Banking Legislation & Policy

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HIGHLIGHTS

Recent Developments

Free Annual Credit Reports Available Nationwide

As of September 1, residents nationwide became eligible to receive free annual credit reports from each of the three national credit bureaus. The Federal Trade Commission's (FTC's) free annual credit report program was mandated by the Fair and Accurate Credit Transactions Act of 2003 (see *Banking Legislation and Policy*, October-December 2003), and the program was implemented in stages, with West Coast residents being the first to have access and East Coast residents qualifying in the last phase. Consumers across the country can now request a free credit report from each of the three national credit bureaus once every 12 months. The requests can be made to each of the three credit bureaus at the same time, or they can be staggered during the 12-month period. Consumers can make requests by mail, electronic mail, or telephone. For more information about the free credit report program, see the FTC's website at *www.ftc.gov/credit*.

U.S. Court of Appeals for the Federal Circuit Decides a *Winstar* Case

On August 17, the U.S Court of Appeals for the Federal Circuit let stand a lower court ruling that required the U.S. government to pay a bank, its parent company, and its subsidiary $48.7 million in damages because of its breach of contract during the savings and loan crisis in the 1980s. At that time, the government encouraged depository institutions to take over failing thrifts in exchange for receiving supervisory goodwill in the form of relaxed capital requirements. In addition, First Heights Bank, the plaintiff in this case, agreed to acquire failing thrifts in exchange for claiming their net liabilities as tax deductions, even if they were offset by payments from the government. However, in 1993, Congress passed the Guarini Amendment, which prohibited banks like First Heights from claiming the reimbursed liabilities as tax deductions. First Heights sued, arguing that the government violated the terms of the original agreement. The lower court found that the amendment did violate the agreement and awarded First Heights, its parent company, and its subsidiary $48.7 million in damages, and the U.S. Court of Appeals for the Federal Circuit let the decision stand.

SUMMARY OF FEDERAL LEGISLATION

New Legislation

1. Financial Services Regulatory Relief Act of 2005 (H.R. 3505). Introduced by Rep. Hensarling (R-Texas) on July 28, 2005.

Status: Referred to the House Committee on Financial Services.

This bill's many provisions are aimed at relieving the regulatory burdens of banks, thrifts, and credit unions. The bill repeals the prohibition against depository institutions crossing state lines by opening branches, except if a state banking supervisor determines that a depository institution is controlled, directly or indirectly, by a commercial firm, in which case the institution may not acquire, establish, or operate a branch in the state.

National banks may declare and pay dividends in any year in an amount not to exceed the net income of the bank in the current year, plus the retained income for the two preceding years, minus any transfers required by the Office of the Comptroller of the Currency (OCC). Federal branches or agencies of foreign banks will be required to keep extra deposits, investment securities, and other assets on deposit in order to protect depositors and investors. The amount of these additional deposits will be stipulated by the OCC, but it cannot be less than what would be required for a state-licensed branch of a foreign bank located in the same state.

The bill makes many amendments to the laws for savings associations, including permitting them to invest in activities that promote public welfare, such as enhancing the welfare of low- and moderate-income communities by providing housing, services, and jobs. The Office of Thrift Supervision (OTS) will determine the amount any savings association may invest in any one project and the aggregate amount thrifts may invest under this program. Aggregate investment amounts are not to exceed 5 percent of the thrift's capital stock actually paid in and unimpaired and 5 percent of the thrift's unimpaired surplus, unless the OTS determines that the thrift is adequately capitalized or the OTS believes that exceeding the limit will not present significant risks to the thrift.

Thrifts will be permitted to make additional investments in small business investment companies, with the limit being increased to 5 percent of the thrift's capital and surplus. Up to 20 percent of a thrift's total assets may be used for loans, none of which is required to go toward small business lending. The aggregate amount of a thrift's nonresidential real estate loans may equal up to 500 percent of its capital when the thrift is found to have safe and sound operating procedures. In addition, thrifts will be permitted to invest in and sell auto loans.

Thrifts will be permitted to merge with nondepository institution affiliates, provided that the resulting institution does not engage in activities that are prohibited for savings associations. The law also increases the limit on real estate loans to a single borrower, allowing thrifts to grant real estate loans of up to $500,000.

