BANKING LEGISLATION & POLICY

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NOTE: This edition brings several important changes to *Banking Legislation and Policy*. First, Sarah Carroll is replacing Joanna Ender as the publication's principal writer. Joanna had a long and excellent tenure, and Sarah looks forward to continuing the high level of quality that Joanna achieved. Second, we have redesigned the format of the publication to make it more useful to readers. In each edition, we will focus on several of the most important events—new legislation, regulations, or court cases—that have occurred during the quarter. We will describe these events in detail and provide additional context and background on the issues involved. We will also include short summaries of all other relevant developments, together with links to the primary sources. Finally, beginning with this edition, *Banking Legislation and Policy* will be published exclusively in electronic format; we will no longer offer printed versions of the publication. We hope that you continue to find *Banking Legislation and Policy* useful and informative.

HIGHLIGHTS

This issue contains detailed descriptions of the following developments:

- Federal legislation to reform student loan programs
- Industrial Bank Holding Company Act of 2007 and related issues
- Insurance Industry Competition Act of 2007

In addition to these descriptions, it summarizes other notable legislative, regulatory, and judicial developments that occurred during the first quarter of 2007.

Federal Student Loan Program Reform

In January, Rep. George Miller (D-Calif.) and Sen. Edward Kennedy (D-Mass.) introduced legislation in the House and Senate to reform federal student loan programs (H.R. 5 and S. 359). Under these bills, interest rates on federal Stafford loans for undergraduates would decrease incrementally over the next five years and would reach 3.4 percent, half of their current level, in July 2011.

In mid-February, Rep. Miller and Sen. Kennedy introduced another pair of bills (H.R. 1010 and S. 572) that would encourage colleges to participate in the federal Direct Loan (DL) program, where loans are financed directly by the Department of Education, instead of the Federal

Family Education Loan (FFEL) program, which relies on private lenders.[1] Currently, the DL and FFEL programs exist in parallel and provide the same types of federally guaranteed loans, but there is some evidence that the DL program is less expensive to maintain. In March, a New York investigation of corruption in private student lending brought some FFEL lenders into further question.

Background

Today's dual system of federal student loan programs evolved from a single private lender-based format that existed under the Guaranteed Student Loan (GSL) program. The GSL program was enacted in 1965 to help undergraduate and graduate students finance their education.[2] Amendments enacted in 1993 renamed the GSL program as the FFEL program and created the Direct Loan program as its intended replacement. At the time, the intention was to phase out the GSL/FFEL program gradually. Amendments enacted in 1998, however, eliminated this phaseout.

Both programs provide low-interest education loans to low- and middle-income students, and an educational institution can choose to participate in either or both of the programs. Private lenders finance loans that are issued under the FFEL program, although the federal government guarantees the loans against borrower default. Loans issued under the DL program are financed directly by the federal government, which provides capital from the Treasury.

Recent Developments

On March 15, New York Attorney General Andrew Cuomo announced that he had discovered evidence of alleged deceptive practices by private student lenders. According to the results of Cuomo's nationwide investigation, some lenders had provided educational institutions with financial kickbacks in exchange for their business and offered extravagant, free trips for college financial aid officers. Lenders also allegedly paid to be included on colleges' preferred lender lists and offered colleges incentives to leave the DL program in order to generate more business. A week after the first announcement, Cuomo announced his intention to sue Education Finance Partners, a private lender, for paying undisclosed kickbacks to colleges that designated it as a preferred lender.

College Student Relief Act (H.R. 5)

The House of Representatives passed the College Student Relief Act by a vote of 356-71 on January 17. George Miller, chairman of the House Education and the Workforce Committee, introduced the bill, which was part of the new Democratic leadership's plan for its first 100 legislative hours. After its passage in the House, it was referred to the Senate Committee on Health, Education, Labor, and Pensions.

