



# BANKING LEGISLATION & POLICY

January - March 2005

Volume 24, Number 1

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## Recent Developments

### **Bankruptcy Reform Bill Becomes Law**

On April 20, President George W. Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. This year marks the fourth congressional session in which bankruptcy reform legislation was introduced. Like the bills in the previous sessions, this law contains a means test to determine whether debtors may file for chapter 7 bankruptcy (under which unsecured debts are discharged) or chapter 13 bankruptcy (under which debts are restructured and some portion of the original

debt is repaid over time). For more information about this session's bankruptcy reform legislation, see the Summary of Federal Legislation section.

### **Wal-Mart Settlement Upheld by Second Circuit**

The U.S. Court of Appeals for the Second Circuit upheld an April 2003 settlement between a class of approximately 5 million merchants and Visa and MasterCard (*Wal-Mart Stores, Inc. v. Visa U.S.A. Inc. v. Reyn's Pasta Bella LLC*, No. 04-1055). The merchants objected to Visa's and MasterCard's

“Honor All Cards” rules, which were being used to require merchants to accept their debit cards as well as their credit cards. The merchants argued that this constituted an illegal “tying” arrangement that allowed the associations to charge excessively high interchange fees for signature debit transactions. The April 2003 settlement was reached after a preliminary ruling that was favorable to the plaintiffs (see *Banking Legislation and Policy*, April-June 2003).

As part of the settlement, Visa and MasterCard agreed to permit merchants to accept only their credit cards and also to pay more than \$3 billion to the merchants. In ex-

change, the settlement released Visa and MasterCard from any outstanding or future claims filed against them or their member banks for the alleged conduct.

Reyn’s Pasta Bella and four other merchants challenged the settlement, hoping to prevent the associations from being released from all other claims resulting from the alleged conduct. However, the court affirmed the settlement, concluding it was fair and that merchants were given adequate notice of it and its terms, including the scope of the release.

## SUMMARY OF FEDERAL LEGISLATION

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### *Enacted Legislation*

**1. Bankruptcy Abuse and Consumer Protection Act of 2005 (S. 256).** Introduced by Sen. Grassley (R-Iowa) on February 1, 2005.

Status: Signed into law by President George W. Bush on April 20.

Related Bill: H.R. 685.

This law will alter the bankruptcy system to prevent debtors with relatively high incomes from discharging their unsecured debts by filing for chapter 7 bankruptcy. Under chapter 7, the bankruptcy court liquidates the debtor’s nonexempt assets and distributes them among his or her unsecured creditors. The remaining unsecured debts are discharged. Under chapter 13, the borrower can keep his or her assets but must participate in a repayment plan for three to five years. Any remaining unsecured debts are then discharged. Both chapters provide a temporary stay, which protects the borrower from collection activities or other legal actions by his or her creditors.

Under current law, debtors may choose which bankruptcy chapter they wish to use. Courts are permitted to dismiss a chapter 7 filing that is found to be “abusive,” but this very rarely occurs, in part because current law does not specify criteria for determining what is abusive. The Bankruptcy Abuse and Consumer Protection Act provides explicit, but also complicated, criteria for making that determination.

The criteria take the form of a means test. In other words, a debtor’s monthly income is compared with a schedule of allowable monthly expenses. If, over a five-year period (60 months), the difference between the debtor’s income and the allowable monthly expenses is greater than \$10,000, a chapter 7 filing would be considered to be abusive. If the difference is less than \$6,000, a chapter 7

filing would be appropriate. If the difference between the debtor’s income and allowable expenses is between \$6,000 and \$10,000, a chapter 7 filing would only be considered to be abusive if this amount was greater than 25 percent of the debtor’s nonpriority, nonsecured debt.

Depending on the debtor’s situation, different classes of people may alert the court that the debtor’s bankruptcy filing abuses chapter 7. If the debtor’s income is greater than the median family income of the state (as determined by the Census Bureau and adjusted for the household size), anyone with an interest in the case, including creditors, could make a claim that the debtor is abusing chapter 7. Otherwise, only a judge or bankruptcy trustee could charge that the filing is an abuse of chapter 7. But if the debtor and his or her spouse have a combined income that is less than or equal to the state median income for a household of one, no claims could be made that the filing abuses chapter 7. If a chapter 7 filing is found to be abusive, the debtor could still file for bankruptcy under chapter 13. Before filing for bankruptcy, a debtor must have received credit counseling within the previous 180 days.

