BANKING LEGISLATION & POLICY

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HIGHLIGHTS

This issue contains a detailed description of legislative and regulatory responses to recent financial liquidity issues linked to problems in the subprime mortgage market.

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

In August, liquidity in certain financial markets in the U.S. and abroad abruptly contracted. The initial trigger was the deteriorating performance of recently originated subprime mortgages that were securitized and sold to investors. Even highly rated mortgage-backed securities became difficult to sell in secondary markets, and the issuance of new mortgage-backed securities declined precipitously. This had an immediate effect on mortgage lenders who relied primarily on the securitization and sale of subprime mortgages as a source of funds for making their loans. This, in turn, led to the closure of some of the largest independent mortgage lenders, as well as a significant reduction in the willingness of the remaining lenders to originate mortgages other than fixed-rate, conforming mortgages to prime borrowers who intended to live in the houses.[1]

Delinquencies and foreclosures have already increased significantly among subprime mortgage borrowers. Many of these loans charge adjustable interest rates, and millions of these mortgages are set to re-price over the next year. With little appreciation in home prices expected in the near future, many of the affected borrowers will have difficulty refinancing their mortgages or managing the increased payments on their current ones.

This issue of *Banking Legislation and Policy* examines the legislative and regulatory response to these shocks. Many of the proposals focus on mortgage modification and loss mitigation strategies, homeownership counseling, and lenders' responsibilities to borrowers. Some also respond to calls to increase the flexibility of the Federal Housing Administration and housing finance government-sponsored enterprises Fannie

[1] A conforming mortgage loan is one in which the original principal is currently less than $417,000. This term refers to the cutoff in the maximum loan size the GSEs Fannie Mae and Freddie Mac are permitted to buy and repackage into mortgage-backed securities. Mortgages with initial balances above this amount are often called "jumbo" loans and are often securitized by private firms.

Mae and Freddie Mac to help strengthen the mortgage market. Policymakers have also begun to address legal and accounting issues that potentially discourage the renegotiation of securitized mortgages at risk of default.

Background

A subprime mortgage is a housing loan that is issued to a borrower perceived to pose a relatively high risk of default. Subprime borrowers often have one or more of the following characteristics: a high debt-to-income ratio; a recent foreclosure, bankruptcy, repossession, or chargeoff; a low credit score (generally 620 or lower); or recent payment delinquencies.[2]

The subprime market has grown rapidly in recent years. While only 5 percent of all mortgages originated in 1995 were subprime, about 20 percent were subprime by 2005.[3] In 2006 alone, over $600 billion in subprime loans were originated.[4] Many subprime mortgages have nontraditional features, often including low initial payments that eventually reset to a higher level. Among the most commonly issued is the 2/28 mortgage, which charges a low, fixed interest rate for the first two years of the loan's duration and then resets to a higher, variable rate for the remaining 28 years. Negative amortization and interest-only mortgages have also become more common.[5]

As housing prices rose quickly in the first part of the decade, mortgage lenders extended increasing amounts of credit to risky borrowers. Initially, delinquency rates were quite low, in part because ongoing appreciation in home values made it relatively easy for borrowers to refinance their loans. Growth in the securitization of these loans made it easier for federally unregulated nonbank financial institutions to issue mortgages. Subprime mortgages produced higher yields for investors, and many hedge funds and other financial institutions invested in securities that were backed by them. In retrospect, while the use of these instruments allowed the institutions to obtain higher yields and diversify their portfolios, it also made it difficult to accurately price their risk.

Before the liquidity crisis occurred, federal regulatory agencies and legislators had produced a number of proposals to address risks in the mortgage market.[6] On May 31, 2007, 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 issued a series of four illustrations intended to help mortgage lenders clarify the terms of nontraditional subprime loans for borrowers, with a particular emphasis on the financial consequences of interest rate changes. In late June, the agencies released a final Statement on Subprime Mortgage Lending, which set guidelines to help lenders issue nontraditional mortgages in a safe and sound manner and avoid consumer complaints about alleged unfair or deceptive practices.

On the legislative side, Sen. Charles Schumer (D-N.Y.)introduced the Borrowers' Protection Act of 2007 (S. 1299), and Sen. Jack Reed (D-R.I.) introduced the Homeownership Protection and Enhancement Act of 2007 (S. 1386) in May. Both bills would have increased the responsibility of mortgage issuers to prevent foreclosures, but neither bill made it out of committee.

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[2] Faten Sabry and Thomas Schopflocher, *The Subprime Meltdown: A Primer* (Part I of A NERA Insights Series), June 2007.

[3] Testimony of Sandra F. Braunstein, Director, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, U.S. House of Representatives, March 27, 2007.

[4] Testimony of Sandra L. Thompson, Director, Division of Supervision and Consumer Protection, Federal Deposit Insurance Corporation, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 22, 2007.

[5] See *Banking Legislation and Policy*, Volume 26, Number 2 for more background information on subprime lending.

[6] For more detail on these proposals, see *Banking Legislation and Policy*, Volume 26, Number 2.

