BANKING LEGISLATION & POLICY

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Recent Developments

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Pennsylvania Legislature Acts to Overturn Philadelphia's Predatory Lending Law

The City of Philadelphia's predatory lending ordinance was effectively overturned on June 25 when Governor Ridge signed Act No. 55 (S.B. 377) into law. A section of this law, the Consumer Equity Protection Act, prohibits municipalities from enacting ordinances pertaining to financial and lending activities and makes clear that such activities are subject to the jurisdiction of the state banking department and federal regulators (the remainder of the law is summarized in **Third District Developments**). It also establishes certain protections for consumers who borrow against the equity in their homes.

The City of Philadelphia's ordinance on subprime lending was scheduled to go into effect July 19. The bill basically outlaws all predatory loans. First, it categorizes mortgage loans as high-cost or threshold loans. A high-cost loan is a loan for less than $150,000 with an interest rate more than 6.5 percentage points above the yield on Treasury securities of a similar maturity, or with points and fees totaling 4 percent of the value of the loan if the loan is for $16,000 or more, or with points and fees exceeding $800 for loans less than $16,000. A threshold loan is a mortgage with an interest rate 4.5 to 6.5 percentage points greater than the yield on Treasury securities; or, in the case of a junior lien, one whose interest rate exceeds the yield on Treasury securities by between 6.5 and 8.0 percentage points. To be considered predatory, a high-cost or threshold loan must have been made through deceptive sales practices or have at least one of the following characteristics: (1) "flipping," i.e., multiple refinancings with added points and fees; (2) a balloon payment, i.e., a scheduled payment that is more than twice as large as the average of earlier payments; (3) prepayment penalties; (4) negative amortization; (5) a provision that increases the interest rate after default; (6) advance payments, i.e., deducting more than two monthly payments from the funds lent; (7) modification or deferral fees; (8) credit insurance payments included in periodic payments; (9) lending without regard for the borrower's ability to repay; or (10) mandatory arbitration to settle disputes with lenders. The bill would also prohibit lenders from making threshold loans or high-cost loans to borrowers who have not received credit counseling.

Any lender that makes a loan considered predatory could be fined between $100 and $300 per day that the loan is in effect, and the borrower could bring suit against the lender. Any company that made 10 or more of these types of loans within a year, or whose predatory loans made up 5 percent or more of the company's portfolio in any given year would be labeled a predatory lender. It would lose its business privilege license and any contracts with the city. The bill also requires that all mortgages recorded with the city be accompanied by a certificate stating the terms of the loan, whether it qualifies as a high-cost or threshold loan, and certifying that the loan does not violate any of the provisions of the ordinance. The city bill exempts banks, thrifts, and credit unions, but, in practice, it would apply to finance company subsidiaries of bank and financial holding companies as well. The Philadelphia ordinance was passed unanimously by the city council in April, but Philadelphia Mayor John Street refused to sign it. According to the city charter, a bill that is not vetoed by the mayor automatically becomes law regardless of whether it has the mayor's signature.

The state law contains consumer protection language, but it is not as strict as Philadelphia's ordinance. For example, the state law applies to loans of $100,000 or less, rather than $150,000, as stipulated in Philadelphia's ordinance. Also, in place of mandatory credit counseling, the Pennsylvania law requires lenders to give borrowers a written notice stating that the loan is a mortgage, that the borrower could lose his or her home for failure to repay, that the borrower should consider credit counseling before accepting the loan, and that the borrower is under no obligation to accept the loan and could benefit from shopping for better terms from other lenders.

The state law prohibits a number of practices and limits a number of others. The law prohibits balloon payments that come due less than 10 years after a loan commences. The law limits the use of prepayment penalties to the first 60 months of the loan and prohibits charging them when a lender refinances its own loan to a borrower. If a lender offers loans with prepayment penalties, it must also offer loans without the penalties. The law prohibits call provisions that permit lenders to accelerate payments at their sole discretion (there are exceptions for defaults, due-on-sale provisions, fraud, or where the borrower's actions adversely affect the lender's security interest). It prohibits negative amortization schedules (except to upper-income borrowers). It prohibits increases in the interest rate as a result of the borrower's default, advance payments using loaned funds, and lending without regard for the borrower's ability to repay (a borrower is presumed to have the ability to repay if the monthly payments do not exceed 50 percent of his or her gross income at the time the loan is consummated). The law prohibits lenders from disbursing funds directly to home improvement contractors. The bill also prohibits the refinancing of low-interest loans from government agencies or nonprofit corporations within the first 10 years of the term of the loan without the written consent of the borrower.