Allowable expenses will be calculated using the Internal Revenue Service’s Collections Financial Standards system that assigns dollar amounts to different categories of monthly living expenses. The three basic categories are food and clothing, housing and utilities, and transportation. The food and clothing allowances vary depending on the size of the household and gross monthly income, where a single person with a smaller monthly income would have a lower allowance than a larger family with a larger income. The housing and utilities allowance varies by geographic location and the size of the household, where a smaller household in a rural area would receive a smaller allowance than a larger household in a metropolitan area. Finally, the transportation allowance varies by region, depending on the number of cars in the household and whether the household is in a metropolitan area. Additional allowable expenses include costs to care for an elderly or sick

family member, tuition expenses for dependent children, and payments on secured debts (such as mortgage and car payments) and priority unsecured debts (such as alimony and student loans).

Under the law, if an unsecured creditor rejects a repayment plan that is proposed by an approved nonprofit credit counselor, the borrower may petition the court to reduce the creditor's claim in bankruptcy by up to 20 percent. The proposed plan must require the borrower to repay at least 60 percent of the unsecured debt.

The law also sets new limits on the frequency with which debts may be discharged under chapter 7 and chapter 13 bankruptcy plans. A person's debts may not be discharged under chapter 7 if the debtor has discharged debts under the same chapter within the past eight years. This is an increase from the current limit of six years. A person could not receive a discharge under chapter 13 within four years of receiving a discharge under another chapter, or within two years of receiving a discharge under another chapter 13 filing. In addition, to be eligible to obtain a discharge, a borrower must complete a course in financial management.

One common complaint about the current bankruptcy system is that there are no uniform homestead exemptions (the dollar amount of equity in a debtor's primary residence that is protected from creditors). States are free to set their own exemption levels. Some states are more lenient than others, and a few exempt all equity in the primary residence regardless of the amount. This raises the possibility that a debtor, anticipating bankruptcy, could move to a state with a high homestead exemption. By selling nonexempt assets and using the proceeds to buy a home, the debtor could increase the amount of his or her wealth that is protected from creditors. This law addresses this concern by requiring a two-year residency in any state in order to qualify for its homestead exemption.

Another provision of the law makes permanent chapter 12 of the bankruptcy code. Chapter 12 protects farmers facing financial ruin, helping them reorganize their debt and continue their farming business. Finally, another important provision makes netting contracts between two or more financial institutions enforceable. Netting contracts are sometimes included in derivatives transactions. When two or more financial institutions swap derivatives, netting contracts require that if either of the parties files for bankruptcy, each party's total future payments to the other party would be calculated and netted, and the one party would only owe the other party the net difference. This law prevents netting contracts from being stayed by state and federal law.

The law also requires many consumer notices to be made. First, companies will be required to disclose an example of the cost of making only the minimum payment on open-end lines of credit (credit cards) and the time it will take to repay the balance. The notices must inform consumers of a toll-free telephone number that can be called to determine the time it will take to pay off their balances.

Next, lenders must disclose that mortgage interest is not tax-deductible if the interest is on a loan balance that exceeds the fair market value of the house. Another disclosure must inform consumers that "low introductory rates" are just that: introductory. This disclosure must explain when the introductory rate will expire and what the new rate will be following the introductory period. Further, if the introductory rate can change for any other reason, the disclosure must list the reasons and the new rate that will replace the introductory rate. Companies must also inform borrowers in each billing statement of any fees or penalties that may be applied to the account and the date upon which the penalties will be imposed. Finally, companies are prohibited from closing an open-ended credit plan (credit cards) merely because the borrower hasn't incurred finance charges.

### *New Legislation*

**1. Mortgage Lending Improvements and Uniform National Standards Act (H.R. 1295).** Introduced by Rep. Ney (R-Ohio) on March 15, 2005.

Status: Referred to the House Committee on Financial Services.

This bill includes many provisions that address different aspects of mortgage lending, including prohibiting unfair lending practices and loan flipping, setting guidelines for higher-cost mortgage loans and prepayment penalties, and coordinating federal and state laws. The definition of a higher-cost mortgage loan includes any of the following: 1) a first mortgage on the borrower's primary residence that carries an interest rate that is more than eight percentage points higher than the yield on Treasury securities of a comparable maturity; 2) a junior mortgage on the borrower's primary residence that carries an interest rate that is more than 10 percentage points higher than the yield on Treasury securities of a comparable maturity; or 3) a loan that has points and fees equal to more than 5 percent of the total loan amount (or 6 percent for loans of less than \$40,000). Some of the major provisions of the bill are summarized below.

Creditors would be prohibited from financing points and fees that exceed 5 percent of the total higher-cost mortgage loan (or 6 percent for loans of less than \$40,000). If a creditor does finance any portion of points and fees, the creditor must disclose to the borrower that the points and fees do not have to be financed. The bill would require creditors to verify a borrower's ability to repay before offering them a higher-cost mortgage loan. In addition, higher-cost mortgages could not include debt cancellation or suspension contracts, or single-premium credit life insurance policies – policies that ensure that the creditor will be repaid if the borrower dies or becomes disabled or unemployed.