The bill would amend the Higher Education Act of 1965 by incrementally reducing interest rates on the unpaid principal balance of loans originated under both the Direct Loan and FFEL programs according to the following schedule:

- 6.8% if the first disbursement is made between July 1, 2006, and July 1, 2007
- 6.12% if the first disbursement is made between July 1, 2007, and July 1, 2008
- 5.44% if the first disbursement is made between July 1, 2008, and July 1, 2009
- 4.76% if the first disbursement is made between July 1, 2009, and July 1, 2010
- 4.08% if the first disbursement is made between July 1, 2010, and July 1, 2011
- 3.4% if the first disbursement is made between July 1, 2011, and July 1, 2012.

Between 2007 and 2012, the bill would create a net benefit of $2.6 billion for the federal

[1] This incentive program was also included in S. 359.
[2] P.L. 89-329.

government.[3] On their own, the interest rate cuts would raise federal government expenses because of reduced interest receipts in the DL program and increased subsidies for private lenders in the FFEL program. To offset these costs, however, the College Student Relief Act would reduce benefits to private FFEL lenders through several measures, allowing the government to save money overall. Lender insurance would be reduced to 95 percent of a loan's unpaid balance, a drop from the current 97 percent insurance rate. Fees paid to lenders to compensate them for efforts to collect on defaulted loans would fall incrementally from 23 percent of the defaulted collections, eventually reaching 18 percent. The bill would eliminate exceptional performer status, which rewards private lenders that exhibit high levels of due diligence, and for large lenders, it would also reduce special allowance payments by one-tenth of a percentage point. Loan origination fees, for which lenders currently pay 0.5 percent of the principal amount, would increase to 1 percent, and collecting the fees from borrowers would be prohibited. Finally, beginning in June 2007, lenders whose total holdings are at least 90 percent composed of FFEL consolidated loans would face a loan fee increase to 1.3 percent of a loan's principal and unpaid interest.

Student Debt Relief Act of 2007 (S. 359)

Edward Kennedy, chairman of the Senate Health, Education, Labor, and Pensions Committee, introduced the Student Debt Relief Act of 2007 in the Senate on January 22. The bill was referred to the Committee on Finance and is awaiting further action.

Incremental reductions in FFEL and Direct Loan program interest rates are identical to those outlined in the House bill. However, the Senate bill includes additional measures designed to benefit college students. The bill would extend the Pell grant program through 2012 and increase the maximum grant amount over the next five academic years as follows:

- $5,100 for academic year 2007-2008
- $5,400 for academic year 2008-2009
- $5,700 for academic year 2009-2010
- $6,000 for academic year 2010-2011
- $6,300 for academic year 2011-2012.

The bill would also forgive outstanding federal loans for public sector employees after 10 years and 120 income-contingent payments.[4] It would cap borrowers' loan payments at 15 percent of their discretionary income (calculated as income in excess of 150 percent of the poverty line) and would eliminate the three-year limit on loan deferrals due to economic hardship. The bill would change the definition of economic hardship from having earnings less than "100% of the poverty line for a family of two" to having earnings less than "150% of the poverty line applicable to the borrower's family size." Borrowers would also gain tax benefits: the tax deduction for college expenses incurred by taxpayers or their dependents would increase, and the bill would establish a tax credit for interest paid on student loans, up to $1,500 for taxpayers with incomes of $50,000 or less. Finally, the bill would allow students to consolidate FFEL loans while they were still attending school and would reduce origination fees from 4 percent to 3 percent for Direct Loans.

The bill would also create a Student Aid Reward Program to encourage colleges to participate in the student loan program that is most cost-effective to taxpayers (which would presumably be the DL program). Any college that agreed to participate in that program for at least five years would receive supplemental grant funds equal to at least half the amount of the savings that

[3] Congressional Budget Office Cost Estimate, revised March 19, 2007.

[4] Under the Income Contingent Repayment Plan, borrowers' monthly payments are set based on their adjusted gross income for the previous year.

the decision generated. The college could award the supplemental grants solely to students who already receive Pell grants, or it could also choose to award a portion of the funds to graduate students in need of financial aid. The total amount of supplemental funds disbursed would not be allowed to exceed the total government savings generated by the program.

