BANKING LEGISLATION
& POLICY

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Recent Developments

HIGHLIGHTS

Federal Reserve Proposes to Amend Discount Window Programs

On May 24 the Board of Governors of the Federal Reserve System proposed a rule that would revise the Federal Reserve's discount window programs, which provide credit to help depository institutions meet temporary liquidity needs. The proposed rule is intended to make these programs a more effective policy tool and reduce administrative costs.

Under the current Regulation A, Federal Reserve Banks make credit available to depository institutions at the discount window through three programs: adjustment credit, seasonal credit, and extended credit. Banks that need short-term credit may apply for adjustment credit at 25 to 50 basis points below market rates, but they must first demonstrate they have exhausted all other alternatives. The seasonal credit program is designed to provide longer-term assistance (at or above market rates) to smaller, mainly agricultural, banks to help them meet funding needs that result from expected patterns in their deposits and loans. Finally, the extended credit program allows the Fed to act as lender of last resort by providing longer-term credit (at or above market rates) to depository institutions where similar assistance is not reasonably available from other sources.

The Board proposes to replace the adjustment credit with a new facility, which would be available as a backup source of liquidity for banks that need short-term credit. It would be available only to institutions found to be in sound financial condition. This new facility, called primary credit, would be extended at a rate initially set at 100 basis points above the target federal funds rate and subsequently set by individual Federal Reserve Banks (subject to Board approval). This would eliminate any incentive for institutions to seek the discount window to exploit the below-market rates. Currently, the Board expends considerable administrative effort verifying that borrowers have exhausted all other sources of available funds to exclude those borrowers that are simply trying to exploit the beneficial interest rate. Financial institutions also face administrative costs associated with this verification process and are often reluctant to borrow from the discount widow because it may signal weakness to the market. Primary credit is designed to reduce the administrative burden on all parties and the reluctance of depository institutions to borrow from the discount window.

The proposed rule would replace extended credit with a new facility called secondary credit, which would be made available to institutions that do not qualify for primary credit. Secondary credit would provide temporary funding if doing so would be consistent with the institution's timely return to market funding sources or would facilitate the orderly resolution of serious financial difficulties. The interest rate set on secondary credit would be 50 basis points higher than for primary credit, to reflect the less sound condition of borrowers of secondary credit. The Board notes that because some borrowers that are currently eligible for adjustment credit will not qualify for primary credit, secondary credit will be used much more extensively than extended credit is used currently.

The proposed rule would make only minor revisions to the current seasonal credit provisions of Regulation A. Seasonal credit borrowers would not be required to demonstrate that they could not obtain similar assistance from other sources. Finally, because of a significant expansion in the funding opportunities for small depository institutions in recent years, the Board is requesting comment on whether small depository institutions still lack reasonable access to funding markets and, if not, whether the seasonal credit program should be eliminated entirely. Comments on this proposal were due August 22, 2002. For further information, see 67 *Federal Register*, pp. 36544-51. (Regulation A).

Merrill Lynch Reaches Conflict of Interest Settlement

On May 21, Merrill Lynch & Co. and the New York State Attorney General reached a settlement over charges of conflicts of interest between the firm's equity analysts and its investment banking business. The New York Attorney General brought a suit in state court on April 8, 2002, alleging that Merrill Lynch's "stock ratings were biased and distorted in an attempt to secure and maintain lucrative contracts for investment banking services. As a result, the firm often disseminated misleading information that helped its corporate clients but harmed individual investors."

As part of the settlement agreement, Merrill Lynch has agreed to several immediate reforms and issued a public apology. Merrill Lynch did not make an admission of wrongdoing that would be legally binding in future civil litigation related to this matter. However, Merrill Lynch has agreed to: 1) pay a $100 million penalty; 2) prohibit investment banking input into analysts' compensation; 3) sever the link between compensation for analysts and investment banking; 4) create a new investment review committee to approve all research recommendations; 5) issue a report upon the discontinuation of research coverage that discloses the rationale for the coverage termination; 6) disclose in research reports whether the firm has or may receive any compensation from the covered company for providing investment banking services in connection with mergers and acquisitions within the past 12 months; and 7) establish a monitor to ensure compliance with the agreement.

SUMMARY OF FEDERAL LEGISLATION

New Legislation

1. Protection of Policyholders Act (H.R. 4505). Introduced by Rep. Frank (D-MA) on April 18, 2002.

Status: Referred to the House Committee on Financial Services.

This bill would repeal sections of the Gramm-Leach-Bliley Act that permit interstate moves by mutual insurance companies as part of a reorganization to become a stock company.

2. Expanded Access to Financial Services Act of 2002 (H.R. 4612). Introduced by Rep. Ose (R-CA) on April 25, 2002.

Status: Referred to the House Committee on Financial Services.