Federal Regulation

Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages

On September 4, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the National Credit Union Administration, and the Conference of State Bank Supervisors released a joint statement advising servicers of securitized mortgages that they should "work constructively with residential borrowers at risk of default" and help them avoid foreclosure by any methods allowable under the contract documents governing the securitized loans.

Specifically, the agencies suggest that servicers identify borrowers at risk of default (for example, those whose interest rates are about to reset to higher levels), contact them to assess their ability to repay their mortgages, and develop loss mitigation strategies to avoid foreclosure, if necessary. Such strategies might include "loan modifications; deferral of payments; extension of loan maturities; conversion of adjustable-rate mortgages into fixed-rate or fully indexed, fully amortizing adjustable-rate mortgages; capitalization of delinquent amounts; or any combination of these." The statement points out that these loss mitigation strategies are generally less costly to the servicer than foreclosure would be. The agencies also encourage mortgage servicers to refer at-risk borrowers to homeownership counseling agencies for assistance when appropriate.

Despite the agencies' encouragement, loan renegotiations seem to be uncommon. In an October 4 speech, FDIC Chairman Sheila Bair claimed that less than 1 percent of troubled subprime mortgages "were being restructured in any meaningful way." This may be due in part to legal issues that may arise when renegotiating loans that have been securitized. FAS 140, a statement issued by the Financial Accounting Standards Board in 2000, specifies the characteristics of the special interest trusts to which securitized subprime mortgages are often transferred. Servicers of these trusts are required to remain passive; that is, they are not permitted to make decisions other than those inherent to their servicing duties. Although servicers can react to loans that have already defaulted, there was a concern this restriction would preclude renegotiating the mortgages of borrowers at risk of defaulting but not yet in default. If such modifications were found to violate FAS 140, a servicer might risk undoing the sale, forcing the consolidation of the trust's assets on to the original lender's balance sheet.

Anticipating this issue, the House Financial Services Committee sent a letter on June 15 to the Securities and Exchange Commission, which oversees the Financial Accounting Standards Board, asking whether it would be permissible under FAS 140 for loan servicers to renegotiate mortgages for which default is "reasonably foreseeable," rather than waiting until the loans actually defaulted. SEC Chairman Christopher Cox replied that the modification of loans at risk of default did not constitute active management and did not preclude off-balance-sheet treatment under FAS 140.

Even given this clarification, however, it could remain difficult to renegotiate subprime mortgages. The Real Estate Mortgage Investment Conduit (REMIC) structure, under which most subprime mortgage securitizations exist, allows securitizers to sell different classes of instruments that are secured by the same mortgages without being subject to corporate taxes. As a result, although investors might hold securities from the same mortgage pool, their interests could conflict since they receive different payoffs in a given scenario. While renegotiating the terms of a mortgage to avoid foreclosure might be better overall for the instruments secured by the mortgage, modification might worsen some investors' individual payoffs, making it likely that they would object. Moreover, a servicer that attempted to solve this problem by coordinating an agreement or a compensation arrangement between different classes of investors could be accused of engaging in a prohibited level of active management.

Debt-to-Income Ratio Guidance

The Federal Deposit Insurance Corporation and the Conference of State Bank Supervisors, along with the American Association of Residential Mortgage Realtors, released a supplemental statement on September 4 cautioning their supervised institutions to take into account a borrower's ability to repay his or her new obligations when renegotiating mortgages to prevent foreclosure. Specifically, the regulators advise institutions to select loss mitigation strategies that will avoid generating debt-to-income (DTI) ratios of more than 50 percent, since it is likely to be difficult for borrowers with higher ratios to repay their debts.[7] The statement emphasizes that the DTI ratio should reflect the borrower's total monthly housing-related obligations, including principal, interest, taxes, and insurance, as well as other debt obligations.

Call Report Proposal

On September 11, 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 requested comment on a proposal to increase the amount of mortgage information banks are required to disclose on their quarterly Consolidated Reports of Condition and Income, commonly referred to as call reports. Some other changes included in the proposal would also apply to savings associations and their analogous Thrift Financial Reports (TFRs).

Under the proposal, banks would be required to list quarterly average balances and interest and fee income for one- to four-family mortgages separately from all other loans secured by real estate. The proposal would also require banks to disclose separately the principal amounts of restructured one- to four-family mortgages that are both in and out of delinquency. Banks would be required to provide specific information on one- to four-family mortgages undergoing foreclosure processes; they are currently required to report on mortgages in foreclosure only when that process has been completed. Finally, the proposal would require banks to report the principal amount of mortgages they had sold but were then forced to repurchase or indemnify due to borrower defaults, loan defects, breaches of representation and warranty, and other causes. Comments on the proposal were due November 13.

GSE Portfolio Cap Increase

On September 19, the Office of Federal Housing Enterprise Oversight (OFHEO), the primary regulator for housing GSEs Fannie Mae and Freddie Mac, announced that it would relax the GSEs' portfolio caps slightly to help provide liquidity in the subprime mortgage market. The OFHEO imposed limits of just under $730 billion on the two organizations' mortgage assets last year in response to ongoing financial reporting issues. With the announcement, the OFHEO agreed to allow them to increase their portfolios' sizes to $735 billion, effective as of the third quarter of 2007. In addition, Fannie Mae will be allowed an annual portfolio growth rate of 2 percent, beginning October 1; Freddie Mac is already allowed this rate of growth under its voluntary agreement. For the fourth quarter of 2007, the quarterly growth limit will also be raised temporarily from 0.5 percent to 1 percent. The GSEs will be required to report frequently on their purchases of subprime mortgages, as well as on overall market conditions and their portfolio sizes.

