, the Supreme Court ruled that a national bank is a citizen of the state in which its main office is located, as designated by its articles of association (*Wachovia Bank v. Schmidt*, No. 04-1186). The case stems from a group of South Carolina plaintiffs who filed suit in a South Carolina state court against Wachovia Bank (a national bank with its main office in North Carolina). Wachovia petitioned the federal courts to compel arbitration of the dispute, arguing that the federal court had jurisdiction because the parties were citizens of different states. The plaintiffs contended that national banking associations are citizens of the states in which they are located, which they interpreted to mean any state in which the bank maintains a branch. Under that definition, the plaintiffs argued, Wachovia was a citizen of South Carolina, as it had branches in the state, and that it was therefore under state court jurisdiction.

The Supreme Court did not agree with the plaintiffs' interpretation of the term "located," arguing that this would constrict national banks' access to diversity jurisdiction. Diversity jurisdiction is granted by a federal court to opposing parties that reside in different states. Essentially, the court seeks to provide a level playing field for both parties by deciding the case in federal court rather than in state court.

Further, the Supreme Court said that if a bank were considered to be located in every state in which it had a branch office, it would be treated differently than all other corporations that operate establishments in multiple states, as these corporations are thought to be "located" only in the state in which their main offices are located. For that reason, the Supreme Court rejected the ruling of the U.S. Court of Appeals for the 4th Circuit and held that Wachovia Bank is a citizen of North Carolina and that the underlying case is subject to federal jurisdiction.

Supreme Court Declines to Review Case Involving Alleged Violations of TILA

On January 9, the Supreme Court declined to review a ruling by the U.S. Court of Appeals for the 9th Circuit that an automobile dealer did not violate the Truth in Lending Act (TILA) by failing to disclose a \$2,000 rebate that was made available to customers who did not receive a low 0.9 percent annual percentage rate on their auto loans (*Virachack v. University Ford*, No. 05-573).

The plaintiffs, Malinee and Ritnarone Virachack, bought a vehicle from University Ford using mostly credit, and the dealer extended the plaintiffs an auto loan with a 0.9 percent interest rate. At the same time, the dealer was offering a \$2,000 rebate on the same vehicle model and year to customers who did not receive the 0.9 percent financing. The rebate was not included in the dealer's TILA disclosures, which the Virachacks alleged was a violation of the TILA. The court of appeals found that the disclosure was not required under the TILA because the rebate was not used to induce customers to employ a means of payment

other than credit and because it would have been available to any customer as long as he or she was not also receiving the 0.9 percent financing. For more information about the appeals court's decision, see *Banking Legislation and Policy*, April-July, 2005.

A Contract's Arbitration Clause Is Binding, Even When the Contract Is Alleged to Be Illegal

On February 21, the Supreme Court ruled that if parties agree to a contract that contains an arbitration clause, disputes should be handled by an arbitrator, even if the disputed matter is whether the contract is legal and valid (*Buckeye Check Cashing Inc. v. Cardegna*, No. 04-1264). The case arose after plaintiffs John Cardegna and Donna Reuter entered into deferred-payment transactions – essentially, payday loans – with Buckeye Check Cashing. In these transactions, the plaintiffs received cash from Buckeye in exchange for a personal check in the amount of the cash plus a finance charge. Along with each of these transactions, the plaintiffs signed agreements that any dispute over the transaction would be settled by an arbitrator. Later, the plaintiffs brought suit against Buckeye in Florida state court, alleging that the company charged usurious interest rates for these transactions and therefore violated several Florida laws. The plaintiffs did not challenge the arbitration clause itself, arguing instead that the entire contract was void.

The Supreme Court found that "regardless of whether it is brought in federal or state court, a challenge to the validity of a contract as a whole, and not specifically to the arbitration clause within it, must go to the arbitrator, not the court." The court gave three reasons for this. First, according to federal arbitration law, an arbitration provision is severable from the remainder of a contract. Next, unless the challenge is to the arbitration clause itself, it is the arbitrator's responsibility to determine whether a contract is valid. Finally, federal arbitration law applies in federal and state courts. This finding was inconsistent with the Florida Supreme Court's ruling before it, so the U.S. Supreme Court reversed the ruling and remanded the case for further proceedings.