Before making a higher-cost mortgage loan, creditors would be required to make the following disclosures to

consumers: 1) the interest, fees, and payments on the loan are higher than on other loans; 2) a lower rate might be found elsewhere; 3) a borrower should calculate the time it will take to pay off the loan and the total amount it will cost to repay the loan; and 4) serious financial difficulties may result if a borrower uses a higher-cost loan to pay off other debt.

Higher-cost mortgage loans could not include provisions that accelerate the borrower's indebtedness at the creditor's discretion, except if a borrower defaults on the loan or misleads the creditor in a way that affects the creditor's interest in the loan. Fees to modify, extend, renew, or amend a higher-cost loan could not exceed the amount of one monthly payment or \$300, whichever is less. Each month a creditor who extends a higher-cost mortgage loan must report to a consumer reporting agency the payment history on the loan, whether favorable or unfavorable. Higher-cost mortgage loans could not include terms that require arbitration to settle disagreements. However, voluntary arbitration would be permitted.

The bill lists several limitations on prepayment and late payment penalties. Prepayment penalties could only be charged if the prepayment occurs less than three years after taking the loan, the borrower was offered a choice of loan that did not carry a prepayment penalty, and the penalty is not greater than six months' interest on the amount that is prepaid (this applies to payments of at least 20 percent of the original principal amount that are prepaid in any 12-month period). Prepayment penalties could not be imposed if the prepayment is a result of the debt being accelerated due to default or any other breach of the loan terms. Late payment penalties could only be assessed once a payment is more than 15 days late, and they could not exceed 5 percent of the amount of the past due payment. A single late payment could not be charged more than one penalty.

In order to extend a higher-cost mortgage loan, creditors must suggest that borrowers seek credit counseling. Creditors should provide consumers with a written statement that lists addresses and telephone numbers of credit counselors that would advise them on whether a higher-cost mortgage is appropriate. The bill would establish the Office of Housing Counseling (OHC) in the Department of Housing and Urban Development (HUD), which would be responsible for all aspects of homeownership and rental counseling.

Because this bill would set national standards for these mortgage-lending practices, state laws that govern the practices would be preempted. However, this would not prevent states from enforcing laws governing the licensing, registration, or authorization of people who wish to engage in mortgage-lending activities, as long as the requirements don't conflict with the rest of this bill. Within three years of this bill's enactment, states would be required to establish minimum laws regarding mortgage brokers. The laws must require mortgage brokers to be licensed by submitting a written application. Mortgage brokers would also

be subject to 24 hours of mortgage education, a criminal background check, and continuing education classes.

Finally, this bill would establish a national database of mortgage brokers. The registry would list each mortgage broker licensed by state or federal law. In addition, the registry would include any complaints made against any of the registered brokers and any resulting enforcement actions taken against them.

## **2. Consumer Checking Account Fairness Act (H.R. 799).** Introduced by Rep. Maloney (D-NY) on February 15, 2005.

Status: Referred to the House Committee on Financial Services.

This bill would require banks to credit deposits to consumer checking accounts faster. Banks would not be permitted to assess an overdraft charge on an account if the following conditions are met: 1) the bank already received settlement on a deposit made by a consumer; 2) the bank had not yet made the funds available to the depositor's account; and 3) the bank's making the funds available sooner would have prevented the overdraft.

At the end of each business day banks must credit all deposits to a personal account before debiting any checks drawn on that account. If a bank treats Saturdays as business days when debiting items from accounts, it must also treat Saturdays as business days for crediting deposits to accounts. Finally, if a bank chooses to honor a check written on an overdrawn account, the bank may not assess a fee for paying the check unless the consumer has requested an overdraft protection service.

## **3. Prevention of Predatory Lending Through Education Act (H.R. 200).** Introduced by Rep. Scott (D-Ga.) on January 4, 2005.

Status: Referred to the House Committee on Financial Services.

This bill would authorize the Department of Housing and Urban Development (HUD) to make grants to states, local governments, and nonprofit organizations to fund programs that would warn consumers, through education and counseling, about predatory lending practices. Grant recipients could also use the funding to develop referral programs to direct consumers to education and counseling programs or to regulatory agencies that handle consumer complaints about predatory lending. The bill would also permit HUD to establish a national toll-free telephone number to receive consumer complaints about predatory lending practices and to refer consumers to the appropriate agency for assistance.

In addition, the bill establishes a Predatory Lending Advisory Council within HUD. The council would consist of four representatives of community-based organizations, three officials of state consumer affairs or consumer protec-

tion agencies, three private homeowners, and three representatives of the real estate industry. The council would meet at least three times per year and would be responsible for advising the secretary of HUD about the grant program and the toll-free telephone number authorized by this bill. The council would also be required to study the causes of default and foreclosure of home loans, and to submit the results of this study to Congress and the secretary of HUD within a year after the council is established.