Related Links
Text of H.R. 5
Text of S. 359
Text of H.R. 1010/S. 572
Attorney General Cuomo's press release

Industrial Bank Holding Company Act of 2007 (H.R. 698)

On January 29, House Financial Services Committee Chairman Barney Frank (D-Mass.) and Rep. Paul Gillmor (R-Ohio) introduced H.R. 698, the Industrial Bank Holding Company Act of 2007, in the House of Representatives. This bill, similar to legislation the two congressmen introduced last year, would bar commercial firms from acquiring or establishing new industrial loan companies (ILCs). After its introduction, H.R. 698 was referred to the House Committee on Financial Services, where a hearing on the bill is planned for late April.

Even before the bill was introduced, companies wishing to form or acquire new ILCs had begun to encounter some new obstacles. Over a dozen state legislatures have recently passed or are considering bills to limit ILCs' branching power. Two days after the bill was introduced, the board of the Federal Deposit Insurance Corporation voted to extend its moratorium on applications by commercial firms for ILC deposit insurance and change in control notices until January 31, 2008. On March 16, Wal-Mart, one of the most heavily scrutinized applicants for commercial ILC deposit insurance, abandoned its bid to acquire an ILC, citing the extended delays created by the FDIC decision.

Background

Industrial loan companies, also called industrial banks or thrift companies, are state-chartered financial institutions that were created in the early 20th century to lend money to industrial workers. In some states, they can now perform most of the functions of regular commercial banks. Of the 58 FDIC-insured industrial banks existing on January 30, 2007, 49 were "engaged solely in financial activities," four were owned by individuals, and 15 were "subsidiaries of [commercial] holding companies."[5] Existing ILCs that directly support the business of a commercial parent company include BMW Bank of North America, Volkswagen Bank USA, and Pitney Bowes Bank. Forty-five of the 58 insured ILCs existing at the end of January were located in Utah or California. According to the FDIC, the largest insured ILC as of 2005 was operated by Merrill Lynch, chartered in Utah, and had over $60 million in assets. Overall, ILCs' portfolios tend to be riskier than those held by other types of banks. Last year, the average net chargeoff rate for ILCs was .393, over 2.5 times the rate for commercial banks.[6] At the same time, ILCs' average return on assets was 2.407, over twice the return that commercial banks earned.

A key difference between ILCs and traditional banks is that ILCs are not supervised by the Federal Reserve, since firms can own them without establishing a bank holding company or a financial holding company. The FDIC and state supervisors oversee their operation, and the FDIC insures the deposits of many larger ILCs. However, a 2005 Government Accountability Office report advocated stronger regulation of ILCs, closer to

[5] 72 *Federal Register*, pp. 5291.
[6] As defined by the Federal Reserve Board, an institution's net charge-off rate is "the flow of [its] net charge-offs (gross chargeoffs minus recoveries) during a quarter divided by the average level of its loans outstanding during that quarter."

that imposed on other financial institutions. In testimony prepared for the House Committee on Financial Services in March, FDIC chairman Sheila Bair asked Congress to strengthen the agency's regulatory power over ILC holding companies. Bair suggested that if the FDIC is to be a major ILC regulator, it should be able to "impose consolidated capital requirements" on ILC holding companies, just as the Fed does for bank holding companies.

Apprehension about ILCs has grown in recent years for a few reasons. As evidenced by the GAO report and Bair's testimony, there are some concerns that the current level of ILC supervision is inadequate and could subject the deposit insurance system to unreasonable levels of risk. In addition, some critics have questioned whether commercially controlled ILCs constitute a fundamental breach of the separation of banking and commerce established in federal legislation during the Great Depression. Finally, large retailers' plans to acquire ILCs have been viewed as a threat by some community banks. Wal-Mart's proposal to acquire an ILC in Utah has drawn particular protest, despite the company's claims that it would use its ILC only to process debit and credit transactions.