[7] This threshold is based on a borrower's *gross* monthly income.

In the statement, the OFHEO estimated that the added portfolio flexibility, combined with the GSEs' ability to securitize, sell, and replace assets, would allow the GSEs to purchase at least $20 billion worth of "subprime mortgages, refinanced mortgages for borrowers with lower credit scores, and affordable multi-family housing mortgages." The regulator defended the relatively small portfolio cap increase, citing "ongoing safety and soundness issues," and emphasized the need for congressional guidance and strengthened supervisory power before larger and more permanent increases can be enacted.

IRS Foreclosure Guidance

The Internal Revenue Service updated its website on September 17 with a new section emphasizing the availability of tax relief to many taxpayers who have lost their homes to foreclosure.

In some instances, the difference between the mortgage debt eliminated by a foreclosure and the amount the lender recoups from selling the collateral is treated as taxable income accruing to the debtor (the equivalent of a taxable gift).[8] But that liability may be reduced or eliminated if the borrower is insolvent at the time of foreclosure. The borrower is insolvent if he or she has a negative net worth; that is, his or her total liabilities exceed his or her total assets (including retirement assets).

Debts discharged in bankruptcy do not create a tax liability for the borrower. Outside of bankruptcy, if the borrower is insolvent, any tax liability is determined by calculating the sum of the amount of debt cancelled and the borrowers' net worth (which, by definition, is negative). If this sum is also negative, there is no tax liability. The IRS also reminds borrowers that they can petition to pay any outstanding liability on an installment plan.

HUD Down Payment Assistance Rule

The Department of Housing and Urban Development published a final rule on October 1 that restricts the sources from which a home buyer can receive down payment assistance for FHA-insured mortgages. The final rule incorporates minor changes to the proposed version, which was published for comment on May 11. Under the final rule, a down payment assistance payment cannot consist, in whole or in part, of funds provided by the seller, anyone who benefits financially from the sale, or any third party that is reimbursed by a party that benefits financially from the sale. The notice also clarifies that tribal governments are legitimate sources of down payment assistance.

The rule is motivated by concerns that the "assistance" does not actually help purchasers, because sellers inflate sale prices to compensate for the cost of assistance. In fact, HUD estimates that borrowers who receive down payment assistance from seller-reimbursed nonprofit entities are two to three times more likely to default on their mortgage payments than are borrowers who receive down payment assistance from other sources. In addition, these borrowers are two to three times more likely to lose their homes than all other recipients of single-family FHA-insured loans.

The rule was to have gone into effect on October 31, but on that day, the U.S. District Court for the District of Columbia issued a preliminary injunction barring its enforcement, stating that the agency had "failed to supply a reasoned analysis" and had not made data supporting the rule public.

Federal Legislation

Protecting Access to Safe Mortgages Act

On September 10, Sen. Charles Schumer (D-N.Y.) introduced the Protecting Access to Safe Mortgages Act (S. 2036), an "emergency measure" that would temporarily raise caps on the size of the

[8] Such a tax liability does not occur for mortgages that are *nonrecourse* loans (although there may be other tax consequences). A nonrecourse loan is a loan for which the lender's only remedy in case of default is to repossess the property being financed or used as collateral. A significant share of mortgages are made with recourse.

mortgage portfolios held by Fannie Mae and Freddie Mac and increase the size of mortgages that they could purchase. The bill would require the firms' regulator to increase their portfolio limits by at least 10 percent. Fifty percent of the increase must be used to purchase adjustable-rate mortgages whose rates have or will reset between June 2005 and December 2009. All of the bill's provisions would last for one year. The conforming loan limit, or the maximum size mortgage that the housing finance GSEs are allowed to purchase, would also increase in high-cost geographical areas to the lesser of 150 percent of its current level or the median home price in the area.

The bill is similar in some ways to the more far-reaching Federal Housing Finance Reform Act of 2007, which the House passed on May 22.[9] The new bill was referred to the Senate Committee on Banking, Housing, and Urban Affairs.

Foreclosure Assistance Funding Amendment

On September 11, the Senate approved an amendment to the Transportation, Housing and Urban Development, and Related Agencies Appropriations Act of 2007 (H.R. 3074) that would add $100 million of funding to the $150 million foreclosure prevention program that was approved by the Senate Appropriations Committee in July after the House of Representatives passed the bill on July 24. Senate Banking Committee chairman Chris Dodd (D-Conn.) and Sen. Kit Bond (R-Mo.) proposed the amendment (SA 2832), which was passed by voice vote. If the new version of the bill is enacted, HUD will be authorized to pass the funding to public, private, and nonprofit entities, which will in turn distribute the assistance to homeowners whose mortgages are in default or in imminent danger of default. HUD will also be required to report annually to Congress on the success of its foreclosure mitigation efforts.