Finally, the bill requires that in order to offer single premium insurance at the time the loan is made, a lender must provide consumers with a written notice indicating that the insurance is not required and may be cancelled at any time. If it is legal to offer a comparable insurance product paid via monthly premiums, the lender must also make this option available to the consumer.

In a related development, the American Financial Services Association (AFSA), a Washington-based trade association representing various types of lenders, filed suit to halt the implementation of the City of Philadelphia ordinance. AFSA contends that regulation of lenders is a matter for state banking authorities. A hearing on the AFSA suit was scheduled to take place May 31, but it was postponed. Several lenders, including some members of AFSA, had announced that they would stop doing business in Philadelphia if the ordinance were to go into effect.

Bank Regulators, SEC at Odds Over Broker/Dealer Regulation

The three major federal bank regulators, the Federal Reserve, FDIC, and OCC, have sent a letter to the Securities and Exchange Commission (SEC) criticizing SEC's new rules governing the securities broker / dealer activities of banks and their subsidiaries (for a summary of the rule, see **Summary of Federal Regulations**). The banking regulators believe the SEC's rule is inconsistent with the intent of the Gramm-Leach-Bliley Act (GLBA), which handed functional regulation of bank securities activities to the SEC. The major point of contention is how the rule would treat trust and fiduciary activities of banks. These activities have always been exempt from traditional securities regulation, and GLBA specifically maintained that exemption. However, the SEC's rule states that, in order to qualify for the exemption, banks would have to examine every account annually to ensure that the trustee (i.e., the bank or trust company) is "chiefly compensated" in a specific manner.

Under the regulation, allowable forms of compensation could include a periodic flat fee, a percentage of assets under management, or a per order processing fee. The banking regulators contend that it would be nearly impossible to comply with the requirement that each account be certified yearly. The SEC subsequently announced that it would extend both the comment period and the implementation date of the new rule.

SUMMARY OF FEDERAL LEGISLATION

New Legislation

1. Deposit Insurance Funds Merger Act of 2001 (H.R. 1355). Introduced by Representative LaFalce (D-NY) on April 3, 2001.

Status: Referred to the Committee on Financial Services.

This bill would combine the Bank Insurance Fund and the Savings Association Insurance Fund effective January 1, 2002. The combined fund would be designated the Deposit Insurance Fund.

2. Consumer Debit Card Protection Act (H.R. 1825). Introduced by Representative Barrett (D-WI) on May 14, 2001.

Status: Referred to the Committee on Financial Services.

The bill would divide debit cards into two categories for purposes of the Electronic Funds Transfer Act (EFTA). First, an ATM card would be any card issued by a financial institution for use in initiating electronic funds transfers from automated teller machines and other electronic terminals and that requires a unique form of identification (other than a signature), such as a PIN or a fingerprint. Second, a check card would be defined as any card that can initiate an electronic funds transfer from a customer's account without the use of such an identifier. All check cards would have to have the term check card prominently displayed on their faces.

An unsolicited check card that is sent to a consumer could not be activated without customer authorization. The issuer would also have to clearly state that, once activated, the check card may be used without a code or unique identifier. An issuer sending a check card in response to a consumer's request for an ATM card must promptly issue an ATM card if the consumer refuses the check card.

The bill would limit a consumer's liability for a fraudulent electronic funds transfer to $50 if: 1) the unauthorized transfer was initiated by someone besides the consumer; 2) the transfer did not require the use of a unique identifier, other than a signature; and 3) the unauthorized transfer took place before the card issuer had been notified that the account had been compromised. In addition, financial institutions that issue check cards would be required to provide a 24-hour, toll-free number to which consumers can report missing or stolen cards.

Furthermore, an insufficient funds charge could not be assessed to a consumer if the insufficiency resulted from an unauthorized electronic funds transfer. A depository institution that receives notice from a consumer of an error regarding an electronic funds transfer would be required to provisionally credit the consumer's account within five business days while it continues to carry out an investigation.