**4. Rural Economic Investment Act of 2005 (H.R. 399).** Introduced by Rep. Osborne (R-Neb.) on January 26, 2005. Status: Referred to the House Committee on Ways and Means.

This bill would exclude from a bank's gross taxable income any interest earned from agricultural real estate loans. For the purposes of this bill, agricultural real estate is defined as property that is used to produce at least one agricultural product, or a property that is a single-family residence and is the principal residence of the owner, which is located in a rural area, and which has been purchased or improved upon using the funds from the real estate loan.

**5. Social Security Number Misuse Prevention Act (S. 29).** Introduced by Sen. Feinstein on January 24, 2005.

Status: Referred to the Senate Committee on the Judiciary.

This bill would make it a federal crime to display, sell, or purchase any person's Social Security number without his or her express consent. Before an entity displays, sells, or purchases a person's Social Security number, it must disclose how and by whom the number will be used, and it must obtain written or electronically mailed consent from the person to whom the number is assigned. The bill makes exceptions for health care, national security, law enforcement, and reasonable business purposes (for example, transactions between affiliates), as well as an exception to accommodate programs that match data between federal, state, and local agencies.

The bill would require the U.S. attorney general to study all of the instances in which federal laws permit, require, authorize, or accept the use of Social Security numbers. The attorney general would be required to report the results of the study to Congress and comment on what impact, if any, these uses have on privacy and data security.

In addition, the bill prohibits the display, sale, or purchase of public records that contain Social Security numbers. It would require the attorney general to determine how to treat instances of public records that were made available on the Internet or in paper form before the enactment of this law.

The bill would also prohibit government agencies from displaying a person's Social Security number on his or her paycheck. In addition, federal, state, and local agencies would not be permitted to employ prisoners in any po-

sition in which they have access to other people's Social Security numbers. A final provision prohibits companies from requiring customers to give their Social Security numbers to purchase a good or service. Exceptions are made for background checks, law enforcement purposes, or where required by federal, state, or local law, or for purposes permitted by the Fair Credit Reporting Act. There is also an exception for instances in which a Social Security number is needed to verify the identity of the customer.

**6. Community Choice in Real Estate Act (H.R. 111).** Introduced by Rep. Calvert (R-Calif.) on January 4, 2005.

Status: Referred to the House Committee on Financial Services.

This bill would indefinitely prohibit financial holding companies and national banks from engaging in real estate brokerage or management activities. (An existing ban on these activities will expire on September 30, 2005.) Specifically, the law would prevent the Board of Governors of the Federal Reserve System and the Secretary of the Treasury from ruling that real estate management and brokerage activities are financial in nature and thus permissible activities for banks under the Gramm-Leach-Bliley Act. The bill would not apply to real estate that is owned by a national bank, bank holding company, financial holding company, or an affiliate of a national bank or holding company.

**7. Federal Deposit Insurance Reform Act of 2005 (H.R. 1185).** Introduced by Rep. Bachus (R-Ala.) on March 9, 2005.

Status: Referred to the House Subcommittee on Financial Institutions and Consumer Credit.

This bill is identical to a deposit insurance reform bill introduced in the last congressional session (H.R. 522). Among other things, the bill would combine the Bank Insurance Fund and the Savings Association Insurance Fund into a new Deposit Insurance Fund (DIF) into which all future assessments would go. The bill would also increase from \$100,000 to \$130,000 the amount of deposit insurance coverage per account offered by the Federal Deposit Insurance Corporation. It also increases insurance coverage for municipal deposits and retirement accounts and establishes a range for calculating payments into the DIF. Currently there is a fixed reserve ratio to calculate deposit insurance payments, but the bill would allow the board of directors of the Federal Deposit Insurance Corporation to change the reserve ratio depending on a number of factors, including the DIF's risk of losses and the current economic conditions affecting the insured depository institutions. For more information, see *Banking Legislation and Policy*, January-March 2003, for a summary of last session's deposit insurance reform bill.

**8. United States Financial Policy Committee for Fair Capital Standards Act (H.R. 1226).** Introduced by Rep. Bachus (R-Ala.) on March 10, 2005.

Status: Referred to the House Committee on Financial Services.

This bill establishes a United States Financial Policy Committee, to be composed of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Chairperson of the Federal Deposit Insurance Corporation,

and the Director of the Office of Thrift Supervision. The committee will be required to develop uniform positions on issues being discussed by the Basel Committee on Banking Supervision. All committee members will be required to adhere to the committee's stance on these issues in all negotiations with the Basel Committee. If the committee can't come to a consensus, it will adopt the stance of the chairperson, the Secretary of the Treasury. In addition, the Financial Policy Committee must submit a report to Congress on all Basel Committee proposals before the federal banking agencies may agree to them.