Every five years federal banking agencies will be required to review and streamline the procedures for filing "reports of condition." Community banks with less than $1 billion in total assets will be eligible for the 18-month examination schedule. The bill also stipulates that the Small Bank Holding Company Policy Statement on Assessment of Financial and Managerial Factors will apply to bank holding companies with less than $1 billion in consolidated assets. Furthermore, the limit on small bank holding companies' allowable debt-to-equity ratio in order to remain eligible to pay a corporate dividend and to remain eligible for expedited processing procedures under Regulation Y will be increased from 1:1 to 3:1.

2. Preservation of Federalism in Banking Act (H.R. 3426). Introduced by Rep. Gutierrez (D-Ill.) on July 26, 2005.

Status: Referred to the House Subcommittee on Financial Institutions and Consumer Credit.
Related Bill: S. 1502

This bill clarifies that state consumer protection laws apply to national banks and their subsidiaries and federal savings associations and their subsidiaries. Consumer protection laws include laws that govern unfair or deceptive practices, consumer fraud, and foreclosure. Specifically, state laws will apply to national banks and federal thrifts if they apply to their state counterparts, and if they are in accordance with federal laws (such as the Gramm-Leach-Bliley Act or the Real Estate Settlement Procedures Act) that permit state laws to exceed federal requirements. A state law will not apply to national institutions if the law discriminates against them or if the state law is inconsistent with federal law. Furthermore, state laws that provide greater protection against high-cost mortgage loans will apply to national banks and savings associations.

The bill permits the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) to preempt state laws only when there is a comparable federal law that expressly governs the activity. The bill acknowledges the visitorial powers granted to the OCC and the OTS but clarifies that these powers do not prevent state attorneys general from enforcing federal and state laws against national banks and federal savings associations.

The bill requires the OCC and the OTS to record consumer complaints about their respective governed institutions and report the results to Congress semi-annually. The agencies should gather the following information: 1) the date each consumer complaint was filed; 2) the nature of the complaint; 3) when and how the complaint was resolved; and 4) whether the complaint involved any alleged violation of state law. The results of these studies will be published on the agencies' websites.

3. Safe and Fair Deposit Insurance Act of 2005 (S. 1562). Introduced by Sen. Enzi (R-Wyo.) on July 29, 2005.

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

This bill is similar to the House bill (H.R. 1185) that seeks to reform the deposit insurance system. (For more information on the House bill, see *Banking Legislation and Policy,* April-June 2005.) Like the House bill, this measure combines 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 requires the deposit insurance amount to be recalculated every five years, adjusting for inflation and rounding to the nearest $10,000. In cases where an adjustment would cause a decrease in deposit insurance coverage, no adjustment would be made until the next scheduled five-year adjustment that does not result in a decrease. The bill also increases deposit insurance coverage for retirement accounts from $100,000 to $250,000. This amount would also be adjusted every five years to account for inflation. The adjustment would be derived in the same manner described above and would also be rounded to the nearest $10,000. The bill would extend deposit insurance to provide pass-through coverage for deposits of employee benefit plans. Institutions that are not at least adequately capitalized would not be permitted to accept deposits of employee benefit plans.

The bill permits the FDIC's board of directors to designate a reserve ratio each year. The ratio must fall within the range of 1.0 to 1.5 percent. In determining the ratio, the board of directors should consider the DIF's risk of losses and current economic conditions, and the board should seek to prevent sharp swings in the assessment rates. If the reserve ratio exceeds 1.5 percent, the FDIC must give cash dividends equal to the excess amount to depository institutions. If the reserve ratio is between 1.4 and 1.5 percent, the FDIC must give cash dividends equal to half of the amount in excess of 1.4 percent.

4. Small Business Lending Improvement Act of 2005 (S. 1603). Introduced by Sen. Snowe (R – Maine) on July 29, 2005.

Status: Referred to the Senate Committee on Small Business and Entrepreneurship.

This bill requires the Small Business Administration to create a national preferred lender program that would allow eligible lenders to operate as preferred lenders in any state. It is advantageous to be a preferred lender because it demonstrates to borrowers that the institution has a good record with the SBA and is proficient at processing SBA-guaranteed loans. Once earned, a lender's national preferred lender status would be valid for two years, after which the lender must seek renewal. Renewal would be granted following a review of the lender's performance in the previous term. Failure to qualify as a national preferred lender would not prevent a lender from being a preferred lender in a given state where it meets the state's requirements. The bill also increases a business's borrowing limit under the SBA from $1.5 million to $2.25 million.