This bill would amend the Federal Credit Union Act to allow federal credit unions to offer money order and check cashing services to certain people who are not currently members. Currently, federal credit unions can provide these services only to their members. But credit unions also have three possible types of legislatively defined membership fields: single-common bond, multiple-common bond, or community credit unions. This bill would allow federal credit unions to provide money order and check cashing services to all members of their particular field of membership, not just to members of the credit union.

3. Predatory Lending Consumer Protection Act of 2002 (S. 2438). Introduced by Sen. Sarbanes (D-MD) on May 1, 2002.

Status: Referred to the Committee on Banking, Housing, and Urban Affairs.

This bill would regulate lenders that make high-cost mortgages, defined as any first mortgage with an annual percentage rate that exceeds the yield on a U.S. Treasury security with a comparable maturity by 6 percentage points, or a subordinate mortgage whose APR exceeds the yield on comparable Treasury securities by 8 percentage points. The term would also apply to a mortgage where the total points and fees on the transaction exceed the larger of $1000 or 5 percent of the total loan amount. The bill defines a high-cost lender as a person who acts as a broker on at least six high-cost mortgages during the preceding 12-month period. This definition would apply to directors, employees, or controlling stockholders of the company. Any consultant, shareholder, or other person who participates in or controls the lending practices of a high-cost lender would be considered a high-cost lender for the purposes of the Truth in Lending Act and therefore be subject to the requirements and penalties of the act.

A high-cost mortgage lender would be required to provide disclosures alerting consumers that they may be able to secure a loan with a lower rate. When refinancing a loan, the lender must disclose that the consumer may end up paying a higher total amount than under the original loan. Lenders would also be required to inform the consumer that he or she may benefit from advice provided by a homeownership or credit-counseling agency before agreeing to the terms of the loan.

Under this bill, prepayment penalties are allowed in only the first two years of a high-cost mortgage and prohibited entirely if creditor-financed points and fees exceed 3 percent of the loan amount. The legislation would prohibit balloon payments and call provisions on high-cost mortgages that are triggered at the discretion of the lender. Creditors would be required to determine the consumer's ability to make the scheduled payments before making a high-cost loan. The financing of fees or points in excess of the greater of $600 or 3 percent of the total loan amount would be prohibited. Furthermore, prepayment fees or refinancing fees applicable to high-cost mortgages would be prohibited if the same lender refinances the original mortgage. The bill also prohibits single premium credit insurance in connection with any high-cost mortgage loan.

The legislation would prohibit the inclusion of mandatory arbitration provisions for high-cost mortgages. Damage awards for violations of the Truth in Lending Act related to mortgage loans would be substantially increased. Finally, high-cost lenders would be bound to report each borrower's complete payment history to a credit bureau.

4. Mortgage Loan Consumer Protection Act (H.R. 4818). Introduced by Rep. LaFalce (D-NY) on May 22, 2002.

Status: Referred to the Committee on Financial Services.
Related bill: H.R. 4627.

This bill would amend the Real Estate Settlement Protections Act of 1974 (RESPA) and the Truth in Lending Act (TILA) by addressing mortgage loan disclosures, closing costs and fees, escrow accounts, and enforcement provisions for existing RESPA requirements. The bill also contains provisions that would allow borrowers to sue and recover damages from lenders who violate RESPA.

The bill would direct HUD to revise its HUD-1 Settlement Statement to provide separate totals for three types of costs that are paid at settlement: closing costs, prepaid costs, and all other costs. This bill would require that the stated annual percentage rate (APR) of a mortgage loan reflect all of the costs required to be paid to obtain the loan. Currently, a number of fees are excluded from the APR calculation.

The bill expands protections against unwarranted mortgage closing costs and certain other fees. It would require lenders to make available the HUD-1 Settlement Statement at least two days prior to closing so that borrowers have an opportunity to challenge fees and charges in the final settlement statement. The bill reaffirms HUD's decision to prohibit anyone from giving or accepting a fee, kickback, or anything of value in exchange for referrals of settlement service business involving a federally related mortgage loan. Currently, RESPA prohibits fee splitting and receiving unearned fees for services not actually performed. This bill would make it clear that the act of marking up the cost of services performed or goods sold by another settlement service without providing reasons that justify the charge may violate RESPA.

The bill would add consumer protections for the administration of escrow accounts, which lenders use to pay property taxes and insurance premiums on consumers' behalf. The bill would make loan servicers liable for fees and penalties arising from their failure to make timely payment of taxes, insurance premiums, and other charges. Also, the bill requires lenders to return all escrow funds at the time of loan repayment, provided the borrower gives seven days' notice of their intent to repay (if not, the lender has 21 days to return the escrow funds).

5. Public Company Accounting Reform and Investor Protection Act of 2002 (S. 2673). Introduced by Sen. Sarbanes (D-MD) on June 25, 2002.

Status: Passed the Senate on July 15, 2002 by a vote of 97-0; bill now in conference committee with H.R. 3763.