Expanding American Homeownership Act of 2007

The House of Representatives passed the Expanding American Homeownership Act of 2007 (H.R. 1852) on September 18. The bill was introduced by Rep. Maxine Waters (D-Calif.) in late March. The bill would increase the maximum size of mortgages the FHA is permitted to insure. Currently, this limit is set to the lesser of 95 percent of the median price of area homes or 87 percent of the Freddie Mac conforming loan limit. The bill would increase the FHA mortgage limit to the lesser of 125 percent of the median price of area homes or 175 percent of the conforming loan limit (currently $417,000). The maximum term of FHA-insured loans would also be extended from 35 to 40 years. The bill would allow the FHA to accept zero-down-payment loans and to charge higher mortgage insurance premiums to riskier borrowers. For home buyers eligible for low or zero down payments, up-front mortgage insurance premiums would be capped at 3 percent of the initial insured principal amount. Annual premiums would be capped at 0.75 percent of the remaining insured principal amount. The bill would also extend FHA eligibility to borrowers who already have mortgages, rather than to just first-time home buyers.

The bill would require mortgage lenders to inform borrowers about available loss mitigation resources and foreclosure counseling when they enter into mortgages, and subprime borrowers would be required to obtain third-party homeownership counseling prior to closing on their mortgages. It also proposes a pilot program to establish an automated process for providing mortgage lenders with alternative credit rating information, such as rent, utility, and insurance payment history, for potential borrowers with limited credit histories. A more controversial provision of the bill would use the additional revenues resulting from the proposed increase in the FHA mortgage size cap to fund affordable housing programs.

[9] See *Banking Legislation and Policy*, Volume 26, Issue 2 for more information on the Federal Housing Finance Reform Act of 2007.

Following the liquidity crisis, the Bush administration expressed qualified support for FHA reform. The bill was referred to the Senate Committee on Banking, Housing, and Urban Affairs after its passage in the House.

American Home Ownership Preservation Act of 2007

On September 27, Sen. Hillary Clinton (D-N.Y.) introduced a bill (S. 2114) containing several measures intended to regulate the mortgage industry. The bill would require a mortgage broker to fully disclose to a potential borrower the nature of his or her relationship with and his or her responsibilities to the borrower. It would also require the federal banking agencies to set up a national, publicly available registry of all mortgage brokers, including authorization to obtain professionally related credit and legal histories. In addition, S. 2114 would prohibit prepayment penalties on home mortgage products. The bill would authorize up to $1 billion in funding for state governments and tribal agencies to spend on foreclosure prevention and mortgage refinancing programs. Finally, it would require Fannie Mae and Freddie Mac to identify at-risk homeowners and assist them via refinancing or in negotiations with private lenders. The bill was referred to the Committee on Banking, Housing, and Urban Affairs.

Emergency Home Ownership and Mortgage Equity Protection Act of 2007

On October 4, the House Judiciary Subcommittee on Commercial and Administrative Law approved, by a 5-4 vote, the Emergency Home Ownership and Mortgage Equity Protection Act of 2007 (H.R. 3609). The bill was introduced by Rep. Brad Miller (D-N.C.) and Rep. Linda Sánchez (D-Calif.). The bill would allow bankruptcy courts to modify the terms of mortgages on a debtor's principal residence during Chapter 13 proceedings, with the intention of preventing foreclosures on "unsustainable subprime mortgages." Under U.S. bankruptcy code, courts are currently forbidden to modify mortgages secured by debtors' principal residences, although they are allowed to modify mortgages secured by investment properties and nonprincipal residences. After the subcommittee markup, the bill was referred to the full Committee on the Judiciary, where it awaits further action.

Mortgage Forgiveness Debt Relief Act of 2007

On October 4, the House of Representatives passed a tax relief bill introduced by Ways and Means Committee Chairman Charles Rangel (D-N.Y.) by an overwhelming 386-27 vote. Under the bill (H.R. 3648), taxpayers could exclude up to $2 million of home mortgage debt discharged as a result of foreclosure or renegotiation from their gross income for federal income tax purposes. As the current law stands, if an entity forecloses on a house that is currently worth less than its original purchase price and forgives the remaining debt, the Internal Revenue Service generally includes the forgiven debt in its calculation of the debtor's income (see above). Additionally, the bill would extend the tax deduction for private mortgage insurance until 2014.

The bill now awaits further action in the Senate Committee on Finance.

Third District Legislation

Pennsylvania

Several bills on abusive lending that were introduced in the Pennsylvania legislature in mid-March have garnered renewed interest. SB 483, introduced on March 15, would cap interest rates on home mortgages with original principal amounts of $197,000 or less at 6 percent per year for all mortgage lenders. SB 485, introduced the same day, would increase penalties for real estate appraisers that engaged in fraudulent behavior. SB 487 would set licensing and regulation guidelines for mortgage brokers and originators, and SB 488 would regulate the secondary mortgage market by establishing licensing and capital requirements for secondary mortgage loan brokers, capping the interest rates and loan application fees that lenders can charge, and mandating biannual state examinations of secondary mortgage lenders and brokers. The Senate Banking and Insurance Committee held a hearing on the bills on September 18.