In response to current concerns, many state legislatures have recently passed or are now considering laws limiting the branching power of ILCs, perhaps creating an additional source of pressure for Congress to pass legislation of its own. Last year, bills were passed in Iowa, Maryland, Missouri, Oklahoma, and Virginia. In late March of this year, legislators in Colorado, West Virginia, and Tennessee enacted similar bills, while legislation remained pending in 11 other states as of early April.

FDIC Moratorium

The FDIC moratorium on ILC deposit insurance and change of control notices was first enacted in July 2006 and expired on January 31, 2007. This original moratorium placed a hold on applications from commercial and financial firms alike, citing a need to "further evaluate industry developments, the various issues, facts, and arguments raised with respect to the industrial bank industry, whether there are emerging safety or policy issues involving industrial banks…and whether statutory, regulatory, or policy changes should be made in the FDIC's oversight of industrial banks in order to protect the deposit insurance fund or important Congressional objectives."

On January 31, 2007, when the original moratorium was due to expire, the FDIC Board of Directors voted to extend the moratorium by a year for commercial firms and to begin processing ILC applications from financial firms. On March 20, the FDIC approved three of the four pending applications for ILCs owned by financial parent companies. Since Wal-Mart abandoned its ILC proposal, the three commercial firms remaining with pending applications are Home Depot, Daimler-Chrysler, and American Pioneer.

Recent Federal Legislation

In recent sessions of Congress, legislators have attempted to pass ILC legislation without much success. In the 108th Congress, House members tried to limit nonfinancial ILCs' interstate branching power in amendments to the Financial Services Regulatory Relief Act of 2003 (H.R.1375).[7] The bill passed the House but did not make it beyond the Senate Committee on Banking, Housing, and Urban Affairs. In the 109th Congress, H.R. 3505, which also would have restricted commercial ILCs' interstate branching abilities, passed the House but again did not make it past a Senate committee. Other bills that would have strengthened ILC regulation were introduced in the House but were never taken up.

[7] The Financial Services Regulatory Relief Act of 2003 is summarized in *Banking Legislation and Policy, Volume 23, Number 1*.

Industrial Bank Holding Company Act of 2007 (H.R. 698)

The Industrial Bank Holding Company Act of 2007 would first add formal ILC and ILC holding company definitions to the Federal Deposit Insurance Act. Under the bill, an ILC or industrial bank would be defined as "any insured State bank that is an industrial bank, industrial loan company, or other institution described in section 2(c)(2)(H) of the Bank Holding Company Act of 1956." An industrial bank holding company would be defined as any company that directly or indirectly controls an ILC and is not already a bank holding company or savings and loan holding company.

The bill would require every industrial bank holding company to register with the FDIC within 90 days of becoming an industrial bank holding company. For existing companies that newly became industrial bank holding companies under the definitions outlined in the bill, the registration deadline would fall 90 days after the bill's enactment.

Most significantly, the bill would ban commercial firms from becoming industrial bank holding companies. Within the bill, a commercial firm is defined as any entity that has derived at least 15 percent of its gross revenue from nonfinancial activities during at least three of the past four calendar quarters. Commercial firms that acquired control of ILCs between October 1, 2003, and the bill's introduction on January 29 would be allowed to maintain them, but they would not be allowed to create or take control of any more. These grandfathered commercial ILCs would also be prohibited from engaging in new activities and from establishing or acquiring branches in new states.

Related Links

H.R. 698

FDIC Moratorium Notice

Insurance Industry Competition Act of 2007 (S. 618, H.R. 1081)

On February 15, a bipartisan bill that would make the insurance industry subject to federal antitrust laws was introduced in both houses of Congress. Insurance companies currently enjoy a limited exemption from antitrust regulation under the McCarran-Ferguson Act of 1945.[8] Senate Judiciary Committee Chairman Patrick Leahy (D-Vt.) introduced the bill, known as the Insurance Industry Competition Act of 2007 (S. 618). Rep. Peter DeFazio (D-Ore.) introduced a companion bill (H.R. 1081) in the House, and it was referred to the Committees on the Judiciary; Energy; and Commerce and Financial Services.