The bill would create a five-member board called the Public Company Accounting Oversight Board, which would oversee the audit of public companies. Two members, who are or have been certified public accountants, would be chosen from the public, and the SEC would choose the chairman of the board. The board would not be an agency or establishment of the United States government nor would any of its employees be deemed an agent or employee of the U.S. government. It would be funded through various fees assessed to public companies. The board would establish quality standards for audits, perform reviews of individual audits, register public accounting firms, conduct inspections of audit firms, and establish standards of ethics and independence for auditors. The board will have a full range of disciplinary and investigative powers.

The bill would prohibit auditors from providing a range of services to clients, including bookkeeping and financial information systems design, but tax-related services would still be permitted. The bill would require accounting firms that audit public companies to change the lead and managing partners on audits every five years.

The bill would also require that chief executive officers and chief financial officers of public companies take greater responsibility for their companies' financial reports. CEOs and CFOs would be required to certify the financial statements. Furthermore, the CEO and CFO of a public company required to make an accounting restatement would have to reimburse the company for any bonuses or incentive compensation received and for any profits from the sale of securities of the company, during the 12-month period following the filing of the restated financial report. Directors and executive officers of public companies would be prohibited from purchasing, selling, or transferring stock in the company when the employees of the company are restricted in making such transactions.

Public companies subject to the Securities Exchange Act of 1934 would be required to disclose all off-balance-sheet transactions, arrangements, and other relationships with unconsolidated entities that may have an effect on the financial condition of the company. The bill would also require enhanced conflict of interest disclosures that detail loans and loan guarantees provided by a company and to its directors or executive officers.

The bill would prohibit investment firms from retaliating against analysts who write negative reports about clients of the firm. Furthermore, people involved in investment banking activities would be prohibited from supervising research analysts, clearing their reports, or determining their compensation. The bill would also require securities analysts to disclose any potential conflicts of interest when they are making public appearances.

6. Financial Accounting Standards Board Act (H.R. 5058). Introduced by Rep. Stearns (R-FL) on June 27, 2002.

Status: Referred to the House Committee on Energy and Commerce.

This bill would require the Financial Accounting Standards Board (FASB) to develop new standards for off-balance-sheet accounting, revenue recognition, special purpose entities, and mark-to-market accounting. FASB would be required to finish a study on the fair value measure of assets and liabilities within one year and a project that studies the recognition of revenue and liabilities within 18 months. Finally, the bill directs FASB to establish accounting standards so that a reasonably well-informed reader could discern the true timing and uncertainty of a firm's cash flows, as well as a true picture of a firm's resources and liabilities.

Pending Legislation

1. Business Checking Freedom Act of 2002 (H.R. 1009). Introduced by Rep. Toomey (R-PA) on March 13, 2001.

Status: Passed House on April 9, 2002, by voice vote; measure was received in the Senate April 15, 2002.

This bill would legalize the payment of interest on commercial checking accounts by repealing the sections of the Federal Reserve Act, Home Owners Loan Act, and Federal Deposit Insurance Act that currently prohibit the practice. The legislation would also permit the Federal Reserve System to pay interest on reserves maintained at the Reserve Banks by depository institutions.

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

Status: Passed the House on May 22, 2002, by a vote of 408 to 18; measure was received in the Senate on May 23, 2002.
Related bill: S. 1945.

This bill would reform the federal deposit insurance system by altering the way the insurance funds are managed and the insurance coverage is priced. Currently, banks and savings associations pay their insurance assessments into separate funds, and these funds provide coverage for depositors, depending on the type of institution. This bill would combine these two funds, the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF), into one fund called the Deposit Insurance Fund (DIF). In particular, the bill would also increase FDIC deposit insurance coverage from $100,000 to $130,000 per account while indexing this coverage level to the rate of inflation (adjusting the coverage level every 10 years). For deposit accounts in regular IRAs held at depository institutions, the deposit insurance coverage limit would be raised to $260,000.

The bill would remove the current fixed designated reserve ratio (DRR) of 1.25 percent and replace it with a reserve range from 1.00 percent to 1.50 percent. The FDIC would have to designate a target for the DRR prior to each calendar year and publish this target for public comment. The bill would require that when the amount of reserves in the Deposit Insurance Fund exceeds 1.5 percent of the estimated insured deposits, the FDIC rebate funds until this amount reaches the target level set by the FDIC. If the reserves in the DRR exceed 1.4 percent and are less than 1.5 percent, the bill would leave it to the discretion of the FDIC as to whether to rebate or credit any amounts until the reserves reach the target level.

Deposits made by a municipality in an office or branch of an insured depository institution in the same state would be insured in an aggregate amount (across all municipal deposits) not to exceed the total equity capital of the depository institution. Currently, municipal demand deposits (in the aggregate) are insured up to $100,000, and municipal time and savings deposits (in the aggregate) are insured up to $100,000. Finally, the bill would permit the DIF to invest in U.S. government or agency obligations, securities guaranteed by the U.S. government, and other securities with the approval of the Secretary of the Treasury. Currently, the BIF and SAIF can invest only in U.S. government obligations and obligations guaranteed by the U.S. government.