New Jersey

Two bills introduced in May and currently pending in the New Jersey state legislature would strengthen state regulation of mortgage lenders. The Teaser Rate Protection Act (AB 4213) would require mortgage issuers to verify borrowers' ability to repay loans. Specifically, for adjustable and "teaser" rate mortgages, issuers would be required to calculate the ability to repay based on a fully indexed rate and full amortization over the life of the loan. SR 103 asks the United States Congress to allow state predatory lending laws to apply to federally regulated institutions and their subsidiaries or to enact federal legislation that will "restrict predatory lending practices by all federally chartered institutions and their subsidiaries."

Delaware

The Delaware Predatory Mortgage Lending Act (HB 162), introduced on May 9, would prevent unfair mortgage lending practices by prohibiting balloon payments and negative amortization features on high-cost mortgage loans and placing a cap on prepayment penalties. The bill would also make it illegal for default on a high-cost mortgage loan to trigger an increase in the mortgage's interest rate.

Legislation in Other States

California

Gov. Arnold Schwarzenegger (R) signed a bill into law on October 5 that will apply federal subprime mortgage guidelines to all California state-regulated financial institutions, as well as real estate brokers and licensees. Specifically, recent proposals by the federal regulatory agencies, the Conference of State Bank Supervisors, and the American Association of Residential Mortgage Regulators will apply. The bill will affect over 10,000 lenders, state-chartered credit unions, and real estate brokers. The California Assembly passed the bill on September 5 by a 61-10 vote; the Senate approved it the next day by a vote of 35-1.

Federal Legislation

Enacted

College Cost Reduction Act

President Bush signed the College Cost Reduction Act (H.R. 2669) into law on September 27. The bill, which was introduced by House Education and Labor Committee Chairman George Miller (D-Calif.), will increase the maximum size of federal Pell grants by $500 per year over the next five years and cut interest rates on federal student loans from 6.8 percent to 3.4 percent over the same period. To offset these costs, the law will reduce subsidies to private and nonprofit lenders by 55 and 40 basis points, respectively. In addition to cutting the special allowance payment subsidy, the law will reduce lender insurance rates and increase loan origination fees. The House passed the bill on July 11 by a vote of 273-149, while the Senate approved it with three amendments, by a 78-18 margin, on July 20. The Bush administration had previously threatened to veto the bill, citing concerns that the legislation did not target the neediest students and that it would be costly to taxpayers.

Higher Education Relief Opportunities for Students Act
President Bush signed the Higher Education Relief Opportunities for Students Act (H.R. 3625) into law on September 30. The House and Senate passed the bill on September 25 and 27, respectively. The bill, introduced by Rep. Joe Sestak (D-Pa.), makes permanent a law that exempts military personnel from repaying their student loans while they are in active service.

Passed in the House of Representatives

FDIC Enforcement Enhancement Act
On July 16, the House of Representatives passed the FDIC Enforcement Enhancement Act (H.R. 2547) by voice vote. The bill would prohibit businesses from falsely implying that their liabilities were guaranteed by the Federal Deposit Insurance Corporation. It would also grant the FDIC jurisdiction over violators and allow the agency to issue immediate cessation orders against them. After its passage in the House, the bill was forwarded to the Senate Committee on Banking, Housing, and Urban Affairs.

Microloan Amendments and Modernization Act
The House of Representatives approved the Microloan Amendments and Modernization Act (H.R. 3020) by a 385-5 vote on September 4. The bill, which Small Business Committee Chairman Nydia Velazquez (D-N.Y.) and Ranking Member Steve Chabot (R-Ohio) introduced in July, would reform the microloan program authorized under the Small Business Act by removing the requirement that loans be short term only and by revising borrower eligibility requirements, among other measures. The bill was passed to the Senate Committee on Small Business and Entrepreneurship, where it awaits further action.

Patent Reform Act of 2007
The House of Representatives passed the Patent Reform Act of 2007 (H.R. 1908) on September 7 by a 220-175 vote. Among other measures, the bill would make tax planning methods unpatentable. The bill defines a tax planning method as a strategy or technique designed to reduce a person's tax liability, excluding software and other tools used solely to perform calculations or prepare tax returns. The bill was introduced by Rep. Howard Berman (D-Calif.) and now awaits action in the Senate.

Terrorism Risk Insurance Revision and Extension Act of 2007
The House of Representatives passed the Terrorism Risk Insurance Revision and Extension Act of 2007 (H.R. 2761) on September 19 by a vote of 312 to 110. The bill, which would extend the Terrorism Risk Insurance Act for 15 years, generated debate because of its potentially high level of expense and lack of budget offsets. In a compromise, the House passed an amendment that would require Congress to approve funding and a pay-as-you-go waiver in case of an actual terrorist attack. The bill was forwarded to the Senate Committee on Banking, Housing, and Urban Affairs.

Affordable Housing Trust Fund of 2007
On October 10, the House of Representatives passed the National Affordable Housing Trust Fund Act of 2007 (H.R. 2895) by a 264-148 margin. The bill, proposed by the chairman of the House Committee on Financial Services, Barney Frank (D-Mass.), would allocate the funds generated by affordable housing provisions in pending legislation to reform the FHA and the housing finance GSEs. The funds would be distributed by the Department of Housing and Urban Development and could be used for mortgage insurance and

homeownership counseling, among other things. The bill was referred to the Senate Committee on Banking, Housing, and Urban Affairs.