Background

Issues in insurance regulation have been debated in the American judicial and legislative systems for at least the past century and a half. In an 1868 case, the Supreme Court ruled that issuing an insurance policy did not amount to an act of interstate commerce.[9] However, in 1944, the Supreme Court overturned this decision, ruling that insurance companies did engage in interstate commerce and could therefore be regulated by the federal government.[10] Congress responded by passing the McCarran-Ferguson Act of 1945, which exempted insurance companies from federal antitrust laws to the extent that they were regulated by state law. As an exception to this rule, insurers remained subject to federal antitrust law in cases of boycott, coercion, and intimidation.

In recent years, policymakers have begun to question the necessity of this antitrust exemption. A 2005 report by the GAO asked whether the insurance industry possessed any unique characteristics that should make it exempt. Some

[8] P.L. No. 79-15, ch. 20, 59 Stat. 33, codified as amended at 15 U.S.C. §§ 1011-1015.

[9] *Paul v. Virginia*, 75 U.S. 168 (1868).

[10] *United States v. South-Eastern Underwriters Ass'n.* (322 U.S. 533 (1944).

experts cited in the report suggested that the usefulness of limited collaboration between insurance providers, given the inherently high level of uncertainty about future costs in their industry, could justify the exemption. If an insurance provider incorrectly forecast its future costs and became insolvent, it could have a disastrous effect on many policyholders, although the report points out that the same might be argued about banks or other nonexempt entities.

The GAO report also discussed joint ratemaking, which is an important insurance practice whose legality could come under question if the antitrust exemption was lifted. Insurance companies often use pooled historical data collected by third-party rating organizations to project loss costs and price policies. Rating organizations help insurers reduce uncertainty and perhaps avoid potential insolvencies by collecting and distributing this historical loss information; they do not directly set insurance rates. Nonetheless, there is a concern that, by sharing such information, insurance companies could potentially facilitate collusion. In the absence of the McCarran-Ferguson exemption, such concerns might be taken up by the federal authorities (the Federal Trade Commission or the Antitrust Division of the Department of Justice).

Recent Federal Legislation

In the last Congress, the Insurance Competitive Pricing Act of 2005 (H.R. 2401), the Insurance Industry Antitrust Enforcement Act of 2006 (S. 4025), and the National Insurance Act of 2006 (S. 2509) were introduced but did not make it beyond committee.[11] The first bill would have made the insurance industry subject to federal antitrust law specifically in matters of price fixing, agreements to split customers or geographical areas between competitors, unlawfully tying the sale of one type of insurance to the sale of any other type of insurance or product, and attempting to form a monopoly. The joint ratemaking process would have remained legal. The second bill would have subjected insurance companies to federal antitrust law except where an action was specifically and actively regulated by a state or where a third-party agency, rather than an insurance provider, collected historical loss data or distributed standardized forms and literature. The third bill would have made federally chartered insurance companies subject to federal antitrust law, while state-chartered companies would have remained exempt.

Insurance Industry Competition Act of 2007 (S. 618, H.R. 1081)

If passed, the Insurance Industry Competition Act would make two major alterations to the McCarran-Ferguson Act. First, the legislation would specifically allow the Sherman Act, the Clayton Act, and the Federal Trade Commission Act to supersede state law "as it relates to unfair methods of competition." In matters other than unfair competition, state law would retain precedence.

Second, the bill specifies that the Department of Justice and the Federal Trade Commission would be jointly responsible for enforcing the law and could "issue joint statements of their antitrust enforcement policies regarding joint activities in the business of insurance." Under this provision, the two agencies would be able to clarify how they plan to enforce antitrust laws, which are old and rather ambiguous.

Related Links

H.R. 1081/S. 618
GAO Report GAO-05-81

[11] The National Insurance Act of 2006 is summarized in *Banking Legislation and Policy*, Volume 25, Number 2.