5. Consumer Identity Protection and Security Act (S. 1461). Introduced by Sen. Shelby (R-Ala.) on July 21, 2005.

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

This bill requires consumer reporting agencies (CRAs) to place a security freeze on a consumer's information file within two days of the consumer's request. Consumers must submit requests by certified mail, telephone, or electronic mail. After placing a security freeze on an account, a CRA must notify the consumer and provide him or her with a password to access the file or remove the security freeze. Once a security freeze has been placed on a file, a CRA may not release information contained in the file. Consumers may request that specific third parties have access to the file upon which a freeze has been placed, and the CRA must grant access to the authorized parties within three days.

Once a CRA receives a request from a consumer to place a security freeze on his or her account, to terminate the freeze, or to allow limited access to authorized third parties, the CRA must alert the other consumer reporting agencies. The newly alerted CRAs must respond to the request as if it had come to them directly.

If a CRA denies access to an unauthorized party, the CRA must notify the consumer within one business day that access to the file was requested but denied. This bill does not prevent federal, state, and local law enforcement agencies from obtaining information contained in a frozen file if the information is requested pursuant to a court order or warrant, to help enforce child support obligations, to investigate fraud, or to investigate delinquent taxes or unpaid court orders. This bill also does not prevent creditors from obtaining information in a frozen file if the information is sought in regard to a debt the consumer owes.

CRAs would be prevented from charging a fee for implementing a security freeze, for providing limited and authorized access to a frozen file, or for terminating a security freeze.

6. Credit Union Charter Choice Act (H.R. 3206). Introduced by Rep. McHenry (R-N.C.) on July 12, 2005.

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

This bill would amend the Federal Credit Union Act by permitting conversions of federal credit unions to mutual savings banks or savings associations with written notice to the National Credit Union Administration Board (the Board) within 30 days, instead of 90 days, prior to conversion. The notice must include the date that the credit union's members' vote will take place, the reason the credit union wishes to convert, and a brief summary of the material changes the institution and its members will experience following conversion. If the applicant credit union revises any portion of the application, the Board must approve the revised materials within 10 days of their receipt, or within 30 days of the original application's being filed, whichever is later.

The credit union's members must approve the conversion in a secret ballot vote. The credit union must appoint an independent inspector of elections to oversee the vote and count the ballots. The inspector cannot be an employee, officer, or director of the credit union, or any of their family members.

Within 10 days of the vote, the board of directors must submit the results of the vote to the Board and the federal banking agency that will regulate the institution after its conversion. Provided the vote was not conducted fraudulently or recklessly, the Board will have no further authority to approve or review the conversion process.

7. Interest on Business Checking Act of 2005 (S. 1586). Introduced by Sen. Hagel (R-Neb.) on July 29, 2005.

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

This bill permits businesses to own interest-bearing transaction accounts and allows them to make up to 24 transfers per month from any transaction account to another account at the same institution belonging to the same business.

The bill also requires Federal Reserve Banks to pay interest on reserves held at the Banks at least once per quarter. The interest amount should not exceed short-term interest rates. The bill also permits the Board of Governors of the Federal Reserve System (the Board) to have greater flexibility in setting the reserve requirement by establishing a range from which the Board can choose a reserve ratio. The Board can choose a reserve ratio between 0.0 and 3.0 percent to be assessed on the portion of an institution's transaction account deposits that are equal to or less than $25 million. The Board can choose a reserve ratio between 0.0 and 14.0 percent to assess on the portion of transaction account deposits in excess of $25 million.

Pending Legislation

1. Appropriations Bill for Fiscal Year 2006 (H.R. 3058). Introduced by Rep. Knollenberg (R-Mich.) on June 24, 2005.

Status: Passed the House and the Senate; Cleared for White House.

The Senate is considering the appropriations bill for the departments of Transportation, Treasury, Housing, Judiciary, the District of Columbia, and other independent agencies for the fiscal year ending September 30, 2006.

The bill includes a provision that would bar the Treasury Department, for one year, from implementing and enforcing a rule that would permit banks to engage in real estate brokerage and management activities. Congress has included one-year bans on banks' engaging in real estate activities in each of the past several years' appropriations bills. See *Banking Legislation and Policy,* July – September 2004, for more information about last year's appropriations bill.