Homeowners' Defense Act of 2007
The House of Representatives passed an amended version of the Homeowners' Defense Act of 2007 (H.R. 3355) by a 258-155 vote on November 8. The bill would provide support to insurance programs in case of natural disasters by setting up a risk-pooling program for insurance funds and establishing federal loan programs. The original bill, introduced by Rep. Tim Mahoney (D-Fla.) and Rep. Ron Klein (D-Fla.), was replaced with a new version introduced by Financial Services Committee Chairman Rep. Barney Frank (D-Mass.). The bill now awaits further action in the House of Representatives.

Passed in the Senate
Higher Education Amendments of 2007
On July 24, the Senate unanimously passed the Higher Education Amendments Act of 2007 (S. 1642), a bill that would reauthorize the Higher Education Act, which regulates college financial aid programs. The bill would increase federal Pell grant maximums, though to a lesser extent than the now-enacted College Cost Reduction Act did. It also addresses allegations of corruption in the financial aid industry by prohibiting college financial aid officers from accepting gifts from lenders in exchange for preferential treatment.

Small Business Disaster Response and Loan Improvements Act of 2007
The Senate passed the Small Business Disaster Response and Loan Improvements Act of 2007 (S. 163) by a unanimous vote on August 4. The bill, whose primary sponsors were Senate Small Business Committee Chairman John Kerry (D-Mass.), Ranking Member Olympia Snowe (R-Maine), and members Mary Landrieu (D-La.) and David Vitter (R-La.), would increase the maximum loan available under the Small Business Act's disaster response program from $1.5 million to $2 million. It would also allow the Small Business Administration to guarantee up to 85 percent of the principal and interest of disaster response loans issued by qualified private lenders. The bill was referred to the House Small Business Committee, where it awaits further action.

New Legislation
Fair Mortgage Practices Act of 2007
On July 12, Rep. Spencer Bachus (R-Ala.) and co-sponsors introduced the Fair Mortgage Practices Act of 2007 (H.R. 3012), which would tighten lending standards for subprime mortgages. The bill would establish a national mortgage lender licensing system and a registry of all mortgage originators. It also contains consumer protection measures related to borrowers' ability to repay and borrower disclosures. The bill was referred to the Committee on Financial Services and the Committee on the Judiciary, where it awaits further action.

Fairness for Homeowners Act of 2007
On July 18, Rep. Keith Ellison (R-Minn.) introduced the Fairness for Homeowners Act of 2007 (H.R. 3081) in the House of Representatives. The bill, which is based on Minnesota legislation that became effective on August 1, would require mortgage lenders to calculate borrowers' ability to repay using loans' fully indexed and amortized rates, as well as verified income information. It would also limit allowable prepayment

penalties and finance charges, among other measures. The bill was referred to the Committee on Financial Services.

National Insurance Act of 2007
Reps. Melissa Bean (D-Ill.) and Ed Royce (R-Calif.) introduced the National Insurance Act of 2007 (H.R. 3200) in the House of Representatives on July 26. The bill, an identical companion to a Senate bill introduced in May, would establish an optional federal insurance charter, creating a system similar to the currently existing dual banking system. The bill was referred to the House Committee on Financial Services and the Committee on the Judiciary.

Identity Theft Protection Act
Carolyn Maloney (D-N.Y.), chair of the House Financial Services Subcommittee on Financial Institutions and Consumer Credit, and Paul Gillmor (R-Ohio), ranking minority member, introduced the Identity Theft Protection Act (H.R. 3316) in the House on August 2. The bill would allow consumers to place security freezes on their credit reports to prevent identity thieves from accessing their credit files to establish new accounts. The legislation was forwarded to the House Committee on Financial Services, where it awaits further action.

FACT Act Rulewriting Improvement Act of 2007
Rep. Barney Frank (D-Mass.) introduced the FACT Act Rulewriting Improvement Act of 2007 (H.R. 3525) in the House of Representatives on September 14. The bill is intended to hasten the implementation of rules regarding the accuracy of consumer information provided to consumer reporting agencies. The rules were part of the Fair and Accurate Credit Transactions Act of 2003 but have not yet been implemented. The bill was forwarded to the House Committee on Financial Services.

Federal Trade Commission Act Enforcement Bill
On September 18, the House Financial Services Committee approved a bill (H.R. 3526) that would extend rulemaking authority on unfair and deceptive practices to the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency. The Federal Trade Commission Act already grants this power to the Federal Reserve and the National Credit Union Administration. The bill was introduced on September 14 by Financial Services Committee Chairman Barney Frank (D-Mass.).

Social Security Number Privacy and Identity Theft Prevention Act of 2007
On September 24, the House Ways and Means Committee approved an amended version of the Social Security Number Privacy and Identity Theft Prevention Act of 2007 (H.R. 3046). The bill, which was introduced by Rep. Michael R. McNulty (D-N.Y.), would prohibit private companies from selling, buying, or displaying consumers' Social Security numbers under most circumstances.