3. National Bank Offshore Activities Act of 2001 (H.R.2273). Introduced by Representative Conyers (D-MI) on June 21, 2001.

Status: Referred to the Committee on Financial Services.

The bill would require national banks that acquire an interest in an offshore company to report the interest to the Office of the Comptroller of the Currency (OCC) within 30 days of the acquisition. The report would have to include the names of all shareholders, principals, directors, and officers; any criminal convictions, indictments, or investigations of these individuals; the purpose of the offshore business; and a listing of the company's assets and their value. Edge and Agreement Corporations are not included in the definition of an offshore business.

A separate section would require national banks to give the OCC notice of any violation of federal, state, or foreign criminal law, banking or financial laws, or labor laws by any individual associated with an entity that the bank has a correspondent relationship with. The OCC could issue a cease and desist order ordering the bank to terminate the relationship.

SUMMARY OF FEDERAL REGULATIONS

Board of Governors of the Federal Reserve System

Electronic Disclosures (4 / 4 / 2001)
The Board adopted an interim rule that would permit the electronic delivery of required disclosures by creditors to consumers who consent to receive disclosures in this manner. The rule sets standards for electronic disclosures, including the requirement that customers be able to download the information and be given adequate notice of any electronic disclosures made on a creditor's web site. Certain types of transactions would still require paper disclosure. For example, a consumer who initiates a transaction in person must receive the initial disclosure in writing.

The rule applies to all disclosures required under the Equal Credit Opportunity Act (ECOA), Electronic Funds Transfer Act (EFTA), and Truth in Savings Act (TISA). This rule became effective March 30, 2001. Compliance is optional until October 1, 2001. Comments were due June 1, 2001. For further information, see 66 *Federal Register*, pp. 17779-804 (Regulations B, E, and DD).

Affiliate Transactions (5 / 11 / 2001)
The Board proposed a rule that would codify sections 23A and 23B of the Federal Reserve Act into a new regulation called Regulation W. Sections 23A and 23B regulate transactions between a bank and its affiliates to limit risks to the bank and the federal deposit insurance funds. The proposed regulation would apply to both member banks and insured nonmember banks. However, the rule would not apply to savings associations.

Under the proposed rule, a bank could engage in a covered transaction with an affiliate if, after the transaction, the aggregate amount of its covered transactions with any single affiliate does not exceed 10 percent of its capital stock and surplus, and the bank's aggregate covered transactions with all affiliates does not exceed 20 percent of its capital stock and surplus. A bank's covered transactions must be conducted on terms consistent with safe and sound banking practices and are subject to collateral requirements set forth in the Federal Reserve Act. Finally, the proposed rule requires that covered transactions, and certain other transactions, between a bank and its affiliates occur on market terms, that is, terms similar to or at least as advantageous to the bank as comparable transactions between the bank and unaffiliated companies.

Definitions and exceptions. Covered transactions include a purchase of assets or securities, an extension of credit, a guarantee issued on behalf of an affiliate, and certain other transactions that expose a bank to an affiliate's investment or credit risk. For example, the acceptance of securities issued by an affiliate as collateral for a loan to a third party would qualify as a covered transaction. Covered transactions would also include cross-affiliate netting arrangements.

Under the proposed rule, loans and other extensions of credit by a bank to an affiliate must be secured by collateral ranging from 100 percent to 130 percent of the loan depending on the type of collateral. Low-quality assets, intangible assets, mortgage-servicing rights, letters of credit, guarantees, and securities issued by an affiliate or the bank could not be used to satisfy the collateral requirement. The bank must perfect its security interest in the collateral in accordance with applicable law.

A variety of transactions would be exempted from the quantitative limits and collateral requirements. These include purchases of loans without recourse from an affiliated bank, transactions made in the ordinary course of correspondent banking, purchases of securities issued by a servicing affiliate, purchases of assets with readily available market quotations, and purchases of certain municipal securities from a registered broker-dealer. Transactions fully secured by cash, a dedicated deposit account, and obligations issued or guaranteed by the United States are also exempt.

A bank's purchase of an extension of credit originated by an affiliate is exempt if certain conditions are met. First, the bank must independently review the credit-worthiness of the borrower prior to committing to purchase the loan, and before the affiliate commits to making the loan. Second, the total assets sold by the affiliate to the bank and any affiliate banks must not exceed 50 percent of the loans originated by the affiliate. Finally, the bank and its affiliated banks must not represent a principal source of ongoing funding for the affiliates' origination activity.