OTHER DEVELOPMENTS

Federal Legislation

Pending Legislation

Seasoned Customer CTR Exemption Act of 2007

On January 23, the House of Representatives passed the Seasoned Customer CTR Exemption Act of 2007 (H.R. 323) by voice vote. The bill exempts banks from filing currency transaction reports (CTRs) for customers who have conducted multiple transactions with the bank and have done business there for at least a year. Banks are currently required to file CTRs for all currency transactions in excess of $10,000. Rep. Spencer Bachus (R-Ala.) introduced the bill; after its passage in the House, it was forwarded to the Senate Committee on Banking, Housing, and Urban Affairs and is awaiting further action.

New Legislation

Community Choice in Real Estate Act

In January, both houses of Congress introduced bipartisan bills that would permanently bar banks from engaging in real estate brokerage or management activities. Rep. Paul E. Kanjorski (R-Pa.) introduced the Community Choice in Real Estate Act (H.R. 111) on January 4, and it was forwarded to the House Committee on Financial Services. Its Senate equivalent, S. 413, was introduced by Sen. Hillary Clinton (D-N.Y.) on January 26 and forwarded to the Senate Committee on Banking, Housing, and Urban Affairs.

Federal Housing Finance Reform Act of 2007

On March 29, the House Committee on Financial Services approved the Federal Housing Finance Reform Act of 2007 (H.R. 1427). The bill would strengthen regulatory oversight of government-sponsored mortgage funding enterprises Freddie Mac and Fannie Mae and, controversially, would require them to deposit 0.012 percent of the average value of their portfolios during the previous year in an affordable housing fund. The bill was introduced by House Financial Services Chairman Barney Frank (D-Mass.) on March 9 and is relatively faithful to a compromise that Rep. Frank struck with the Treasury Department in December. It is similar to a bill passed by the House in 2005.

Credit Union Regulatory Improvements Act of 2007

Rep. Paul Kanjorski (D-Pa.) introduced the Credit Union Regulatory Improvements Act of 2007 (H.R. 1537) in the House on March 15. Among other measures, the bill would allow credit unions of all charter types to make loans in underserved areas. It was referred to the House Committee on Financial Services.

Credit Union Small Business Lending Act

On March 29, Nydia Velazquez (D-N.Y.), chairwoman of the House Small Business Committee, introduced the Credit Union Small Business Lending Act (H.R. 1849). The bill would encourage credit unions to offer Small Business Administration loans by exempting such loans from the credit union business lending cap, organizing a credit union outreach program, and guaranteeing up to 85 percent of the value of loans under $250,000 made to businesses in underserved areas. The bill was referred to the House Committees on Financial Services and Small Business.

Federal Housing Administration Reform
Two separate bills designed to reform the Federal Housing Administration were introduced in the House of Representatives on March 29. H.R. 1752, which was introduced by Rep. Judy Biggert (R-Ill.), would strengthen the FHA's mortgage program and is identical to the Expanding American Homeownership Act of 2006, which the House passed last year.[12] Financial Services Committee Chairman Barney Frank (D-Mass.) and House Subcommittee on Housing and Community Opportunity Chairman Maxine Waters (D-Calif.) introduced the Expanding American Homeownership Act of 2007 (H.R. 1852). In addition to reforming the FHA mortgage program, this bill would establish an affordable housing fund.

Third District State Legislation
New Jersey
Protection Against Credit Discrimination for Identity Theft Victims
On January 29, a New Jersey law barring creditors from rejecting credit applicants solely because they were the victims of identity theft was signed into law. Creditors can be fined up to $5,000 for each violation. The law will take effect 90 days after its enactment.

Federal Regulation
Board of Governors of the Federal Reserve System
Structured Finance Guidelines
On January 5, a group of federal regulators issued final guidelines for banks that engage in complex structured finance transactions. The statement emphasized the importance of internal controls and approval processes in managing legal and reputational risk, and it was jointly released by the Fed's Board of Governors, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Securities and Exchange Commission. Few financial institutions engage in the specialized types of transactions covered by the guidelines, but they are of particular concern because they have been used fraudulently to misrepresent corporations' financial situations.