SUMMARY OF FEDERAL REGULATIONS

Board of Governors of the Federal Reserve System

Electronic Fund Transfers (8/25)

The Board of Governors of the Federal Reserve System (the Board) issued a proposed rule that changes the wording of disclosures that automated teller machine (ATM) operators must make when they impose fees for electronic fund transfers or balance inquiries. Currently, ATM operators are required to disclose when a fee will be imposed, but this regulation would permit them to make the more general disclosure that a fee "may" be imposed. The operators must notify consumers on the screen or by paper before the transaction is completed, allowing the consumer to decline the services before the fee is imposed.

Comments on this proposed rule were due October 7. For more information, see 70 *Federal Register*, pp. 49891-4.

Small BHCs (9/8)

The Board of Governors of the Federal Reserve System (the Board) issued a proposed rule that would raise the asset threshold for bank holding companies (BHC) to be eligible to take on additional debt to acquire new banks or other companies. Currently, only BHCs with a threshold of up to $150 million in consolidated assets are eligible to take on more debt in order to acquire new subsidiaries. The proposed rule would raise the asset size threshold to $500 million, enabling more small BHCs to acquire new subsidiaries by taking on additional debt.

Small BHCs would also be required to meet several additional criteria in order to qualify. A small BHC must not: 1) engage in significant nonbanking activities, either directly or through its subsidiaries; 2) conduct significant off-balance-sheet activities; or 3) have a significant amount of outstanding debt that is held by the general public. A qualifying BHC may use debt to finance up to 75 percent of the purchase price of a new acquisition (meaning its debt-to-equity ratio is 3:1). The proposed rule would require subordinated debt to be included when calculating the debt-to-equity ratio, following a transition period.

Comments on this proposed rule were due November 7. For more information, see 70 *Federal Register*, pp. 53320-3.

Office of the Comptroller of the Currency

Streamlined CRA Exams (8/2)

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 final rule to raise the asset threshold from $250 million to $1 billion for banks to be considered small and therefore eligible for streamlined Community Reinvestment Act (CRA) examinations. These banks would no longer be required to report the geographic distribution of small business agricultural loans. Additionally, they would no longer have to report information on the location of mortgage loans outside metropolitan statistical areas and metropolitan divisions where the bank has branches.

The final rule also defines an "intermediate small bank" as a bank that has assets of between $250 million and $1 billion. These figures will be adjusted annually based on the consumer price index and rounded to the nearest $1 million. Under the final rule, banks with assets of less than $250 million will be subject to a lending test during their streamlined CRA evaluations, and banks with assets of between $250 million and $1 billion (intermediate small banks) will be subject to a lending test and a community development test.

The Agencies revised the definition of community development to include activities that revitalize or stabilize low- or moderate-income geographical areas, designated disaster areas, and distressed or underserved rural middle-income areas. The expanded definition provides more ways in which banks can satisfy the community development test. The final rule also clarifies that the Agencies will penalize banks in their CRA evaluations if there is evidence that the bank discriminates or uses other illegal credit practices, either inside or outside of their designated assessment areas.

This final rule became effective September 1. For more information, see 70 *Federal Register*, pp. 44256-70.

Employment for Senior Examiners (8/5)

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 proposed rule that would impose restrictions on the employment of senior bank examiners for one year after working at one of the Agencies. Specifically, a senior bank examiner is prohibited, for one year, from working as an employee, officer, director, or consultant at any of the institutions he or she examined for at least two months during the previous 12-month period. Examiners who violate this rule will be subject to removal from their new positions, a monetary penalty of up to $250,000, and a five-year ban from future employment with the institution.

Comments on this proposed rule were due October 4. For more information, see 70 *Federal Register*, pp. 45323-34.

Beneficial Ownership Reports (8/10)

The Office of the Comptroller of the Currency (OCC) issued a final rule to require the electronic filing of beneficial ownership reports by officers, directors, and major shareholders of national banks that have equity securities registered under the Securities Exchange Act of 1934. Once filed, the reports must also be posted on the bank's website, if it has one, for at least 12 months. The reports must be filed by 10 p.m. eastern standard time to be considered filed during that business day.

This final rule became effective September 9. For more information, see 70 *Federal Register*, pp. 43403-5.

Call Report Revisions (8/23)

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 that would revise the Consolidated Reports of Condition and Income (call reports) the Agencies currently use to collect information about banks. The revisions are being made to reduce banks' regulatory burden and to modernize and streamline the information-collecting procedures. The revisions include eliminating certain sections of the call report, in addition to updating some existing sections and adding several new sections.

Comments on the proposed rule were due October 24. For more information, see 70 *Federal Register*, pp. 49363-72.