3. Terrorism Risk Insurance Act of 2002 (S. 2600). Introduced by Sen. Dodd (D-CT) on June 7, 2002.

Status: Passed the Senate on June 19, 2002, by a vote of 84 to 14; now in conference committee with H.R. 3210.

This bill would establish a temporary federal program that provides for a system of shared public and private compensation for insured losses resulting from acts of terrorism in the United States (or for American ships or airplanes outside the U.S.). Under this program, the Secretary of the Treasury (in consultation with the Secretary of State and the Attorney General) would decide whether an attack is an act of terrorism. If it is determined to be terrorism, the federal government will cover 90 percent of aggregate insured losses in excess of $10 billion. Private insurers would be responsible for the first $10 billion in losses. If a terrorist attack generates aggregate insured losses of less than $10 billion, the government would assume 80 percent of any claims that exceed an insurance company's property and casualty market share multiplied by $10 billion. However, the total annual liability of the federal share of compensation would be capped at $100 billion.

Under this bill, the federal terrorism insurance program would last only for one year from the date of enactment unless an extension is authorized by the Secretary of the Treasury. The bill expresses the sense of Congress that private insurance companies should develop the capacity to provide affordable property and casualty insurance coverage for terrorism risk without the need for a federal program to share in the losses.

One sticking point between this Senate bill and its counterpart in the House, H.R. 3210 (which passed the House in November 2001), is that it does not prohibit punitive damages in lawsuits arising from terrorist acts. Both bills establish a federal cause of action for property damage, personal injury, or death arising out of an act of terrorism. The House bill, however, prohibits punitive damages other than those against the terrorists and their conspirators. The Senate bill does not allow federal funds to be used for punitive damages, and these damages are not to be used in the calculation of insured losses.

SUMMARY OF FEDERAL REGULATIONS

Board of Governors of the Federal Reserve System

Risk-Based Capital Standards: Claims on Securities Firms (4 / 9 / 02)
The Board of Governors of the Federal Reserve System, along with the OCC, the FDIC, and the OTS, issued a final rule that amends their risk-based capital standards for banks, bank holding companies, and savings associations. The final rule lowers from 100 percent to 20 percent the risk weight applied to certain claims on, or guaranteed by, qualifying securities firms.

The final rule defines "qualifying securities firms" as securities firms incorporated in the U.S. that are broker-dealers registered with the SEC and in compliance with SEC net capital requirements. Securities firms incorporated in other member countries of the Organization for Economic Cooperation and Development (OECD) that are subject to supervisory and regulatory requirements comparable to those imposed on banks in OECD countries will also be considered qualified. The 20 percent risk weight applies to claims against qualifying securities firms with a long-term credit rating in one of the three highest investment-grade categories, or whose parent company enjoys such a rating and guarantees the claim. A claim may also qualify for the 20 percent risk weight if it arises from a repurchase agreement and meets several other requirements. Such claims must be collateralized by liquid and readily marketable debt or equity securities; marked to market daily; subject to a daily margin maintenance requirement under standard industry documentation; and able to be liquidated, terminated, or accelerated immediately in bankruptcy or in similar proceedings.

In the final rule, the OTS and the FDIC have amended their risk-based capital standards to be consistent with the OCC and the Board. The OTS and the FDIC will allow a zero percent risk weight for certain claims on qualifying securities firms. These claims must be collateralized by cash on deposit in a bank or a security that is issued or guaranteed by the central government of OECD countries (e.g., a U.S. government security). For further information, see 67 *Federal Register*, pp. 16971-980.

Home Mortgage Disclosure (6 / 27 / 02)
The Board issued a final rule that makes amendments to Regulation C. The amendments resulted from an initial rulemaking by the Board on January 23, 2002. Under this rule, lenders covered by HMDA must report the spread between the APR on a loan and the yield on a comparable Treasury security if that spread exceeds 3 percentage points for first-lien loans and 5 percentage points for subordinate-lien loans. Also, lenders will have to report the lien status of applications and originated loans. Both of these amendments will take effect January 1, 2004. Lenders will also be required to report data on the ethnicity, race, and sex of loan applications taken over the telephone. This change takes effect January 1, 2003. For further information, see 67 *Federal Register*, pp.43217-27. (Regulation C).

Federal Deposit Insurance Corporation

Payment of Post-Insolvency Interest in Receiverships with Surplus Funds (5 / 14 / 02)
The Federal Deposit Insurance Corporation made final a rule that establishes a uniform interest rate, calculation method, and payment priority for post-insolvency interest. The final rule is essentially identical to the proposed rule, issued on December 12, 2001. For a summary of the proposed rule, see *Banking Legislation and Policy*, October-December 2001. The effective date of the final rule was June 13, 2002. For

further information, see 67 *Federal Register*, pp. 34385-87.