Statement on Subprime Mortgage Lending
On March 3, federal regulatory agencies requested comment on a proposed Statement on Subprime Mortgage Lending. The statement mainly addresses concerns about borrowers' comprehension of the terms and risks of subprime adjustable-rate mortgage products as defined in the 2001 Expanded Guidance for Subprime Lending Programs, and it was jointly issued by the Fed, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

Department of Justice
Lending Discrimination Settlement
Compass Bank, based in Birmingham, Ala., responded to lending discrimination allegations by the Department of Justice by agreeing on January 12 to establish a $1.75 billion settlement fund. In 2003, Federal Reserve Board examiners found evidence that the bank had been charging higher interest rates to unmarried loan co-applicants in violation of the Equal Credit Opportunity Act. According to the Department of Justice

[12] The Expanding American Homeownership Act of 2006 is summarized in *Banking Legislation and Policy*, Volume 25, Number 3.

consent order, Compass Bank has since edited its lending procedures and plans to provide additional equal credit opportunity training to its employees.

Federal Deposit Insurance Corporation

Privacy Protection Policy Disclosure

On March 20, federal regulatory agencies requested comment on a proposal to amend rules that describe a standard format banks may use to disclose their privacy protection policies to customers, as mandated by the Gramm-Leach-Bliley Act and the Financial Services Regulatory Act of 2006.[13] Banks are required to make the privacy disclosures both initially and annually, and the form would provide a "safe harbor" for participating banks. Comments on the proposal, which was issued by the FDIC, the Fed, the OCC, the OTS, the National Credit Union Administration, the FTC, the SEC, and the Commodity Futures Trading Commission, are due by May 29.

Federal Trade Commission

Inadequate Disclosure Settlement

Consumerinfo.com has agreed to pay the Federal Trade Commission $300,000 to settle charges of inadequate disclosures to customers. According to the FTC judgment, the company failed to adequately inform customers that when they signed up for a free credit report, they would also be registered automatically for a credit monitoring service at a fee of $79.95 per year. The FTC alleged that this violated the terms of an August 2005 injunction on similar charges.

Deceptive Marketing Settlement

The Federal Trade Commission voted unanimously in mid-March to accept a settlement from Kmart on charges that the retailer deceptively marketed its gift cards from 2003 to May 1, 2006. According to the complaint, advertisements claimed that the gift cards never expired, omitting the fact that after 24 months of inactivity, a $2.10 "dormancy fee" would be deducted for each month the card had been inactive. Under the settlement, Kmart will be required to refund dormancy fees to customers who file claims and will be required to advertise the availability of refunds on its website. The proposed settlement was open for public comment through April 10.

Financial Accounting Standards Board

Hedge Accounting on Variable-Rate Instruments

On January 8, the Financial Accounting Standards Board issued guidance regarding the use of hedge accounting on variable-rate financial instruments whose interest rates are not based explicitly on benchmark (LIBOR or Treasury) rates. The Board ruled that a business can use a cash flow hedge in only some types of situations involving these variable-rate derivatives. The FASB statement presents two detailed situations to illustrate the circumstances under which a cash flow hedge is and is not appropriate.

Bifurcation Rules

The Financial Accounting Standards Board released guidance on January 17 that would exempt banks and other enterprises from applying bifurcation rules to prepayable asset-backed securities that feature embedded

[13] On April 5, the agencies released a corrected third page of the proposal.

derivatives. Bifurcation rules require that the institution separate the embedded derivative from the host contract, an accounting process that banks often find tedious and unnecessary.

Internal Revenue Service

Reporting Nonsufficient Funds Fees

On January 12, the Internal Revenue Service declared in Revenue Ruling 2007-1 that credit card issuers do not need to report nonsufficient funds (NSF) fees received from consumers as interest income. A credit card company charges an NSF fee when it rejects a customer's credit card convenience check because of an insufficient balance in the connected account. The IRS also clarified, however, that issuers do need to include the fees in their gross income for federal income tax purposes.