Federal Deposit Insurance Corporation

Annual Independent Audits (8/2)

The Federal Deposit Insurance Corporation (FDIC) issued a proposed rule raising the asset threshold from $500 million to $1 billion for banks to be exempt from having internal control assessments by management and external auditors. All banks with greater than $500 million in total assets would still be required to develop internal control systems and submit annual reports about the controls to the FDIC; but only banks with more than $1 billion in total assets would be required to have the controls examined by management and external auditors. The proposed rule would also permit banks with less than $1 billion in total assets to have audit committees that are not completely made up of independent members, although banks should make a good faith effort to have as many independent members as possible.

Comments on this proposed rule were due September 16. For more information, see 70 *Federal Register*, pp. 44293-7.

Stored-Value Cards (8/8)

The Federal Deposit Insurance Corporation (FDIC) issued a proposed rule to clarify whether funds underlying stored-value cards, such as employee payroll cards or retail store gift cards, qualify as deposits for insurance-coverage purposes. (See *Banking Legislation and Policy*, April-June 2004, for a summary of an earlier version of this proposed rule.) The FDIC considers the funds that underlie stored-value card deposits if a depository institution has an obligation to either hold or transfer the funds. In that case, the funds qualify for insurance coverage following the same guidelines that apply to other deposits.

The proposed rule clarifies in whose name insurance coverage is given if one person deposits funds on a stored-value card, but another person has access to the funds (such as when an employer deposits funds into an account and distributes a stored-value wage card, in lieu of a paycheck, to an employee, who can then access the account). As long as the depository institution has confirmation that the depositor is not the owner of the funds and can no longer access them, or if it knows who does have access to the account and how much is payable to him or her, the funds are insured in the withdrawing (or second) party's name. However, in the case of a retail store that sells gift cards and has no record of the card's owner, the funds are insured in the retailer's name.

Comments on this proposed rule were due November 7. For more information, see 70 *Federal Register*, pp. 45571-81.

Office of Federal Housing Enterprise Oversight

Mortgage Fraud Reporting (7/28)

The Office of Federal Housing Enterprise Oversight (OFHEO) issued a final rule to define mortgage fraud and to require government-sponsored enterprises (GSEs), such as Fannie Mae and Freddie Mac, to report instances of it. The rule defines mortgage fraud 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 rule, a GSE is required to report mortgage fraud, or suspected mortgage fraud, to the OFHEO before requiring the repurchase of (or declining the purchase of) a mortgage or other similar financial instrument. Reports must be made immediately by mail, electronic mail, or telephone, and once reports have been submitted, GSEs must retain a record of the reports. GSEs cannot disclose information about the reported fraud to any party that may be connected to it, unless the OFHEO approves. GSEs would be required to report fraud to law enforcement agencies. (For more information on the proposed rule, see *Banking Legislation and Policy*, January-March 2005.)

This final rule became effective August 29. For more information, see 70 *Federal Register*, pp. 43625-8.

Securities and Exchange Commission

Broker-Dealer Registration (9/9)

The Securities and Exchange Commission (SEC) announced that depository institutions would have until September 30, 2006, to comply with the Gramm-Leach-Bliley Act's (GLBA) brokerage registration requirements. Prior to the GLBA's passage, banks were permitted to engage in securities activities without registering as brokers or dealers. The new registration requirements had been set to become applicable on September 30, 2005, but the SEC extended the deadline to give banks time to develop systems that would be in compliance.

For more information, see the SEC's press release at www.sec.gov/news/press/2005-130.htm.

SUMMARY OF JUDICIAL DEVELOPMENTS

Maryland Finder's Fee Law Is Not Preempted By Federal Law

The Maryland Court of Appeals, Maryland's highest court, ruled that the state's law that governs mortgage brokers' finder's fees is not preempted by federal law (*Sweeney v. Savings First Mortgage*, No. 148). Linda Sweeney brought suit against her mortgage broker, Savings First Mortgage, alleging that it violated the Maryland finder's fee law by charging her excessive fees as compensation for the procurement of a second-mortgage refinance loan. The Maryland law permits brokers to collect a fee only on the portion of a refinance loan that exceeds the original loan amount. Specifically, the fee cannot exceed 8 percent of the amount above the original loan amount.

In this case, Savings First charged Sweeney a finder's fee of more than $10,000 for the procurement of the refinance loan. According to the Maryland finder's fee law, the broker was only permitted to charge approximately $1,500. Therefore, Sweeney alleged that Savings First violated the finder's fee law.