Financial Crimes Enforcement Network

Systems of Records (5 / 24 / 02)
The Privacy Act of 1974 requires the Financial Crimes Enforcement Network (FinCEN) to give notice of proposed changes to its existing systems of records. FinCEN proposed changes to its Suspicious Activity Reporting System and Bank Secrecy Act Reports System to reflect certain changes in the law made by the USA PATRIOT Act.

The rule proposes to allow U.S. intelligence agencies access to information collected by banks, pursuant to various federal anti-money laundering laws, for the purpose of preventing international terrorism. Next, the rule proposes to amend suspicious activity reports to include information on individuals, entities, and organizations that are reasonably suspected of engaging in terrorist or other criminal activities. Finally, the proposed rule would allow self-regulatory agencies (i.e., the National Association of Securities Dealers) access to Bank Secrecy Act reports under certain circumstances relevant to the re-sponsibilities of those organizations. The revised systems of records took effect July 3, 2002. Comments were due June 24, 2002. For further information, see 67 *Federal Register*, pp. 36669-71.

Anti-Money Laundering (5 / 30 / 02)
FinCEN issued a proposed rule implementing Section 312 of the USA PATRIOT Act. Section 312 requires U.S. financial institutions that manage private banking accounts or correspondent accounts in the U.S. for non-U.S. persons to take certain measures to prevent or detect money laundering. A private banking account is defined as an account that requires a minimum deposit of $1,000,000 and is assigned to another person who acts as a liaison between the financial institution and the beneficial owner. A correspondent account is defined as an account established to receive deposits from or make payments on behalf of a foreign financial institution.

Financial institutions would be required to maintain a due diligence program to detect and report money laundering activity associated with a correspondent account. Enhanced due diligence would be required for any U.S. financial institution that maintains a correspondent account with a bank operating under an offshore banking license, a license from a country listed as noncooperative with international anti-money laundering principles, or a license from any other country designated by the Treasury. At a minimum, the financial institution would be required to examine the foreign bank's anti-money laundering program, determine whether the foreign bank maintains correspondent accounts for other foreign banks, and identify all of the owners of a foreign bank (for nonpublicly traded banks only) and the extent of their interest. If a foreign financial institution cannot comply with these requirements, the U.S. financial institution must refuse to open the account or suspend further account activity.

The proposed rule would also establish due diligence requirements for private banking accounts maintained for non-U.S. persons. U.S. financial institutions would be required to identify the nominal and beneficial owners of the account and the source of the funds in the account. U.S. financial institutions would also be required to provide increased scrutiny of private banking accounts operated for senior foreign political officials and their families. For further information on the USA PATRIOT Act and Section 312 in particular, see *Banking Legislation and Policy*, October-December 2001. For further information on this proposed rule, see 67 *Federal Register*, pp. 37736-44.

Office of the Comptroller of the Currency

Electronic Activities (5 / 17 / 02)
The OCC issued a final rule amending its regulations to make it easier for banks to conduct business electronically. The rule is a combination of new and revised regulations that are divided into three categories: national bank powers, location with respect to the conduct of electronic activities, and electronic safety and soundness requirements. The OCC initially proposed and requested comment on this rule July 2, 2001. The final rule contains several changes that reflect issues raised by comments submitted to the OCC.

The OCC will consider the following standards when considering proposed new electronic banking activities: (1) whether the activity is a logical outgrowth of a recognized banking activity, (2) whether the activity strengthens the bank by benefiting its customers and business, (3) whether it presents a risk that banks have experience managing, and (4) whether it is permissible for state-chartered banks.

The rule also addresses two other issues in relation to national bank powers: the ability to act as finders, and the ability to act as a digital certification authority. The OCC has been allowing national banks to act as finders and formalizes this stance in this rule. A finder serves as a third party that brings together interested parties of financial and nonfinancial products and services. The rule prohibits banks from engaging in any activity that would characterize the bank as a broker for activities not usually permitted for national banks.

Digital signatures allow recipients of electronic messages to verify the identity of the sender. A reliable third party is necessary to provide a public key that assigns and decodes these digital signatures. The final rule provides that national banks may issue digital certificates to verify any attribute for which verification is incidental to the business of banking. The rule contains a nonexclusive list of examples of attributes that digital certificates may be used to verify (e.g., financial capacity).

The second section of the rule addresses the issue of the location of a national bank. The rule establishes that a national bank's location will not be solely determined by the presence of a technology center (i.e., a computer server), an automated loan center, or because customers can access the bank's products electronically in a state. The rule also addresses how location is defined for a national bank that conducts business exclusively over the Internet. National banks are permitted by law to charge interest rates that are permitted by the home state of the national bank in question (i.e., the state where the main office is located). For Internet-only banks, the rule establishes that the state listed on the bank's organization certificate (required when each national bank is chartered) is the home state.