## SUMMARY OF FEDERAL REGULATIONS

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### **Conflicting Guidance on Overdraft Protection Services**

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the National Credit Union Administration (together, the Agencies) and the Office of Thrift Supervision (OTS) issued two separate guidances on bounced-check, or overdraft, protection services. An example of these services is an overdraft line of credit. Even if a consumer does not have an overdraft line of credit, sometimes a depository institution will pay an overdrawn item on a limited, discretionary basis. Depository institutions usually charge a fee for this service.

The primary difference between the two guidances is that the OTS regards overdraft protection as a fee for a service, while the Agencies regard it as a form of credit. Nevertheless, the Agencies state that, in most cases, these services are not subject to the Truth in Lending Act and Regulation Z. One exception, they point out, is a closed-end overdraft repayment loan that carries a finance charge. In that case, the Agencies state that Regulation Z would apply.

Both guidances advised depository institutions to charge off all overdrawn balances within 60 days of an account being overdrawn. Any payments received after an account is charged off should be reported as a recovery. The guidances also contain a list of best practices that depository institutions should follow, including fairly representing overdraft protection programs and alternatives, training staff to explain the programs' features, explaining that the program is discretionary, distinguishing overdraft protection services from "free" account features, clearly disclosing program fees, allowing consumers to opt out of the service, and alerting consumers before a transaction triggers any fees. In addition, the OTS guidance warns thrifts against manipulating transactions (such as check clearing and debit processing) to create more overdrafts and increase fees. The Agencies' guidance does not contain this warning.

For more information about the Agencies' guidance,

see 70 *Federal Register*, 9127-32. For more information about the OTS's guidance, see 70 *Federal Register*, pp. 8428-31.

### **Office of the Comptroller of the Currency**

#### *Basel II Implementation (1/27)*

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (together, the Agencies) issued guidelines to help depository institutions implement the advanced internal ratings-based approach and the advanced measurement approaches (together, the advanced approaches) for calculating risk under Basel II. The Agencies will require depository institutions to qualify for the advanced approaches, and the guidelines describe how depository institutions can prepare to qualify.

The first step is the development of an implementation plan. The plan must include: 1) a self-assessment of how the institution meets the Agencies' qualification standards; 2) a list of areas in which the institution needs to do additional work; 3) a plan for how the institution will address those needs; 4) a timeline for completing this work; 5) a budget that shows that the institution can afford to do the work; 6) the approval of the institution's board of directors; and 7) a format for regular discussion with the institution's primary regulator.

An institution's primary regulator must approve its implementation plan before the institution can qualify to use the advanced approaches. The Agencies suggest that institutions submit first drafts of the plans to regulators by the third quarter of 2005 to be sure they are approved in time to adopt the advanced approaches as soon as Basel II becomes effective. The Agencies also plan to propose that for one year an institution must simultaneously use its current methodology for calculating risk-based capital

along with using the advanced approaches. This means that if an institution expects to begin using the advanced approaches in 2008 (when the Agencies expect Basel II will be effective), the institution must do a parallel-run during 2007. The one-year parallel-run must be completed before an institution can qualify to use the advanced approaches.

For more information on this guidance, see [www.federalreserve.gov/boarddocs/press/bcreg/2005/20050127/attachment.pdf](http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050127/attachment.pdf).

#### *Regulatory Burden Reduction (2/3)*

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (together, the Agencies) requested comments on ways to reduce regulatory burden associated with money laundering, safety and soundness, and securities rules. The Agencies requested comment on whether any of the rules pertaining to these topics are inconsistent with or duplicate other rules. The Agencies specifically invited comment on whether there are less burdensome alternatives to the rules and whether they are outdated, are sufficiently clear, and allow an appropriate degree of flexibility; also, what effect, if any, do the rules have on competition, and are they unduly burdensome to small institutions (those with assets of \$150 million or less).

Comments were due May 4. For more information, see 70 *Federal Register*, pp. 5571-7.

#### *Mortgage Lending Practices (2/7)*

The Office of the Comptroller of the Currency (OCC) issued a final rule to provide national banks and their operating subsidiaries with guidelines for their residential mortgage lending activities. The guidelines stress that banks must effectively manage against credit, legal, compliance, and reputation risks associated with real estate lending activities, and they must not engage in abusive, predatory, unfair, or deceptive lending practices. The guidelines specifically list several unsound and abusive practices, including equity stripping, fee packing, loan flipping, and encouraging a borrower to breach a contract and default on an existing loan in connection with a refinancing of that loan.