Savings First argued that the finder's fee law is preempted by the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) and therefore was not applicable. The DIDMCA is a federal law that prohibits states from "limiting the rate or amount of interest, discount points, finance charges, or other charges" that apply to mortgages. The court considered whether the finder's fee law is preempted by the DIDMCA and determined that it is not, because the DIDMCA pertains to creditors and the finder's fee law pertains to brokers. Accordingly, the Court of Appeals reversed a lower court's decision and remanded the case for further proceedings.

OCC Has Exclusive Visitorial Powers over National Banks' Operating Subsidiaries

The U.S. Court of Appeals for the Ninth Circuit ruled that the National Bank Act preempts the California Commissioner of Corporations' (Commissioner's) power to exercise investigative and licensing authority over operating subsidiaries of national banks (*Wells Fargo Bank N.A. v. Boutris*, No. 03-16194). The case arises from California's attempts to require Wells Fargo Home Mortgage Inc. (WFHMI) and National City Mortgage Co. (NCMC), operating subsidiaries of Wells Fargo National Bank and National City Bank of Indiana, respectively, to submit to audits of their residential mortgages.

Wells Fargo petitioned the Office of the Comptroller of the Currency (OCC) to seek an injunction against the commissioner on the grounds that the OCC has exclusive visitorial powers over national banks. Furthermore, Wells Fargo contended that the operating subsidiaries of national banks are not subject to state laws relating to licensing requirements, such as those promulgated by the Commissioner, because the OCC sought to completely occupy the field of licensing requirements for mortgage lenders. The court agreed with Wells Fargo on both counts, ruling that the Commissioner's attempts to audit and impose licensing restrictions on national banks' operating subsidiaries are preempted by the National Bank Act, which grants exclusive governing authority to the OCC in these matters.

In its deliberations, the court also considered whether a California law that imposes per diem loan-interest limits is preempted by the Depository Institutions Deregulation and Monetary Control Act (DIDMCA), a federal law that prohibits states from "limiting the rate or amount of interest, discount points, finance charges, or other charges" that apply to mortgages. The California statute under consideration was Cal. Civ. Code 2948.5(a), which says that borrowers are not required to pay interest on a mortgage for more than one day prior to the mortgage being recorded or before funds are paid into escrow. The court determined that the California statute is not preempted by DIDMCA because the California statute limits the time during which interest can be charged but does not limit the rate or amount of interest that can be charged. Therefore, the court said, nothing prevents a lender from increasing the interest rate during the time interest can be charged in order to make up for the interest lost during the time the California statute prevents it from being charged.

State Laws Are Preempted for National Banks' Operating Subsidiaries

The U.S. Court of Appeals for the Second Circuit ruled that the operating subsidiary of Wachovia Bank, a national bank, is not subject to six Connecticut banking laws because they are preempted by the National Banking Act (NBA), a federal law (*Wachovia Bank, N.A. v. Burke*, No. 04-3770). The six Connecticut laws in question seek to impose licensing requirements on mortgage lenders, require mortgage lenders to keep records that may be inspected by the Connecticut banking commissioner, and permit the Connecticut banking commissioner to issue cease and desist orders against mortgage lenders to enforce the state laws.

Wachovia Bank brought suit against the commissioner, claiming that its operating subsidiary, Wachovia Mortgage, is not subject to these state laws because, as an operating subsidiary of a national bank, it is subject to state laws only to the extent that its national bank parent is. Furthermore, Wachovia Bank attempted to bring a cause of action against the commissioner, claiming that the laws infringed on Wachovia Mortgage's right to operate without regard to these state laws.

The court found that Wachovia Mortgage, as an operating subsidiary of a national bank, is not subject to the state laws in question. The laws are preempted for national banks by the National Bank Act, and therefore they are preempted for national banks' operating subsidiaries by extension. Operating subsidiaries are recognized components of a national bank's banking business and are used to carry on typical banking business that would otherwise occur at the bank itself. An operating subsidiary is viewed as a division of a national bank and is therefore subject to the same treatment afforded to national banks.

The court disagreed with the notion that the Connecticut laws had infringed on Wachovia Mortgage's rights, however, saying that Congress did not intend to bestow individual rights on private banking entities. The court cautioned that preempting state laws for national banks should not be confused with granting a federal right that is enforceable.