The final section of the rule concerns the safety and soundness of shared electronic space. Internet technology has expanded the opportunity for banks and third parties to join together in marketing relationships. An example would be a national bank having a link to a stockbroker or insurance agency on the official bank web site. The rule requires that national banks that share web pages and other electronic space with other businesses must take reasonable steps to clearly, conspicuously, and understandably distinguish between its services and those offered by the third party. For further information, see 67 *Federal Register*, pp. 34992-006.

Deposit Production Offices (6 / 6 / 2002)
The Interstate Banking and Branching Efficiency Act prohibits the establishment of an out-of-state branch for the purpose of deposit production. The OCC, together with the Federal Deposit Insurance Corporation and the Federal Reserve Board, issued a final rule that expands the prohibition to the establishment of any branch or bank controlled by an out-of-state bank holding company for the purpose of deposit production.

Under current regulations, the appropriate regulator computes the statewide average loan-to-deposit ratio for all banks chartered or headquartered in a given state. That ratio is then compared to the loan-to-deposit ratio for the covered interstate branches of an out-of-state bank. If the latter 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 (See *Banking Legislation and Policy*, July-September 1997). For further information, see 67 *Federal Register*, pp. 38844-9. (Regulation H)

Office of Federal Housing Enterprise Oversight

Corporate Governance (6 / 4 / 02)
The Office of Federal Housing Enterprise Oversight (OFHEO), the principal regulator of Fannie Mae and Freddie Mac, issued a final rule that restates and amplifies the current minimum safety and soundness standards of corporate governance for Fannie Mae and Freddie Mac. This rule was originally proposed Sept. 12, 2001.

The final rule requires Fannie Mae and Freddie Mac to follow the corporate governance practices, procedures, and laws of the jurisdiction in which they are located, Delaware law, or the Model Business Corporation Act. They must establish audit and compensation committees of their boards of directors and ensure that the compensation of executives and board members is not excessive. The regulation limits executive compensation to "that which is reasonable and commensurate with their duties." Additionally, a quorum of directors must be a majority of the entire board, and directors may not vote by proxy. Also, each enterprise must adopt written conflict of interest standards. Finally, the rule states the broad authority of OFHEO to prohibit indemnification of an executive or board member of Fannie Mae or Freddie Mac. This includes the indemnification of activities involving intentional misconduct or recklessness. For further information, see 67 *Federal Register*, pp. 38361-71.

Office of Thrift Supervision

Mutual Savings Associations, Mutual Holding Company Reorganizations, and Conversions From Mutual to Stock Form (4 / 9 / 02)
The Office of Thrift Supervision is proposing changes governing mutual-to-stock conversions. This initial Notice of Proposed Rulemaking was published July 12, 2000. As a result of public comments, the OTS has extensively modified the original proposal.

The original proposed rule contained a requirement that a mutual thrift gain OTS approval of its business plan prior to mutual-to-stock conversion. This new proposal allows thrifts to convert at the time they submit a business plan to the OTS. The new proposal also permits stock repurchases to be included in business plans.

The new proposal contains several changes intended to enhance the attractiveness of the mutual holding company option. These changes include permitting mutual holding companies to issue additional stock benefit plans and easing voting requirements. The OTS has done this to encourage mutual associations seeking new capital to consider the mutual holding company form of organization as an alternative to full conversion.

In response to public comments, this proposed rule places additional limitations on management benefit plans for mutual holding companies. The amount of stock permitted to be allocated at the time of reorganization to management benefit plans (excluding employee stock plans) would not be allowed to exceed 25 percent of the number of shares issued to minority shareholders in the public offering. Also, the new proposal would allow checking account holders to be included in initial public offerings of converting mutuals. Finally, the new proposal would codify the rules on establishing charitable foundations in connection with a conversion.

Written comments on this new proposal were due May 9, 2002. For further information on the original proposal, see 65 *Federal Register*, pp. 43092-128. For further information on the new proposal, see 67 *Federal Register*, pp. 17228-55.

Alternative Mortgage Transaction Parity Act (4 / 25 / 02)
The Office of Thrift Supervision is proposing to amend its regulations that apply to state-chartered housing creditors under the Alternative Mortgage Transaction Parity Act (Parity Act). The Parity Act was enacted in 1982, at a time of unusually high interest rates, to encourage variable rate mortgages and other creative financing. The law allowed state-chartered mortgage bankers

and other lenders to originate alternative mortgage loans, which state laws then prohibited or restricted. This law granted state-chartered housing creditors parity with federally chartered lenders, who were exempt from the restrictive state laws. Alternative mortgages are loans that have payment features that are different from the conventional fixed-rate, fixed-term mortgage loan (e.g., variable interest rates, balloon payments, or call features).