In addition, the guidelines list practices that may, depending on the circumstance, be abusive. The list includes financing single-premium insurance, negative amortization, and mandatory arbitration. If a loan contains any of these terms, the bank must exercise caution, especially if the borrower has a poor credit history or is elderly, substantially indebted, not financially sophisticated, or hindered by language barriers. The guidelines encourage banks to educate consumers about the costs, risks, and benefits of loan terms. Banks should also attempt to mitigate risks involved with mortgage loans that the bank purchases or makes through an intermediary.

This final rule became effective April 8. For more information, see 70 *Federal Register*, pp. 6329-34.

#### *Streamlined CRA Examinations (3/11)*

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (together, the Agencies) issued a proposed rule to increase the number of banks that are eligible for streamlined Community Reinvestment Act (CRA) examinations. The Agencies propose to define small banks as those with less than \$1 billion in assets and intermediate small banks as those with between \$250 million and \$1 billion in assets. These limits would be adjusted annually using the Consumer Price Index to account for inflation.

Under the proposed rule, during CRA examinations small banks would be subject only to a lending test. A lending test assesses the bank's lending activities, including its loan-to-deposit ratio, its record of lending to borrowers of different income levels, the geographic distribution of its loans, and its record of response to complaints about not meeting its obligations under the CRA.

In addition to the lending test, intermediate small banks would be subject to a community development test. The community development test assesses, among other things, the number and dollar amount of a bank's community development loans and other services the bank provides to its community. The new two-part exam for intermediate small banks is more streamlined than the current test for banks of the same size and is somewhat of a compromise between the Agencies' previous proposals (see *Banking Legislation and Policy*, January-March 2004) and a 2004 rule issued by the Office of Thrift Supervision (see *Banking Legislation and Policy*, July-September 2004).

The Agencies also propose to redefine community development to encompass more activities. The new definition will include affordable housing (including multi-family rental housing) for low- or moderate-income individuals, individuals in underserved rural areas, or individuals located in disaster areas. In addition, community development activities will include activities that revitalize or stabilize low- or moderate-income areas, underserved rural areas, or disaster areas.

Comments on this proposed rule were due May 10. For more information, see 70 *Federal Register*, pp. 12148-61.

#### *Commercial Credit Exposures (3/28)*

The Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (together, the Agencies) issued a notice of their intent to reclassify commercial credit exposures using a two-dimensional framework that would assess a borrower's creditworthiness and take into consideration the estimated loss severities associated with each credit facility. Commercial credit exposures include commercial and industrial loans, leases, receivables, mortgages, and other extensions of credit that are made for business purposes. The current system of classifying commercial credit exposures focuses on the borrowers' weaknesses but doesn't specify

how to account for factors that mitigate losses, such as collateral and guarantees. The Agencies believe this has led to the current classification system being applied differently by different institutions. The Agencies proposed the new system to provide a uniform classification system.

First, depository institutions must assign borrowers a rating of marginal, weak, or default. Marginal borrowers have potential weaknesses that, if not corrected, may negatively affect their ability to repay. However, marginal borrowers generally demonstrate sufficient financial flexibility to react to negative financial trends and meet debt obligations. Weak ratings are assigned to borrowers who do not possess sufficient payment capacity and could, in all likelihood, default. Borrowers are assigned a default rating when their credit exposures meet the definition of non-accrual, or when the institution has charged off or written-down the credit exposure.

Next, for each borrower rated default, depository institutions would assign a credit facility rating of either remote risk of loss, low loss severity, moderate loss severity, or high loss severity. Remote risk of loss facilities include those secured by cash, marketable securities, commodities, or livestock. Facilities would receive a low loss-severity rating if the loss is estimated to be 5 percent or less of the institution's total investment. Moderate loss-severity ratings would be assigned to facilities that will most likely not be recovered in full, and the associated losses are estimated to be between 5 and 30 percent of the institution's total investment. A facility would receive a high loss-severity rating if it is not likely to be recovered in full and the associated loss is estimated to be greater than 30 percent of the institution's total investment. Institutions may also assign these ratings to borrowers rated marginal or weak, but this is not required.

Depository institutions would include in their criticized assets all loans to borrowers classified as weak or in default, plus loans to marginal borrowers that do not receive a remote risk-of-loss rating. In classified assets, depository institutions would include all loans to borrowers rated weak and default, except when the loan facilities associated with them receive a remote risk-of-loss rating.

Comments on this proposal are due June 30. For more information, see 70 *Federal Register*, pp. 15681-8.