Computing the value of covered transactions. Credit transactions must initially be valued as the sum of the funds provided by the bank to, or on behalf of, the affiliate plus any additional amount that the bank could be required to provide. Purchases of assets by a bank from an affiliate must initially be valued at the total amount paid, plus any liabilities assumed by the bank. A bank's purchases of securities issued by an affiliate must be valued at the greater of (1) the amount paid by the bank, including any liabilities assumed, or (2) their value as carried on the bank's balance sheet. If a bank merges with an affiliate, the transaction would initially be valued at the amount paid by the bank for the affiliate's securities plus the total liabilities of the affiliate at the date of the merger.

Financial subsidiaries. The 10 percent limit on covered transactions with an individual affiliate does not apply to a bank's transactions with one of its financial subsidiaries, but those transactions do count against the 20 percent cap on covered transactions with all the bank's affiliates. Previously, transactions between a bank and its financial subsidiaries were exempt from section 23A. A bank's investment in a financial subsidiary would be valued at the greater of (1) the consideration paid by the bank, including any liabilities assumed, less any amortization, or (2) their carrying value on the banks' financial statements, excluding the bank's share of any change in the subsidiary's retained earnings since the purchase of the securities. Any extension of credit to a financial subsidiary by a nonbank affiliate of the bank is considered a covered transaction if the extension of credit is counted as capital of the subsidiary under federal or state law or regulation.

Attributing third-party transactions to an affiliate. The proposal considers a transaction between a bank and a third party to be a transaction between a bank and an affiliate to the extent that the proceeds of the transaction benefit the affiliate. For example, a loan made to an individual with the understanding that the funds would be used to purchase securities from the bank's dealer affiliate would be considered a transaction between the bank and its affiliate for the purposes of this rule. These transactions are subject to the collateral and threshold limitations of the proposal. However, agency and riskless principal transactions, preexisting lines of credit, and general-purpose credit cards are exempted (see below).

The proposed regulation provides guidance for covered transactions in which a security issued by an affiliate is accepted by the bank as collateral for a loan to a third party. Ordinarily, when a loan is secured exclusively by an affiliate's securities, the transaction would be valued as the amount of credit extended. But if the affiliate's securities have a ready market, the transaction would be valued at the lesser of the credit extended or the fair market value of the securities pledged as collateral. For a loan secured by an affiliate's securities and other collateral, the transaction would be valued at the lesser of (1) the credit extended minus the market value of the other collateral, or (2) the fair market value of the affiliate's securities pledged as collateral, assuming those securities have a ready market.

Intraday credit. The proposal clarifies that a transaction comes under section 23A if it exists at any time during the business day. This rule is a departure from current industry practice of complying with section 23A only with regard to overnight positions. Intraday credit exposures that result from ordinary clearing and settlement operations would not count as covered transactions as long as the bank has adequate policies for monitoring and managing them and the bank maintains adequate records. Intraday extensions of credit must occur at market terms, as required by section 23B.

Derivatives. The Gramm-Leach-Bliley Act requires the Board to determine whether credit exposure arising from derivative transactions between a bank and its affiliates is a covered transaction. In a separate rule (see below), the Board proposed to include derivatives transactions among the transactions subject to section 23B's market terms requirement and to require that depository institutions establish policies to manage any credit exposure that might result from derivatives transactions with their affiliates.

In this proposal, the Board seeks comment on a variety of issues, including (1) the appropriate regulatory definition of the term "derivative transaction"; (2) whether it is appropriate to treat certain derivative transactions that effectively act as a loan differently than other derivative transactions; (3) whether to require banks to adopt specific policies regarding derivative transactions with their affiliates; (4) whether to require banks to disclose to regulators their net credit exposure to affiliates as a result of derivative transactions; (5) whether and how to establish regulatory limits on a bank's net credit exposure arising from derivative transactions with its affiliates; and (6) whether to require banks to collateralize any net credit exposure arising from derivative transactions with their affiliates. Comments are due August 15, 2001. For further information, see 66 *Federal Register*, pp. 24186-219.