Commercial Loan Originator and Purchaser May Have Breached Warranties

The U.S. Court of Appeals for the Second Circuit affirmed in part and reversed in part a district court's ruling that an originator and a purchaser of a commercial mortgage loan did not breach their warranties associated with that loan (*LaSalle Bank v. Noruma Asset Capital Corp.,* No. 04-5488). LaSalle Bank, a trustee of a pool of mortgage funds, originally brought the case against Noruma Asset Capital Corporation (Noruma) and its affiliate, Asset Securitization Corporation (ASC), alleging that the defendants breached warranties relating to a particular mortgage that was included in the pool of securitized mortgage funds. The mortgage loan in question, known as the "Doctors Hospital Loan," was originated by Noruma and later sold to its affiliate, ASC, to be included in a trust with other mortgages. Once the funds were pooled, ASC would sell bonds in the trust, and ASC contracted with LaSalle to be the trustee that would manage the funds.

As part of these transactions, a number of warranties were made. First, Noruma made a warranty to ASC that no fraudulent acts were committed in originating the mortgage loan, and all practices involved in originating the loan were in accordance with industry standards (the origination warranty). Next, Noruma made a warranty to ASC that the real property underlying the loan was appraised to be at least 80 percent of the principal loan amount (the 80 percent warranty). Noruma's final warranty to ASC was that the loan satisfied IRS requirements that would shelter it from taxes once included in the trust (the qualified mortgage warranty). One of the ways in which a mortgage loan can qualify is if the fair market value of the property is equal to at least 80 percent of the loan. If ASC were to later find that the mortgage was defective or in breach of the qualified mortgage warranty, Noruma agreed to either cure the breach or repurchase the loan. The qualified mortgage warranty included a safe-harbor provision that protected the sponsor, ASC, if it reasonably believed the loan was secured by real property at the time the loan was included with the pool of funds.

ASC also made a number of warranties to LaSalle, the trustee of the funds. First, ASC made the warranty that it believed all of Noruma's warranties and representations were correct. Also, ASC made the warranty that the loan was secured by real property, and that either: 1) substantially all of the proceeds were used to improve the property that was the security for the loan; or 2) the fair market value of the real property was equal to at least 80 percent of the principal amount of the loan. ASC also made the warranty that if any of the warranties were breached, or if the loan was found to no longer qualify for tax shelter, ASC would remedy the breach, or Noruma would repurchase the loan.

Noruma, in originating the $50 million loan, claims it completed due diligence and believed each of the warranties to be true. However, less than three years after the loan was included in the trust managed by LaSalle, Doctors Hospital filed for bankruptcy and defaulted on the loan. This prompted LaSalle, on behalf of the bondholders, to file this lawsuit alleging that Noruma and ASC breached their warranties.

The district court originally found in favor of the defendants, saying that Noruma's evidence of due diligence procedures showed that it had acted in accordance with the warranties. In any case, the district court said, Noruma and ASC were protected by the safe-harbor provision. The U.S. Court of Appeals agreed that Noruma had not breached the origination warranty, based on the evidence presented; however, the court reversed the district court's other judgments for the following reasons.

First, Noruma and ASC contended that the 80 percent warranty and the qualified mortgage warranty were substantially the same, so that if one was satisfied, the other was as well. Therefore, because the loan qualified for tax shelter and satisfied the qualified mortgage warranty, Noruma and ASC contend that the loan must have also satisfied the 80 percent warranty. However, the court of appeals disagreed. The court said that the two warranties were made for distinctly different reasons. The 80 percent warranty was made to assure investors that the loan is securitized, and the qualified mortgage warranty attests to the loan's tax status, which other criteria go into determining. Therefore, satisfying the qualified mortgage warranty does not necessarily mean that the loan satisfied the 80 percent warranty. The court said that whether or not the loan satisfied the 80 percent warranty was for the district court to decide on remand.

The court also disagreed with the district court that Noruma was protected by the safe-harbor provision. The court ruled that the safe-harbor provision protects sponsors, not originators, or mortgage loans based on a caveat in the provision that says a sponsor is not protected if it knows, or has reason to know, that the loan fails the tests that qualify it for tax exemption. Since the provision makes this exception for sponsors, who might or might not have reason to know this, it must follow that the same exception applies to originators, who would certainly be thought to at least have reason to know if it did not qualify. As an affiliate of the originator, Noruma, the court questioned whether ASC might have had reason to know that the loan did not satisfy the conditions, and it instructed the district court to consider this on remand.