Bankruptcy Courts Do Not Have the Authority to Deny Arbitration

The U.S. Court of Appeals for the 2nd Circuit ruled that a bankruptcy court did not have the authority to deny arbitration of charges of a bankruptcy stay violation (*MBNA America Bank v. Hill*, No. 04-2086-bk). In the case, Kathleen Hill was one of a class of individuals that filed suit against MBNA America Bank for allegedly violating a stay that the bankruptcy court had granted her when she filed for Chapter 7 bankruptcy. Prior to applying for protection from creditors under the bankruptcy code, Hill arranged for MBNA to withdraw monthly payments of \$159.01 from her account to pay down the balance she owed on a consumer loan. After Hill filed for bankruptcy, the bankruptcy court notified all of her creditors by mail. Despite receiving the notice, MBNA continued to withdraw monthly payments from Hill's account, which she alleged was a violation of the automatic stay

provision of the Bankruptcy Code. MBNA appealed to the bankruptcy court to dismiss the case in favor of arbitration, since Hill's credit agreement contained a clause that compelled arbitration to settle any claim or dispute related to the account. The bankruptcy court, and the district court after it, refused to dismiss the case in favor of arbitration, claiming that compelling arbitration would seriously jeopardize the objectives of the Bankruptcy Code, which are to provide debtors with a fresh start, protect the assets of the estate, and allow the bankruptcy court to centralize disputes concerning an estate.

The Court of Appeals rejected these findings, however, and ruled that the bankruptcy court did not have the authority to deny arbitration in this case. While the court acknowledged that bankruptcy courts generally have discretion to refuse to compel arbitration of core bankruptcy matters (those directly related to the bankruptcy case), they do not have the discretion to override an arbitration agreement unless it finds that the proceedings are based on provisions of the Bankruptcy Code that inherently conflict with federal arbitration laws or if they necessarily jeopardize the objectives of the Bankruptcy Code.

In this case, the court found that arbitration would not seriously jeopardize the Bankruptcy Code objectives because: (1) Hill's estate had been fully administered and her debts had been discharged, meaning she no longer required protection from her creditors; (2) as a class-action case, her claims weren't directly connected to her bankruptcy case; and (3) the bankruptcy court is not uniquely able to interpret and enforce provisions of an automatic stay, and therefore the matter can be decided by someone other than the bankruptcy court.

On January 10 in a similar case, the U.S. Court of Appeals for the 3rd Circuit also ruled that bankruptcy courts do not have the discretion to deny arbitration (*Mintze v. American General Financial Services*, No. 03-4745). In this case, Ethel Mintze sought a loan from American General Financial Services to pay for a new heater for her home. American General loaned her the money in exchange for consolidating that loan with her mortgage and the balance of her credit card debt. American General also financed the settlement charges plus the premiums for two life insurance policies. The loan agreement contained an arbitration clause that required all disputes to be handled by an arbitrator.

When Mintze began to fall behind in her payments to American General, she filed for Chapter 13 bankruptcy. In addition, she filed a complaint against American General in bankruptcy court, in which she alleged that the company induced her to enter into an abusive and illegal home equity loan. She sought to enforce a pre-petition rescission of the mortgage under the Truth in Lending Act. In response, American General petitioned the bankruptcy court to dismiss the case in favor of arbitration.

The bankruptcy court declined to dismiss the case, ruling that it was the proper jurisdiction for deciding the claims. Upon American General's appeal, the district court affirmed the lower court's ruling. The court of appeals, however, reversed the rulings of each of the lower courts. Based on federal arbitration laws, the court ruled that the bankruptcy court lacked the authority to deny arbitration. Therefore, the court remanded the case and instructed the bankruptcy court to compel arbitration.