Affiliate Transactions Involving Derivatives or Intraday Extensions of Credit (5 / 11 / 2001)
The Board proposed an interim rule addressing derivative transactions and intraday extensions of credit involving a depository institution and its affiliates. The rule specifies that such transactions are subject to the market terms requirement of section 23B of the Federal Reserve Act. The rule would require depository institutions to establish policies and procedures to manage credit exposures that arise from derivative transactions with their affiliates. These policies and procedures should be comparable to ones used to manage credit exposures arising from derivative transactions with unaffiliated companies. The proposed rule would also require depository institutions to establish policies and procedures to monitor and manage any credit exposure arising from intraday extensions of credit to individual affiliates and the total exposure from extensions of intraday credit to all their affiliates. Comments are due August 15, 2001. The rule becomes effective January 1, 2002. For further information, see 66 *Federal Register*, pp. 24229-33.

Affiliate Transactions Involving Liquid Assets (5 / 11 / 2001)
The Board made final a rule that would expand the types of asset purchases that are exempt from the requirements of section 23A of the Federal Reserve Act (FRA). Section 23A contains an exemption for assets with a readily identifiable and publicly available market quotation. Previous Board interpretations limited these exempted assets to obligations of the United States, precious metals, exchange-traded securities, and foreign exchange.

The proposal allows a security issued by third parties to qualify for this exemption if it is purchased from a registered broker-dealer affiliate and it has a ready market as defined by the Securities and Exchange Commission (SEC). In addition, the rule requires that the security be eligible for direct purchase by a member bank under section 9 of the FRA and that it not be considered a low-quality asset as defined in section 23A. The price of the security must be verifiable in any one of three methods: 1) a widely disseminated news source; 2) an electronic service that provides data from real-time financial networks; or 3) two independent dealer quotes on the exact security purchased. Securities purchased from an affiliate during or within 30 days of the underwriting period are ineligible for this exemption. This exemption does not apply to securities issued by an affiliate unless the securities are backed by a guarantee of the U.S. government. This rule became effective June 11, 2001. For further information, see 66 *Federal Register*, pp. 24220-5.

Banks Loans Used in Certain Transactions with Affiliates (5 / 11 / 2001)
The Board made final a rule exempting from the quantitative limits established in section 23A certain types of loans made by a depository institution to its customers when the proceeds of the loan are used to purchase securities from an affiliate of the depository institution. The rule includes a Board interpretation that when an affiliate acts exclusively as a broker in the securities transaction and retains no portion of the loan proceeds, the limits in section 23A do not apply. If the affiliate retains a portion of the loan proceeds as a result of charging a market-rate brokerage commission or agency fee, the rule would exempt that portion of the loan from section 23A. A market-rate brokerage commission or fee is a charge that is no greater than the amount an affiliate charges customers who are neither affiliates nor borrowers of an affiliated depository institution for comparable transactions.

The rule contains several other exemptions: loans for the purchase of securities from an affiliate when the affiliate is acting as a riskless principal in the transaction, and loans that are used to purchase securities from an affiliate when the loan represents a preexisting commitment not conditioned on the purchase of securities from an affiliate. The rule became effective June 11, 2001. For further information, see 66 *Federal Register*, pp. 24226-9.

Federal Deposit Insurance Corporation

Deposit Brokers (4 / 3 / 2001)
The FDIC made final a rule repealing registration requirements for deposit brokers. Furthermore, brokers are no longer required to maintain records regarding the amounts and maturities of deposits placed at an insured depository institution. Finally, as a result of this new rule, brokers should no longer advertise themselves as FDIC-registered or otherwise indicate that they are approved by the FDIC. This rule became effective April 3, 2001. For further information, see 66 *Federal Register*, pp. 17621-2.

Deposit Production Offices (4 / 9 / 2001)
The FDIC, together with the Office of the Comptroller of the Currency and the Federal Reserve Board, proposed a rule that would broaden the prohibition on deposit production offices. Deposit production offices are bank branches whose main purpose is to collect deposits, rather than to collect deposits and to make loans. The proposal would prohibit the establishment of any branch or bank controlled by an out-of-state bank holding company for the purpose of deposit production.