The OTS is proposing to remove its preemption of state regulations concerning late fees and prepayment penalties. States and consumer groups support this proposal, contending that lenders have been taking advantage of the OTS preemption to avoid state restrictions on these late fees and prepayment penalties. The OTS recommends that Congress consider allowing states the opportunity to opt out of the federal preemption in the Parity Act, in light of the fact that laws in nearly all 50 states allow alternative mortgage loans. Comments on this proposed rule were due June 24, 2002. For further information, see 67 *Federal Register*, pp. 20468-74.

Capital (5 / 10 / 02)
The OTS has issued a final rule that modifies its regulations concerning capital requirements and makes some other technical changes. The goal of these changes is to bring the OTS capital requirements in line with those of the other federal banking regulators. The most significant change concerns capital requirements for one- to four-family residential first mortgage loans. Prior to this final rule, a one- to four-family residential first mortgage loan qualified for a 50 percent risk weight if, among other criteria, it had a loan-to-value (LTV) ratio of 80 percent or less. The final rule eliminates the explicit LTV ratio requirement for qualifying mortgage loans. Under the final rule such loans qualify for the 50 percent risk weight if they are underwritten in accordance with the prudent underwriting standards found in the Interagency Guidelines for Real Estate Lending. Under these guidelines, one- to four-family residential first mortgage loans with an LTV ratio of 90 percent or above must have appropriate credit enhancements, such as mortgage insurance and readily marketable collateral. Loans whose LTV ratio at origination would not qualify for 50 percent risk-weighting could qualify when the mortgage loan is paid down to an appropriate LTV ratio after origination. The rule also eliminates the requirement that a thrift must deduct from capital that portion of a land loan or nonresidential construction loan exceeding an 80 percent LTV ratio. All federal banking regulators require these types of loans be risk weighted at 100 percent.

Second, the OTS is eliminating the interest rate risk component of its risk-based capital guidelines. The interest rate risk component was an explicit capital deduction on institutions with above normal levels of interest risk. The OTS reviewed its interest rate risk guidelines, as required by the Federal Deposit Insurance Corporation Improvement Act of 1991, and concluded that was no longer necessary in light of other OTS regulations that are currently used to measure and limit interest rate risk.

Finally, the rule amends the OTS definition of an Organization of Economic Cooperation and Development (OECD) country. Under current OTS regulations, certain assets backed by the governments, public utilities, or depository institutions in OECD countries receive preferential risk weighting over similar assets from non-OECD countries. The rule amends the definition of an OECD country to bring the OTS regulations in line with the other federal banking regulators' definition. The definition is amended to exclude those countries that have rescheduled their sovereign debt in the previous five years. The effective date of the final rule is July 1, 2002. For further information, see 67 *Federal Register*, pp. 31722-27.

Broker/Dealer Activities (6 / 11 / 02)
The OTS issued a proposed rule specifying the recordkeeping and confirmation requirements for savings associations that undertake securities transactions. This proposal is based on the recordkeeping and confirmation requirements already instituted by the Federal Reserve, the FDIC, and the OCC. Recently, the SEC granted savings associations the same ability to perform certain broker-dealer activities as banks without registering as a broker-dealer (for more information on the SEC rule, see *Banking Legislation and Policy*, April-June 2001). Prior to this rule, savings associations could not act as a broker-dealer for their customers unless they registered with the SEC.

The proposed rule would require savings associations to provide certain notifications to a customer after a securities transaction has been completed. The rule allows savings associations to choose between three methods: providing the registered broker-dealer confirmation or providing a written notice or an alternative (electronic) method of notification. The proposed rule makes it clear that the savings association is responsible for timely delivery, no matter the method (or if the broker-dealer sends it directly to the customer), and content of the confirmation. The content of these confirmations would be based on the SEC's requirements for registered broker-dealers.

Separately, the proposed rule would amend OTS rules governing the fiduciary powers of federal thrifts. These amendments would ensure that the OTS's rules governing federal thrifts remain in line with those covering national banks. The proposed rule would streamline application procedures, clarify when a federal savings association may act in a fiduciary capacity without obtaining fiduciary powers from the OTS, and make other technical changes. Comments were due August 12, 2002. For further information, see 67 *Federal Register*, pp. 39886-900.

On April 11, 2002, the U.S. Court of Appeals for the Sixth Circuit held that credit card over-limit fees had to be disclosed as finance charges for the purposes of the Truth in Lending Act (TILA). The court ruled that the language of TILA lacks ambiguity in regard to this matter and that over-limit charges "fall squarely within the statutory definition of a finance charge." The defendants argued that the Federal Reserve Board's Regulation Z explicitly excludes over-limit fees from the definition of finance charges and the court should defer to this regulation. However, the court disagreed, saying, "Where a statute and an agency regulation regarding the same matters conflict, courts must defer to the statute."