Office of the Comptroller of the Currency

Implementation of Financial Services Regulatory Relief Act of 2006

On April 10, federal regulatory agencies requested comment on rules to implement the Financial Services Regulatory Relief Act of 2006. Under the newly proposed rules, well-managed banks with $500 million or less in assets could become subject to an 18-month on-site examination cycle, whereas under the existing rules, only banks with assets of $250 million or less qualify for the extended cycle.

Office of Thrift Supervision

Thrift Gift Card Program Guidance

The Office of Thrift Supervision issued guidance on February 28 for gift card programs offered by OTS-regulated thrifts. The statement encourages uniform practices among these programs and outlines OTS expectations regarding account administration, marketing, and consumer disclosures.

Community Reinvestment Act Regulations

On March 19, the Office of Thrift Supervision issued a final rule that alters its Community Reinvestment Act regulations to match regulations set by the OCC, FDIC, and Fed. The new version of the regulation eliminates the choice of alternative weighting measures for the assessment of large thrifts, reclassifies thrifts with assets of $250 million to $1 billion as "intermediate small savings associations," indexes changes in these limits annually based on the consumer price index, and clarifies the impact of illegal credit practices on an institution's CRA rating.

Savings and Loan Holding Company Regulation

On March 27, the Office of Thrift Supervision requested comment on a proposed change to savings and loan holding company (SLHC) regulation. Currently, the OTS limits SLHCs' permissible activities to only some of those permitted for bank holding companies. Under the new proposal, SLHCs would be permitted to engage in any activities permitted by the Federal Reserve under regulations enacted under section 4(c) of the BHCA.

Judicial Developments

Circuit Court Rulings

Class Action Rescission Suits

The U.S. Court of Appeals for the First Circuit and the California Court of Appeal (Fourth District) ruled in separate cases in January that class action suits seeking the rescission of loans under the Truth in Lending Act

are invalid. In the federal case, the plaintiffs complained that First Horizon Home Loan Corporation inaccurately disclosed borrowers' rescission rights in violation of the Truth in Lending Act (*McKenna v. First Horizon Home Loan Corporation*, No. 06-8018). The court ruled that class-action lawsuits were not intended for rescission cases and, therefore, refused the class certification. In the California case, the plaintiffs claimed that Pacific Mercantile Bank failed to notify them of closing fees associated with their loans (*LaLiberte v. Pacific Mercantile Bank*, Calif.Ct.App., No. G036235). A third case is being reviewed by the U.S. Court of Appeals for the Seventh Circuit.

Enron Shareholder Class Certification

On March 19, the U.S. Court of Appeals for the Fifth Circuit overturned a district court order that had certified a single plaintiff class in a case brought by Enron shareholders against three investment banks that allegedly helped the company to fraudulently conceal its financial condition (*Regents of University of California v. Credit Suisse First Boston (USA) LLC*, 5th Cir., No. 06-20856, 3/19/07). According to the court, the three banks—Credit Suisse First Boston, Merrill Lynch, and Barclays Bank PLC—committed actions that "at most aided and abetted Enron's deceit" and did not constitute manipulation, and there was no classwide presumption of reliance in the case.

District Court Rulings

Auditing Negligence Settlement

On March 14, a federal judge for the U.S. District Court for the Southern District of West Virginia ordered Grant Thornton, an independent auditor, to pay damages to the Federal Deposit Insurance Corporation as compensation for its failure to uncover loan fraud by First National Bank of Keystone (*Grant Thornton LLP v. Federal Deposit Insurance Corporation*, S.D. W.Va., No. 1:00-0655, 3/14/07). Grant Thornton began its investigation in August 1998 as ordered by the OCC, and the bank's eventual failure in September 1999 cost the FDIC about $750 million. According to the court opinion, the losses "would not have occurred but for the negligence of Grant Thornton" and, had the auditor acted responsibly, the bank would have been closed six months prior to its failure. Grant Thornton might be forced to repay over $25 million for its negligence. The opinion is not yet available on the court's website.

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