Under current and proposed regulations, compliance with the prohibition is determined on a state-by-state basis (for details, see *Banking Legislation and Policy*, July-September, 1997). The appropriate bank regulator initially compares the loan-to-deposit ratio of the branches of an out-of-state bank to the average loan-to-deposit ratio for all banks chartered or headquartered in the state. If the former ratio is less than 50 percent of the statewide average, the regulator must conduct a more detailed investigation to determine whether those branches are satisfying the credit needs of their communities. Comments were due June 8, 2001. For further information, see 66 *Federal Register*, pp. 18411-6. (Regulation H).

Office of the Comptroller of the Currency

Debt Cancellation Contracts (4 / 18 / 2001)

The OCC proposed a rule dealing with banks' sales of debt cancellation contracts (DCCs) and debt suspension agreements (DSAs) to their customers. These are agreements that allow for the cancellation of all or part of a customer's loan obligation (for a DCC) or the temporary suspension of payments (under a DSA). For example, a customer may decide to pay a fee in order to purchase the right to suspend credit card payments if he or she becomes unemployed.

The rule would prohibit banks from conditioning the extension of credit or credit terms on a consumer's willingness to purchase a DCC or DSA. In these contracts, banks must not include any term that they do not routinely enforce. Also, these contracts may not give the bank the right to unilaterally modify the terms of the contract. A customer must affirmatively consent, either in writing or electronically, to purchase a DCC or DSA.

The rule requires banks to make a number of disclosures to consumers before a DCC or DSA is purchased. A bank must inform consumers that the decision to extend credit or the terms of any credit extended are not dependent on the purchase of a DCC or DSA. The bank must disclose the total cost of the contract and the manner in which the fees will be charged. The bank must further describe the notification procedures the consumer must use if an event that triggers a DCC or DSA occurs. If the activation of a DCC or DSA will preclude the consumer from using a credit line, or if it triggers additional charges on a credit line, the bank must disclose this fact. The bank must disclose any limitations on the consumer's ability to collect benefits under the terms of the DCC or DSA, such as a waiting period or a limit on the number of payments the customer may defer. Also, any circumstances under which the customer may terminate the contract must be disclosed. A bank may offer a contract that does not provide any refund if the consumer terminates the contract or pays off the loan early, but this fact must be disclosed at the time the contract is purchased. Also, the bank must offer the consumer an alternative contract that would provide for a refund under such circumstances.

Finally, the rule would require banks to maintain separate reserves, or purchase insurance from a third party, to cover expected losses from DCCs and DSAs. Comments on the proposed rule were due June 18, 2001. For further information, see 66 *Federal Register*, pp. 19901-6.

Assessment of Fees (5 / 8 / 2001)
The OCC made final a rule clarifying its authority to charge a national bank a fee for costs related to the special examination of a third party that provides services to the bank, i.e., bank service companies (BSCs). For example, the OCC might examine a data processing company, to ensure that its procedures don't bring additional risk to the bank. The rule would cover BSCs that are subject to examination as authorized by the Bank Service Company Act. The fee would be based on an hourly rate and determined annually by the OCC.

To determine whether a fee for the special examination is warranted, the OCC will consider the: 1) high risk or unusual nature of activities conducted by the service provider for the banks; 2) the significance to the bank's operations and income of the activities conducted by the third-party service providers; and 3) the extent to which the bank has sufficient systems, controls, and personnel to adequately monitor and control risks arising from the activities of the third-party service provider. This rule became effective June 7, 2001. For further information, see 66 *Federal Register*, pp. 23151-3.

Assessment of Fees (6 / 1 / 2001)
The OCC made final a rule modifying its fee assessment structure for independent credit card banks and all institutions with a composite CAMEL or ROCA rating of 3, 4, or 5.* An independent credit card bank is a national bank engaged primarily in credit card operations and is not affiliated with a full-service national bank. The rule creates an additional assessment based on the total outstanding balances due on accounts owned by the independent credit card bank on the last day of the assessment period. This amount is placed into a formula to compute the additional assessment.

The final rule increases the current assessment fee surcharge applicable to all institutions with a ROCA or CAMEL composite rating of 3, 4, or 5. For an institution with a 3 rating, the surcharge is 50 percent of the institution's aggregate component assessment. For institutions with a 4 or 5 rating the ratings-based surcharge is 100 percent. This rule became effective July 1, 2001. For further information, see 66 *Federal Register*, pp. 29890-4.