In *Pfennig v. Household Credit Services, Inc. and MBNA America Bank, N.A.* (no. 00-4213) the plaintiff sued the credit card company for charging a fee after the extension of credit in excess of her credit limit without disclosing the fee as a finance charge, as required by TILA. Subsequently, the credit card company charged her an over-limit fee of $29 per month while her balance exceeded her credit limit. The defendants argued that the cardholder "unilaterally exceeded her credit limit." The court rejected this argument, ruling that the charges in excess of the credit limit were authorized by the lender and the over-limit fee was "incident to the extension of credit" and therefore met the statutory definition of the term "finance charge." The court highlighted the fact that TILA is a remedial statute that should be given liberal interpretation that benefits consumers, so as to protect their interests in credit transactions. In the end, the court found the defendants not liable for their actions because they had relied in good faith on Regulation Z. The court also denied the plaintiff's attempt to have the case certified for class action.

On May 9, the U.S. District Court for the Eastern District of Louisiana upheld privacy safeguards enacted by the Gramm-Leach-Bliley Act. The court ruled in the case of *Union Planters Bank N.A. v. Gavel, D.* (E.La., No. 02-1224) that Union Planters Bank's insurance broker was prohibited from complying with a subpoena requesting the release of nonpublic personal information about Union Planters Bank's customers. The subpoena arose from a separate case (*Silah v. Union Planters Bank*) in which the bank's handling and placement of flood insurance policies (through its insurance broker) was called into question. As part of that case, Union Planters Bank's insurance broker was subpoenaed for information. However, the U.S. District Court issued an injunction prohibiting the broker from complying with the subpoena because it would lead to a release of nonpublic personal information covered by the Gramm-Leach-Bliley Act.

On June 10, 2002, the U.S. Court of Appeals for the Ninth Circuit upheld a lower court's decision that a mortgage lender can pay a mortgage broker a yield-spread premium if it passes a two-part test issued by the Department of Housing and Urban Development (see 66 *Federal Register*, p. 53052). A yield-spread premium is a lump sum paid by a lender to a mortgage broker at closing when the loan originated by the broker bears an above-par interest rate. The par rate is the rate at which the lender will fund 100 percent of a loan with no premiums or discounts to the broker.

Mortgage brokers serve as intermediaries by bringing together lenders and borrowers. Brokers also address the individual needs of the borrower (such as their credit rating, sensitivity to interest rate fluctuations, and aversion to up-front fees) during the mortgage settlement process. Mortgage brokers are compensated for the services directly through fees the borrower pays initially at settlement and, later, indirectly through yield-spread premiums from the lender. The Real Estate Settlement Procedures Act prohibits the giving or receiving of fees for referral as part of a real estate settlement service but permits fees to be paid for services actually performed in making the loan.

In this case, *Schuetz v. Banc One Mortgage Corp.* (No. 01-16206), the plaintiff alleged the direct fees she paid to the broker fully compensated the broker for the services performed. She also argued that the yield-spread premium paid by the lender was not tied to, or in exchange for, any particular service and therefore violated RESPA's prohibition on referral fees. The district court found that the two-part test developed by HUD to determine the propriety of a yield-spread premium payment was the proper test for this case. The test asks 1) whether services were actually performed for the total compensation paid to the mortgage broker and 2) whether that compensation is reasonably related to the services provided. The district court found that the yield-spread premium was reasonably related to the services provided and ruled in favor of Banc One. The appeals court in this ruling reaffirms this earlier decision.

However, the U.S. Court of Appeals for the Eleventh Circuit upheld class-action status in a similar case, prior to HUD's policy statement (*Culpepper v. Irwin Mortgage*). The Eleventh Circuit ruled that in this particular case the only service the yield-spread premium was compensation for was the referral, and therefore it violated RESPA. The current split decision in the federal circuits could pave the way in the near future for the Supreme Court to review the legality of using yield-spread premiums as compensation for mortgage brokers.

Pennsylvania

On June 25, 2002, compliance with the revised Mortgage Bankers and Brokers and Consumer Equity Protection Act became mandatory. Chapter 5 of the act imposes a number of new restrictions on high-cost loans in an attempt to curb predatory lending in the state of Pennsylvania. The act, which was signed into law on June 25, 2001, received a great deal of publicity because it overturned an ordinance on subprime lending that the city of Philadelphia had passed. The new law prevents municipalities from passing ordinances pertaining to financial and lending activities and makes it clear that they are subject to the jurisdiction of the state banking department.

The law imposes new restrictions, prohibitions, and penalties on high-cost loans, which are referred to as "covered loans" for the purposes of the new law. Lenders, brokers, and others involved in the residential mortgage lending process are now subject to these new restrictions. For a detailed description of the Mortgage Bankers and Brokers and Consumer Equity Protection Act and the new restrictions it imposes on "covered loans," see *Banking Legislation and Policy*, April-June 2001.

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