Mississippi Insurance Law Reverse-Preempts Federal Arbitration Laws

On January 11, the U.S. Court of Appeals for the 5th Circuit ruled that a Mississippi insurance law that protects the victims of uninsured or underinsured motorists reverse-preempts federal laws that enforce arbitration clauses in contracts (*American Bankers Insurance v. Inman*, No. 04-61131). Mississippi resident Jack Inman was the victim of an accident that occurred when the motorcycle he was driving was struck from behind by a car whose driver was underinsured. The other motorist's insurance only covered him for liability up to \$10,000, but Inman's injuries were so extensive that he made a demand for \$100,000 under the underinsured motorist coverage provision of his insurance policy with American Bankers Insurance. Mississippi state law requires the underinsured motorist coverage provision to be included in every insurance contract in the state. The law prohibits required arbitration of disputes stemming from the uninsured motorist coverage provisions of personal automobile insurance policies and makes a jury trial possible for every policy dispute regarding uninsured and underinsured driver coverage. Nonetheless, American Bankers' contract contained a provision that required all disputes over the policy to be settled by an arbitrator.

When Inman brought suit in district court, American Bankers responded by petitioning the court to compel arbitration in accordance with the policy agreement. The district court found that the Mississippi law reverse-preempts federal arbitration laws that enforce arbitration clauses because of the McCarran-Ferguson Act. (Reverse preemption means that the state law preempts the federal law, whereas preemption typically refers to federal laws preempting state laws.) The court of appeals affirmed the district court's ruling, explaining that the McCarran-Ferguson Act allows a state law to reverse-preempt federal law if three conditions are met: (1) the federal law does not specifically relate to the insurance business; (2) the state law was enacted for the purpose of regulating the insurance business; and (3) the federal law invalidates, impairs, or supersedes the state law.

The court found that the first and third requirements were met without question, since the Federal Arbitration Act does not relate specifically to the insurance business and enforcing it would mean invalidating the Mississippi law that prohibits requiring arbitration. The court then determined that the second condition was also met because the state law met three conditions for determining whether it was enacted to regulate the insurance industry. First, the court found that the law transferred or spread the policyholder's risk. Next, the court determined that the law was an integral part of the relationship between the policyholder and the insurance provider. And finally, the court decided that there was no dispute over the fact that the Mississippi law is limited to the insurance industry. Therefore, the court of appeals affirmed the district court's refusal to compel arbitration.

Slattery Awarded More Than \$371 Million in Winstar Settlement

On February 10, the U.S. Court of Federal Claims ordered the government to pay more than \$371 million to shareholders of Meritor Savings Bank to resolve the United States' breach of

contract that resulted in the bank's seizure by regulators (*Slattery v. United States*, No. 93-280C). In 1982, Meritor agreed to merge with Western Savings Fund, a failing institution that otherwise would have closed. Because the merger prevented the closure of Western Savings and a \$696 million loss to the bank insurance fund (BIF), the government agreed that in exchange for Meritor's acquiring Western Savings, it would treat the differences between Western's assets and liabilities as goodwill on Meritor's books. However, later the government reconsidered its agreement and became concerned that the goodwill presented a threat to the BIF. As a result, the government compelled the bank to take a series of actions that resulted in its not being able to meet its capital requirements. Soon thereafter, the bank was seized by regulators.

The shareholders filed suit to recover damages arising from Meritor's seizure as a result of the government's breach of contract. The court awarded the shareholders total damages of \$371,733,059, marking the second largest award in a case of this kind.

Notable Settlements

Far West Credit Settles Allegations of FCRA Violations

Far West Credit, a consumer reporting agency (CRA), recently reached a settlement with the Federal Trade Commission (FTC) over charges that the company violated the Fair Credit Reporting Act (FCRA) by neglecting to verify the accuracy of information in its credit reports. As part of its business, the Utah-based company purchases credit information about consumers from nationwide CRAs, such as Equifax, TransUnion, and Experian, and then merges all of the information into one consolidated report. When there is insufficient information at the national CRAs, Far West accepts documentation from the consumer or other interested third parties (such as mortgage brokers or mortgage originators) to show credit status with businesses that do not report to the nationwide credit bureaus (such as landlords, cable companies, and utility companies). Far West often adds this information to the consumer's credit report.