RESPA Does Not Ban Overcharges, But Does Prohibit Markups

The U.S. Court of Appeals for the Third Circuit ruled that the Real Estate Settlement Procedures Act (RESPA) does not prohibit overcharges, but it does ban markups on fees charged by a lender or service provider (*Santiago v. GMAC Mortgage Group Inc.*, No. 03-4273). The case was brought by Francis Santiago, who alleges that his mortgage provider, GMAC Mortgage Group, violated Section 8(b) of RESPA by overcharging him for a funding fee and marking up a tax service fee and a flood certification fee that were provided by third parties. GMAC contends that RESPA does not provide for a cause of action due to overcharges or markups on mortgage service fees.

The court ruled that Section 8(b) of RESPA does not specifically prohibit overcharges, because that would require dividing charges into those that are "reasonable" and "unreasonable." As the court notes, nowhere in Section 8(b) does it mention, or explain how to calculate, "unreasonable charges." On the other hand, the court found that Section 8(b) does prohibit markups, despite GMAC's interpretation that the statute prohibits only kickbacks. (A markup occurs when a lender hires a third-party vendor to complete a service and pays the vendor a fee, say $80, but charges the borrower more, say $100, and keeps the extra $20, despite not having rendered any service to warrant the extra fee. A kickback occurs when the lender hires the same third-party vendor, who this time charges $100, which the lender charges the borrower. After the lender distributes the fee to the vendor, the vendor returns $20 to the lender as a referral fee.)

According to the court's reading of the statute, because it describes kickbacks as well as other scenarios that are not labeled kickbacks, Congress intended to encompass markups as well as kickbacks. Therefore, the court dismissed Santiago's overcharges claim but agreed that markups are prohibited by Section 8(b). The case was remanded to district court to determine whether GMAC's charges did, in fact, constitute markups.

New Jersey

On September 22, New Jersey Governor Richard Codey signed the state's Identity Theft Prevention Act (A. 4001). The law is similar to the proposed federal Consumer Identity Protection and Security Act (see *Summary of Federal Legislation* section), as it permits consumers to place security freezes on their credit reports to prevent unauthorized persons from obtaining credit or loans in the consumers' names. A security freeze, as defined by this law, is a notice placed in a consumer's credit report that prohibits the consumer reporting agency (CRA) from releasing the report, or any information contained in it, without the consumer's prior consent. The law does not prevent a CRA from informing third parties that a security freeze has been placed on a file if the third party requests information from the file.

A consumer can request a security freeze by contacting any CRA by mail, certified mail, or electronic mail. Within five business days of receiving a consumer's request for a security freeze, the CRA must comply. At the same time, the CRA must inform the consumer of his or her unique personal identification number (PIN) that must be used to authorize release of information contained in the credit report. A consumer can request that specified third parties have access to the credit report by providing the CRA with his or her personal identifying information and PIN, in addition to identifying information of the third party that will have access to the information. The CRA will comply with the temporary lift within three days of receiving the request. CRAs must develop procedures for accepting requests for temporary lifts, and the requests should be processed within 15 minutes of their receipt.

A CRA may permanently remove a security freeze from a consumer's file if the consumer requests it or if the CRA determines that the freeze was placed on the account due to a material misrepresentation of fact by the consumer. In the latter case, a CRA must alert the consumer that the freeze will be removed at least five days prior to the removal taking effect.

Credit freezes do not apply in situations where a consumer has an existing account with a creditor and a copy of the consumer's credit report is requested by the creditor, one of its agents, or affiliates for purposes of reviewing the consumer's account or investigating fraud. In addition, the freeze does not apply to law enforcement agencies, child support enforcement agencies, credit monitoring services to which the consumer subscribes, and to entities attempting to provide a copy of the consumer's credit report to the consumer at the consumer's request.

CRAs may not charge a fee for instituting a credit freeze. However, the law permits them to charge a fee of $5 or less to temporarily lift a credit freeze, permanently remove a credit freeze, or to reissue a PIN if the consumer loses or forgets the original PIN.

The law includes two other identity theft prevention measures. First, New Jersey businesses that maintain records of their customers' personally identifying information must alert customers if their security has been breached and unauthorized persons may have gained access to a consumer's information. Next, businesses must take precautions with consumers' Social Security numbers, including not displaying more than three consecutive digits of a person's number, not printing the number on materials that are mailed to the consumer, and not requiring the Social Security number to be used to access the company's website, unless a PIN or password is also required.

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