Federal Regulation
Board of Governors of the Federal Reserve System
Temporary Exemption from Lending Restriction
The Board of Governors announced in an August 20 letter that it would temporarily allow JPMorgan Chase Co. to lend up to $25 million to its securities affiliate to facilitate the easing of tight credit markets. Ordinarily, transactions between banks and their subsidiaries are limited by section 23A of the Federal Reserve Act. The

exemption was set to last as long as the Federal Reserve's special discount window lending facility remained available.

Permitted Medical Activities for Financial Holding Companies
The Board of Governors announced on September 7 its decision that financial holding companies are permitted to own entities that conduct disease management and mail-order pharmacy activities under the Bank Holding Company Act. Although the Board does not consider these activities to be financial in nature, it ruled that they are complementary to financial activities performed by a health insurance provider. The determination came in response to a request by the Federal Deposit Insurance Corporation.

Extended Examination Cycle for Small Banks
On September 25, the Board of Governors, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision issued final rules allowing well-managed financial institutions with less than $500 million in total assets to qualify for an extended 18-month on-site examination cycle. Before, these institutions were subject to a 12-month cycle; only institutions with less than $250 million in total assets were eligible for the expanded cycle. The rules implement a section of the Financial Services Regulatory Relief Act of 2006 and are identical to interim rules that the agencies issued in April.

Protected Federal Benefit Garnishment Guidelines
On September 28, the Board of Governors, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the National Credit Union issued proposed guidelines for federally regulated institutions handling garnishment orders on customer accounts that contain legally protected federal benefit payments. With some exceptions, Social Security benefits, supplemental security income benefits, veterans' benefits, and similar types of payment are exempt from garnishment orders. Comments are due on November 27.

Department of Defense
Military Abusive Lending Protection
On August 31, the Department of Defense issued a final rule protecting military service members and their dependents from potentially abusive lending practices. Specifically, the rule targets payday lenders that offer small, closed-dollar loans at extremely high interest rates, by increasing required disclosures to borrowers and capping interest rates, among other measures. The rule took effect on October 1.

Department of Housing and Urban Development
New Lending Discrimination Division
The Department of Housing and Urban Development announced on July 11 that it would create a new Fair Lending Division to investigate claims of mortgage lending discrimination and ensure the fair lending practices of government-sponsored enterprises Fannie Mae and Freddie Mac. The new division will be part of the Office of Fair Housing and Equal Opportunity.

Department of the Treasury

Anti-Money-Laundering Rule

The Financial Crimes Enforcement Network, part of the Department of the Treasury, released a final rule on August 9 implementing an anti-money-laundering provision of the USA PATRIOT Act. The rule clarifies due diligence procedures that banks must use to assess risk in high-risk foreign banking relationships. Specifically, domestic banks will be required to identify the owners of high-risk foreign banks with which they do business, along with other details to help assess risk levels. The rule went into effect on September 10.

Internet Gambling Restrictions

The Department of the Treasury and the Board of Governors of the Federal Reserve System released a joint proposed rule to implement the Unlawful Internet Gambling Enforcement Act of 2006 on October 4. The rule bars businesses from accepting payments made in connection with unlawful Internet gambling and requires certain financial institutions to implement policies to prevent the transfer of such payments. Comments on the proposed rule are due by December 12.

Federal Deposit Insurance Corporation

Deposit Insurance Fund Rebate Methods

On September 18, the Federal Deposit Insurance Corporation issued an advance notice of proposed rulemaking and requested comment on alternative methods for providing rebates to banks under the dividend requirements of the Federal Deposit Insurance Reform Act of 2005. Under the law, the FDIC is required to provide banks with rebates if its Deposit Insurance Fund exceeds 1.35 percent of insured deposits. Comments are due November 19.

Federal Trade Commission

Injunction Against Card Marketer

The Federal Trade Commission announced on August 7 that a judge for the U.S. District Court for the Central District of California had filed a temporary restraining order stopping a company marketing Visa- and MasterCard-branded stored-value cards on the Internet from making unauthorized debits from customers' accounts. The commission alleges that the company deceived customers into providing personal information without disclosing that it would be used to withdraw a $159.95 fee from their bank accounts. The judge will hold a hearing to determine whether to extend the injunction.

Consumer Reporting Agency Consent Orders

On September 17, the Federal Trade Commission issued proposed consent orders against two firms that report consumer information to insurance companies (*In re Milliman, Inc.*, FTC, File No. 0623189, 9/17/07 and *In re Ingenix, Inc.*, FTC, File No. 0623190, 9/17/07). According to the orders, the firms are consumer reporting agencies and therefore must comply with the Fair Credit Reporting Act by providing additional consumer disclosures and limiting the distribution of consumer information, among other responsibilities.

Office of the Comptroller of the Currency

Regulatory Relief for National Banks

On July 3, the Office of the Comptroller of the Currency issued a notice of proposed rulemaking that would relieve national banks of some regulatory requirements. The proposal, which comes as a result of the agency's regular review of its regulations, would reduce the number of applications banks are required to file in certain situations and would shorten review periods for capital changes, among other miscellaneous changes.