Far West provided credit reports to many companies, including Keystone Mortgage and Investment Company, a mortgage originator. Keystone, which had an interest in seeing its mortgage deals approved, provided Far West with information about its customers' credit to be used in creating reports for consumers who had insufficient credit histories at nationwide CRAs. The FTC alleges that Far West did not verify the accuracy of Keystone's information and that much of the information was false and required more careful review. Once Far West added the information to the credit reports, it provided the enhanced reports to Keystone, where they were then used to obtain mortgage loans insured by the Federal Housing Administration (FHA) and the Department of Housing and Urban Development (HUD), some of which defaulted.

Without admitting liability for these allegations, Far West agreed to enter into a consent agreement with the FTC to settle the charges. As part of the settlement, Far West must pay a civil penalty of \$120,000. The company is also required to follow reasonable procedures to ensure the maximum possible accuracy of

information in its consumer reports, and it must make its records available to the FTC for three years so the agency can monitor its compliance with the order.

CardSystems Solutions Reaches Settlement with the FTC

The Federal Trade Commission (FTC) announced that it had reached a settlement agreement with CardSystems Solutions and its successor, Solidus Networks. The FTC had charged the company with failing to protect consumers' sensitive personal information stored on its computer networks. CardSystems Solutions is a credit card processing firm that obtains approval for debit and credit card purchases from the banks that issue the cards. In processing these transactions, CardSystems collects data from the magnetic strip of a card, including the card number, expiration date, the security code that proves authenticity, and other data. The company stores this information on its computer network for up to 30 days.

The FTC charged that CardSystems engaged in a number of unsafe practices, including unnecessarily storing information, inadequately assessing the vulnerability of its computer network, not implementing defenses to potential network attacks, failing to use strong passwords, and failing to employ measures to detect unauthorized access to the stored personal information. The FTC argued that these practices led to millions of dollars of fraudulent purchases and required banks to cancel and re-issue thousands of credit cards, all of which caused consumers to worry, be inconvenienced, and lose time dealing with the affected cards.

During the course of the FTC's investigation, CardSystems Solutions was bought by Solidus Networks, which does business as Pay By Touch Solutions. As part of the settlement, CardSystems and Solidus agreed to establish and maintain a comprehensive information security program. Every other year for the next 20 years, they must also obtain an audit from a qualified, independent third-party professional to confirm that their security program meets the FTC's standards. Furthermore, CardSystems and Solidus face potential liability under federal banking laws and regulations and in private litigation for losses related to the breach.

Ameriquist Mortgage Settles Charges of Unfair or Deceptive Lending Practices

Ameriquist Mortgage and its parent company, ACC Capital Holdings Company, have agreed to pay \$325 million to settle allegations by state attorneys general that Ameriquist engaged in unfair and deceptive lending practices. State attorneys general charged Ameriquist with misleading consumers about key loan terms, including interest rates and prepayment penalties. They also alleged that Ameriquist inflated consumers' income levels and pressured appraisers to inflate property values so that borrowers could get bigger loans. In addition, the attorneys general alleged that the company told borrowers to ignore written information in their loan contracts and promised to give them lower rates later but instead gave them higher rates. Finally, they alleged that Ameriquist employees deceived customers and used high pressure sales tactics to meet their sales quota for mortgage refinances and that the company rewarded them with high commission-based wages.