#### *Unauthorized Access to Customer Information (3/29)*

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (together, the Agencies) issued a guidance to help depository institutions develop appropriate procedures for protecting customers' personal information and notifying customers if their information has been misused. First, institutions should place controls on systems that access the sensitive customer information and conduct background checks on all employees authorized to handle the information. Next, institutions should develop response programs for dealing with unauthorized access to

customer information and ensure that their service providers are also protecting customer information. The response program should also direct that, in the case of a breach, the institution will notify its primary federal regulator and law enforcement authorities, as well as complete a suspicious activity report.

Once an institution realizes that customer information has been accessed by an unauthorized user, the institution should conduct an investigation into the extent of the breach and which customers are affected. Institutions should then notify all affected customers as soon as possible, unless law enforcement agencies determine that notifying customers will interfere with criminal investigations. Institutions may notify customers either by telephone, written mail, or electronic mail. The notice should provide a toll-free telephone number that customers can call for more information. In addition, the notice should advise customers to carefully scrutinize their account statements for the next one or two years to be sure they don't become victims of identity theft.

This guidance became effective March 29. For more information, see 70 *Federal Register*, pp. 15736-54.

### **Board of Governors of the Federal Reserve System**

#### *Remote Checks (3/4)*

The Board of Governors of the Federal Reserve System (the Board) issued a proposed rule to shift liability for remotely created checks to depository banks (the bank whose customer requested that a remote check be drawn on his or her account). Remotely created checks are created by the entity that is to be paid (at the request of the customer), and they are not signed by the customer. Instead, the check usually contains a mark that indicates it was approved by the customer. For example, a person might request that his or her cable company collect its monthly payment by a remotely created check. In that case, the individual would give the cable company his or her checking account information, and the company would present a remotely created check to the customer's bank to request payment.

Typically, a payee bank, the institution that is being paid, bears the liability for fraudulent checks. However, the Board proposes to shift liability for remotely created checks to the bank from which the customer's money was taken, because it believes the customer's own bank is in the best position to know whether the customer would have requested the remotely created check.

Comments on this proposed rule were due May 3. For more information, see 70 *Federal Register*, pp. 10509-13.

### **Office of Thrift Supervision**

#### *Holding Companies (3/2)*

The Office of Thrift Supervision (OTS) issued an interim final rule to establish an expedited review process to

determine if a company has a controlling influence over a thrift, in which case the company would become an OTS-regulated entity. If the OTS believes that a company holds up to 10 percent of a thrift's stock and might have gained control over the thrift, the OTS will issue a notice to the company. After receiving the notice, the company may deny the allegations or consent to them and be subject to the OTS's authority on some matters. If the company denies the allegations, and the facts contained within the notice are not disputed, the OTS will preside over a hearing and enter a final decision. Under current practice, the proceeding would be conducted by an administrative law judge. However, if there are facts in dispute, or if either party seeks discovery or to present oral testimony, the current review process would be used instead of the expedited review.

This interim final rule became effective April 1. Comments on the rule were due May 2. For more information, see 70 *Federal Register*, pp. 10021-3.

#### *CRA Examinations for Large Thrifts (3/2)*

The Office of Thrift Supervision (OTS) issued a final rule to allow large thrifts to choose the weights they would like to have applied to the lending, service, and investment components of Community Reinvestment Act (CRA) examinations. Large savings associations are those that have more than \$1 billion in assets. Currently CRA examinations for large thrifts entail a three-part test composed of an assessment of their lending, service, and investment. Currently a thrift's lending grade would be given a 50 percent weight, and the grades for service and investment would each carry a 25 percent weight. However, under the new rule, a thrift will be able to choose alternate weights for each of the test components, as long as lending always carries at least a 50 percent weight.

This final rule became effective April 1. For more information, see 70 *Federal Register*, pp. 10023-30.

### **Department of Housing and Urban Development**

#### *Mortgage Default Reporting (1/21)*

The Department of Housing and Urban Development (HUD) issued a proposed rule that would require earlier reporting by lenders of HUD mortgages that are delinquent or in default. Under current rules, lenders are required to report delinquent mortgages when they are 90 or more days past due and default mortgages after they are in default for at least 60 days. The proposed rule would require lenders to report loans as delinquent if a monthly payment is not made by the last day of the month in which the payment was past due.

Comments on this proposed rule were due February 22. For more information, see 70 *Federal Register*, pp. 3266-8.

### **Office of Federal Housing Enterprise Oversight**

#### *Mortgage Fraud Reporting (2/25)*

The Office of Federal Housing Enterprise Oversight (OFHEO) issued a proposed rule to define mortgage fraud and to require government sponsored enterprises (GSEs), such as Fannie Mae and Freddie Mac, to report instances of it. Mortgage fraud would be defined as any misstatement, misrepresentation, or omission upon which a GSE relied in making its decision to fund or purchase a mortgage or mortgage-backed security. Under the proposed rule, a GSE would be required to report mortgage fraud, or suspected mortgage fraud, to the OFHEO before requiring a mortgage, or other financial instrument, to be repurchased. GSEs would be required to retain records of mortgage fraud and would be prohibited from disclosing information about the fraud to any parties connected with the fraud without prior approval by the OFHEO. Furthermore, GSEs would be required to develop adequate internal controls to detect mortgage fraud.