Management of Multiple Small Banks
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 published a final rule on July 16 that allows an individual to manage more than one depository institution, as long as both institutions are small and have offices in the same metropolitan area. The final rule is identical to the interim version that the agencies published on January 11, 2007.

Office of Thrift Supervision
Unfair and Deceptive Practices Regulation
The Office of Thrift Supervision issued an advance notice of proposed rulemaking on August 6 that asks whether it should issue additional rules on unfair and deceptive acts or practices by OTS-regulated entities. The agency is authorized to write and enforce these regulations under the Federal Trade Commission Act and the Home Owners' Loan Act. Comments were due by November 5.

Securities and Exchange Commission
Regulation R Adoption
The Securities and Exchange Commission and the Federal Reserve voted on September 19 and September 24, respectively, to adopt final rules proposed as part of Regulation R.[10] The rules, which implement provisions of the 1999 Gramm-Leach-Bliley Act, set guidelines for banks and savings associations acting as brokers. The rules will be implemented in stages, beginning next October. In June, the Securities and Exchange Commission also extended banks' and savings associations' exemption from brokerage registration requirements to late September to allow more time to consider comments on the Regulation R proposal.

Nationally Recognized Statistical Rating Organizations
On September 24, the Securities and Exchange Commission granted registration to seven nationally recognized statistical rating organizations. The firms, the first to register under the Credit Rating Agency Reform Act of 2006, include A.M. Best Company, Inc.; DBRS, Ltd.; Fitch, Inc.; Japan Credit Rating Agency, Ltd.; Moody's Investors Service, Inc.; Rating and Investment Information, Inc.; and Standard & Poor's Ratings Services. The firms are required to disclose their rating procedures and methodologies, as well as certain performance measurement statistics.

Judicial Developments
Circuit Court Rulings
Unearned Mortgage Lending Fees
On August 6, the U.S. Court of Appeals for the Second Circuit issued a ruling stating that borrowers can sue mortgage lenders for charging them unearned fees, even if the lenders do not split the fees among multiple parties (*Cohen v. JP Morgan Chase and Co.*, 2nd Cir., No. 06-0409, 8/6/07). The Department of Housing and Urban Development prohibits the charging of unearned fees under the Real Estate Settlement Procedures Act.

[10] For a more detailed explanation of Regulation R, see *Banking Legislation and Policy*, Volume 25, Number 4.

The Fourth, Seventh, and Eighth Circuits have previously ruled that borrowers can sue only if the fees are split between multiple parties.

Mortgage Prepayment Charge Ruling
The U.S. Court of Appeals for the Seventh Circuit released a decision (*River East Plaza L.L.C. v. The Variable Annuity Life Insurance Co.*, 7th Cir., No. 06-3856, 8/22/07) on August 22 upholding a commercial mortgage prepayment charge. The ruling reversed a previous decision by a district court which ruled that the charge violated Illinois law.

Adverse Action Consumer Notification
On August 30, the U.S. Court of Appeals for the Third Circuit ruled that a mortgage insurer should have issued adverse action notices to customers when it raised their premiums because of their poor credit scores, even though the insurer had received the information from a lender (*Whitfield v. Radian Guaranty Inc.*, 3d Cir., No. 05-5017, 8/30/07). The court rejected Radian's argument that the Fair Credit Reporting Act required the insurer to issue adverse action notices only if it had gained the information directly from customers' credit reports.

Prepayment Penalty Collection in Bankruptcy
The U.S. Court of Appeals for the First Circuit ruled on August 30 that an oversecured creditor might be able to collect a prepayment penalty as an unsecured claim in a Rhode Island bankruptcy filing without regard to whether the penalty was unreasonable (*UPS Capital Business Credit v. Gencarelli (In re Gencarelli)*, 1st Cir., No. 06-2700, 8/30/07). A bankruptcy court had previously ruled that the penalties were unreasonable; the First Circuit judge sent the case back to bankruptcy court to determine whether the penalties were legally enforceable.

District Court Rulings
Visa Early Termination Rights Ruling
The U.S. District Court for the Southern District of New York ruled on August 8 that Visa U.S.A., Inc., cannot stay an order that allows early termination rights to banks that want to shift their debit portfolios to the MasterCard network (*U.S. v. Visa U.S.A., Inc.*, S.D.N.Y., No. 98 Civ. 7076 (BSF), 8/8/07). The original order rescinded Visa By-Law 3.14, which required any of its top 100 issuers that switched to MasterCard to pay a settlement service fee and allow member banks early termination rights. Visa, arguing that the early termination rights would do it irreparable harm, requested the stay.

Minnesota State Usury Law Exemption
On August 30, a judge from the U.S. District Court for Minnesota ruled that nonbank entities that have purchased charged-off debt are exempt from state usury laws, just as the banks that originated the loans are exempt (*Munoz v. Pipestone Financial, LLC*, No. 04-4142, 2007 US Dist. LEXIS 64314 (D. Minn. August 30, 2007)). A Minnesota resident claimed that Pipestone Financial, LLC, and Messerli and Kramer, P.A., violated the Fair Debt Collection Practices Act by charging him an interest rate greater than the maximum allowed under Minnesota law.

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