In addition to paying the monetary penalty, Ameriquest agreed to a number of other stipulations. First, it will cease to offer salespeople incentives to include prepayment penalties or other fees or charges in mortgages. It will also provide full disclosure of interest rates, discount points, prepayment penalties, and other loan or refinancing terms. Ameriquest agreed to overhaul its appraisal practices by removing branch offices and sales personnel from the appraiser selection process, instituting an automated system to select appraisers from panels created in each state, limiting the company's ability to get second opinions on appraisals,

and prohibiting Ameriquest employees from influencing appraisers. It will cease encouraging prospective borrowers to falsify income sources and levels, and it will provide accurate good faith estimates to borrowers. Further, it will limit prepayment penalty periods on variable rate mortgages and quit soliciting refinance business during the first 24 months of a loan, unless the borrower requests refinancing. Finally, Ameriquest agreed to use independent loan closers and to adopt policies to protect whistleblowers and facilitate reporting of improper conduct.

SUMMARY OF THIRD DISTRICT DEVELOPMENTS

Pennsylvania

On March 1, the Commonwealth Court of Pennsylvania dismissed a petition by the Pennsylvania Bankers Association that aimed to block three credit unions from expanding their membership to the greater communities they served (*Pennsylvania Bankers Association v. Pennsylvania Department of Banking*, No. 42 M.D. 2005, No. 98 M.D. 2005, and No. 157 C.D. 2005).

Credit unions differ from banks because, technically, they are owned by their depositors—instead of making deposits at the institution, members purchase shares in the company. Credit unions are considered nonprofit corporations and are exempt from federal and state taxation on their profits. Banks, however, are subject to all taxation, including taxes on profits.

Traditionally, credit union membership was group-based, but in 2003 the Credit Union Code was revised to permit community-based credit union membership. This means that membership can be based on common bonds, such as geography. Following the revision to the Credit Union Code, three Pennsylvania credit unions notified the Pennsylvania Department of Banking of their intent to expand their membership by becoming geography-based credit unions. The Pennsylvania Bankers Association protested the conversions, claiming that these credit unions would have an unfair advantage over banks. The court ruled that the plaintiffs failed to prove that the conversions would harm them; therefore, their petition was dismissed.

Delaware

On January 26, the Delaware Court of Chancery prevented AmSouth Bancorporation shareholders from filing suit against its board of directors based on a Financial Crimes Enforcement Network (FinCEN) investigation of the bank's compliance with the Bank Secrecy Act and other anti-money laundering regulations (*Stone, et al. v. Ritter, et al.*, No. 1570-N). FinCEN began to investigate AmSouth in connection with investigations of two of its customers. During the course of the investigation, FinCEN found that the bank did not file suspicious activity reports when it should have and failed to develop an appropriate anti-money laundering program. In addition, FinCEN found that the program did not have sufficient board and management oversight and that it was fragmented, meaning that information about sus-

picious activity was not always communicated to the sections of the bank responsible for Bank Secrecy Act compliance.

AmSouth's shareholders attempted to file suit against the bank's board of directors based on FinCEN's findings, but the chancery court prevented the suit, saying that the plaintiffs failed to provide specific facts to support their claims. Instead, the court said that the suit essentially reiterated FinCEN's findings. Therefore, the court dismissed the plaintiffs' claims.

On January 24, Governor Ruth Ann Minner signed into law an act that allows Delaware banks to choose between two methods of calculating their liability for the state bank franchise tax. Beginning in 2007, banks can use the current method of calculating franchise tax, which is based on 56 percent of a bank's in-state and out-of-state income, or use an alternative method whereby banks pay a tax based on income earned in Delaware.

To calculate their franchise tax liability, banks will use a formula that takes into account the bank's Delaware receipts, payroll, and property as a percentage of its total receipts, payroll, and property. The receipts factor is a fraction, with the numerator being the bank's total gross receipts from Delaware and the denominator being the bank's total gross receipts from everywhere. The payroll factor fraction has a numerator of wages, salaries, and other compensation paid to employees who are Delaware residents, and the denominator is wages, salaries, and other compensation paid to all of the bank's employees. The property factor is also a fraction: the numerator is the bank's real and tangible property, owned or rented, in Delaware; the denominator is the bank's real and tangible property everywhere. After the bank calculates each of these factors, it will multiply the receipts factor by two and then add it to the two other factors. The resulting number will be divided by four (or the number of the factors that were added together). The bank will multiply this number by its total net income to determine its tax base.

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