Lending Limits (6 / 11 / 2001)
The FDIC issued a final rule establishing a three-year pilot program expanding the limit on the amount of a loan a bank can make to one borrower for one-to four-family residential mortgages and small-business loans. To be eligible for the program, a bank must have a CAMEL rating of at least "2," be well-capitalized and well managed, and be headquartered in a state that permits lending limits higher than the federal limit. The rule would permit eligible banks to lend up to the lesser of 10 percent of its capital and surplus, the state lending limit, or $10 million to a single borrower. Real estate loans must have a loan-to-value ratio of no more than 80 percent. The rule becomes effective September 10, 2001. For further information, see 66 *Federal Register*, pp. 31114-21.

Office of Thrift Supervision

Mutual to Stock Conversions (5 / 8 / 2001)
The OTS issued a direct final rule and a proposed rule clarifying that the resulting institution of a mutual to stock ownership conversion retains all the rights, property,

* A CAMEL rating measures the financial condition of a bank. CAMEL is an acronym for Capital, Asset quality, Management, Earnings, and Liquidity. A ROCA rating is similar to a CAMEL rating but applies to branches and agencies of foreign banks. The ROCA rating measures Risk management, Operational controls, Compliance, and Asset quality.

and obligations of the previous institution. This is not an actual change in policy; it merely codifies existing practice. Comments on the proposed rule were due June 7, 2001. The final rule became effective July 9, 2001. For further information, see 66 *Federal Register*, pp. 23153-5 for the final rule, and pp. 23198-9 for the proposed rule.

Securities and Exchange Commission

Securities Broker-Dealer Activities
(5 / 18 / 2001)
The Commission put forth interim final rules along with a request for comment implementing provisions of the Gramm-Leach-Bliley Act (GLBA) dealing with the exemption of banks from the Securities and Exchange Act of 1934's definition of the term broker-dealer. The new rules replace the broad exemption from SEC registration requirements afforded to banks with functional exemptions based upon specific securities activities and would apply to savings associations and savings banks in addition to traditional banks.

The rules provide for 15 functional exemptions from the definition of broker or dealer. The rule exempts from the definition of broker third party brokerage arrangements, specific stock purchase plans, sweep accounts, affiliate transactions, private securities offerings, safekeeping and custody activities, municipal securities transactions, and a *de minimis* exception for banks that engage in no more than 500 securities transactions annually. The rule also provides an exemption for banks that underwrite and sell certain asset-backed securities. Finally, the rule provides exemptions for trust and fiduciary activities; permissible securities transactions such as certain U.S., municipal, or Canadian government obligations; and identified banking products as spelled out in section 206 of GLBA.

To qualify for these exemptions, a bank must meet specific requirements set forth by the SEC. For example, to be eligible for the trust or fiduciary exemption, the bank must be chiefly compensated on an individual account basis by either an annual fee, a charge reflecting a percentage of assets under management, a per order processing fee, or any combination of such fees. The rule also contains prohibitions on compensating a bank employee for customer referrals to the bank's brokerage operations with the exception of a nominal one-time cash fee that is not contingent on whether the referral results in a transaction.

The rule became effective May 11, 2001. Compliance was to become mandatory October 1, 2001, and comments were to have been received by July 17, 2001. These dates were changed in the face of criticism from banking regulators and the industry (see **Recent Developments**). Compliance is now mandatory as of May 12, 2002. The new due date for comments is September 4, 2001. For further information, see 66 *Federal Register*, pp. 27760-800.

SUMMARY OF JUDICIAL DEVELOPMENTS

On April 30, the U.S. District Court for the District of Columbia found in favor of the Federal Trade Commission and federal banking regulators in a suit brought against them by a trade group representing credit bureaus and other information service providers. The case, *Individual Reference Services Group, Inc. (IRSG), v. Federal Trade Commission et al.*, D. D.C., No. 00-1828, centers on privacy rules, implementing provisions of the Gramm-Leach-Bliley Act (GLBA), promulgated by the FTC and banking regulators in spring 2000.

Banks and other financial services providers are allowed to disseminate information about their customers to a credit bureau as part of a legitimate business activity, but GLBA's provisions on the redisclosure of information could prevent credit bureaus from releasing this information, in the form of credit headers, without first providing consumers with notice and an opportunity to opt out of the disclosure. A credit header is the identifying information—name, address, and Social Security number—that appears on the top of a consumer's credit report. Credit bureaus have discovered a lucrative market in making this information available to commercial and governmental entities.