Comments on this proposed rule were due March 28. For more information, see 70 *Federal Register*, pp. 9255-7.

### **Federal Trade Commission**

#### *Prescreen Opt-Out Disclosure (1/31)*

The Federal Trade Commission (FTC) issued a final rule to enhance disclosures to consumers about their rights to opt out of receiving prescreened solicitations about credit or insurance. Under the rule, anyone who uses a consumer report to contact a consumer in writing about an offer of credit or insurance must also include a short notice with the offer explaining that the consumer has the right to opt out of receiving prescreened offers. This does not apply if the consumer initiates the transaction.

A short notice must be a clear, concise, and easy to understand statement. It must inform the consumer of his or her right to opt out of receiving prescreened solicitations and provide a toll-free telephone number the consumer can call to opt out. This notice must be displayed in a conspicuous place on the front of the first page of the solicitation document. The short notice must also inform consumers of a longer, more comprehensive notice about their rights and direct them to it.

This final rule becomes effective August 1. For more information, see 70 *Federal Register*, pp. 5022-37.

**New Jersey State-Chartered Thrifts May Still Charge Pre-Payment Penalties**

The U.S. Supreme Court refused to hear a case that challenged a New Jersey Supreme Court opinion allowing a New Jersey thrift to charge prepayment penalties on alternative mortgage transactions, in accordance with an Office of Thrift Supervision (OTS) rule and in defiance of a New Jersey state law banning the penalties (*Glukowsky v. Equity One, Inc.*, No. 04-398). The case initially arose after Equity One charged Mark Glukowsky a prepayment penalty on his "balloon loan" alternative mortgage transaction (AMT). Glukowsky sued the lender, contending that Equity One violated a New Jersey law that prohibits prepayment fees on AMTs. Equity One argued that it was permitted to charge the fee because of a 1996 rule by the OTS that gives state-chartered lenders the same ability as federal lenders to charge prepayment penalties on alternative mortgage transactions. At issue was whether the OTS overstepped its authority by issuing the rule under the Alternative Mortgage Transaction Parity Act (AMTPA). In May 2004, the New Jersey Supreme Court ruled that the OTS reasonably interpreted the AMTPA and was authorized to issue the rule, meaning Equity One was entitled to charge prepayment penalties on AMTs. (For more information on the New Jersey Supreme Court ruling, see *Banking Legislation and Policy*, April-June 2004.)

**SLUSA Preempts State Class Action Case**

The U.S. Court of Appeals for the Third Circuit affirmed a district court's opinion that the Securities Litigation Uniform Standards Act (SLUSA) of 1998 preempts a state court class action lawsuit alleging that a retail brokerage firm breached its contract with its customers by providing biased investment research (*Rowinsky v. Salomon Smith Barney Inc.*, No. 03-4762). The plaintiff, Ryan Rowinsky, on

behalf of himself and a class of plaintiffs, initially filed a lawsuit against Salomon Smith Barney in a Pennsylvania state court, alleging that the company artificially inflated the ratings and analysis of its investment banking clients in order to please its existing and potential investment banking clients and earn millions of dollars. Rowinsky argued that in doing so, Salomon Smith Barney committed a breach of contract with its customers by failing to provide unbiased research and analysis in exchange for the customers' payments.

While the breach of contract claim is a state court claim, Salomon Smith Barney moved to have the case remanded to federal court, arguing that the SLUSA preempts the claim. The SLUSA provides for the transfer of state court class actions to federal court if the suit alleges a misrepresentation or omission of a material fact *in connection with* the purchase or sale of a covered security. The district court dismissed the case on the grounds that the breach of contract was committed in connection with the sale of securities, and therefore the action is preempted by the SLUSA and not eligible to be tried in state court.

The U.S. Court of Appeals for the Third Circuit affirmed the district court's opinion, saying that the plaintiff's claims meet the *in connection with* standard for several reasons. First, the breach of contract necessarily involves or coincides with the purchase or sale of misrepresented securities. Second, the plaintiff alleged that Salomon Smith Barney disseminated material misrepresentations upon which a reasonable investor would rely. Next, the breach occurred in a contract between a broker and investor – a relationship that revolves around trading in securities. Finally, the plaintiffs were seeking recovery of all fees and charges, including trading fees and commissions, which are incurred in connection with purchasing and selling securities.

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