IRSG argued that by adopting a definition of "nonpublic personal information" that allegedly conflicted with the plain language of GLBA and ignored a statutory exemption for consumer reporting agencies, the regulators violated the Administrative Procedures Act. IRSG also asserted the regulators had violated the First and Fifth Amendments to the Constitution by limiting free speech and adopting the regulations without due process. The district court rejected all of these arguments.

GLBA defined "nonpublic personal information" as personally identifiable financial information provided by a customer to a financial institution, resulting from any transaction with the consumer or any service performed for the consumer, or otherwise obtained by the financial institution. The act did not, however, define "personally identifiable financial information." In regulations, the agencies defined this term as (i) information a consumer provides to a regulated financial institution to obtain a financial product or service, (ii) information about a consumer resulting from any transaction involving a financial product or service between a regulated financial institution and the consumer; or (iii) information a regulated financial institution otherwise obtains about a consumer in connection with providing a financial product or service to that consumer.

The court concluded that the agencies' interpretation of the act was neither arbitrary, capricious, nor otherwise an abuse of law. Citing the GLBA and the regulations implementing the act, the court concluded that credit header data were nonpublic personal information because they are assembled using a data source considered nonpublic personal information. The court also concluded that, for the purpose of the privacy requirements of GLBA, credit reporting agencies are financial institutions. Therefore, to disclose credit header information to third parties, credit reporting agencies must comply with GLBA's consumer notice and opt-out requirement. But the court distinguished that instance from information disclosures governed under the Fair Credit Reporting Act (FCRA), where consumer reports are provided to third parties for the purpose of making firm offers of credit or insurance to the consumer. Under GLBA, such disclosures can be made without complying with the act's notice and opt-out requirement.

On April 13, 2001, the U.S. Court of Appeals for the D.C. Circuit ruled in favor of the Federal Trade Commission and against Trans Union Corporation in a case involving the company's use of "tradeline" information to generate target marketing lists that third parties use to sell nonfinancial products and services to consumers (*Trans Union Corp. v. Federal Trade Commission,* 245 F.3d 809).

Unlike credit header data, these lists are generated using summary information about a customer's accounts on his or her credit report, especially the number of accounts held by a customer. In 1994, the FTC ordered Trans Union to cease distributing such reports when they are not used for the purpose of making firm offers of credit or insurance, as permitted under the Fair Credit Reporting Act (FCRA). Trans Union objected, arguing that these lists are not "consumer reports" as defined in the FCRA and therefore the FTC did not have the legal authority to regulate them. The case originally reached the court in 1996, when the FTC was asked to justify its conclusion that these target marketing lists were indeed credit reports for the purposes of the FCRA. This resulted in an administrative hearing in favor of the FTC and a new cease and desist order in 2000. Trans Union appealed to the court, which this time concurred with the FTC's conclusion. The court agreed with the FTC because it presented evidence that some of the information used to generate the target marketing lists were also used in one or more credit scoring models or were used to generate lists of customers who received firm offers of credit or insurance.

SUMMARY OF THIRD DISTRICT DEVELOPMENTS

New Jersey

On May 14, Senators Singer and Inverso introduced SB 2355. The bill would permit consumer lenders, licensed under the New Jersey Licensed Lenders Act, to make consumer loans up to $50,000. Current statutes place a $15,000 limit on the loan amount that consumer lenders may make.

On May 24, S.2270 was reported out of the Commerce Committee and referred to the Budget and Appropriations Committee. The bill would exempt state-chartered credit unions from state sales taxes as long as federally chartered credit unions enjoy the same exemption.

Pennsylvania

On June 25, Governor Ridge signed into law S377. The bill has two parts, one of which, a consumer protection statute for subprime mortgages, is summarized above. The other part, known as the Mortgage Bankers and Brokers Act, requires mortgage bankers and brokers and loan correspondents involved in at least three mortgages in a single year to be licensed by the state banking department and bonded for at least $100,000. There are exceptions: banks, thrifts, and credit unions; attorneys; real estate brokers; builders; government or quasi-government agencies such as Fannie Mae; consumer discount companies; and nonprofit companies making less than 12 mortgages per year. The law also does not apply to commercial mortgages.

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