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Recent Developments

HUD Extends Foreclosure Relief after Hurricanes for FHA-Insured Homeowners

The Department of Housing and Urban Development (HUD) instructed all FHA-approved lenders to provide additional foreclosure relief to FHA-insured families who live or work in the areas hardest hit by hurricanes Katrina and Rita. All pending foreclosures in presidentially declared disaster areas are eligible for assistance. In addition, lenders are prohibited from initiating new foreclosures in these areas. Lenders are encouraged to assist borrowers

with hazard and flood insurance filings, waive late charges, and modify mortgages. The extended relief will be in effect until February 28, 2006.

DSW Reaches Settlement with FTC

Shoe retailer DSW Inc. reached a consent agreement with the Federal Trade Commission (FTC) after the FTC charged that the retailer had neglected to properly safeguard its customers' personally identifying and payment information. In March 2005, DSW reported that

credit card and other purchase information stored on its computer networks had been stolen. A month later, the company announced that checking account and driver's license numbers had also been stolen. In all, close to 1.5 million credit and debit cards were compromised, along with about 96,000 checking accounts and driver's license numbers. A number of these accounts were subsequently subject to fraud, and some customers were forced to close their checking accounts and incur expenses to open new ones.

The FTC noted five ways in which DSW endangered its customers' information. First, the company was found to have stored information for which it no longer had a business need. Next, despite having wireless access to its system, the company did not appropriately safeguard the wireless network from intruders. The company also stored information in unencrypted files that could be easily accessed using only a user ID and password. In addition, the company was found to have not adequately limited the ability of in-store networks to connect to computers on other in-store and corporate networks. Finally, the company did not have sufficient measures to detect unauthorized access to its networks.

As part of the consent agreement, DSW will establish and maintain a data security program to protect its customers' personal information. The company will designate one or more employees to be responsible for the program, and the program must identify risks that threaten the confidentiality of consumer information. Further, the company must outline procedures to guard against the risks, and these procedures must be tested periodically to ensure their effectiveness. Finally, DSW must modify its data security program in response to this testing, or if it believes new circumstances might impair the effectiveness of the program.

DSW must also submit to a twice-annual assessment of its data security program by an independent third party, which must certify that the program is effective and satisfies the requirements of this consent agreement. These assessment reports must be retained by the company for three years following the review. In addition, the company must provide the results of each assessment to its board of directors, officers, managers, and any other person having supervisory responsibility. DSW is subject to the terms of this consent agreement for 20 years.

SUMMARY OF FEDERAL LEGISLATION

Enacted Legislation

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

Status: Signed by President George W. Bush on November 30, 2005. Became Public Law No. 109-115.

On November 30, President Bush signed the appropriations bill for the departments of Transportation, Treasury, and Housing, the judiciary, and other independent agencies for the fiscal year ending September 30, 2006. The bill contains a provision that bars the Treasury Department from implementing and enforcing a rule that would permit banks to engage in real estate brokerage and management activities. Similar one-year bans have been included in each appropriations bill since 2001. See *Banking Legislation and Policy*, July-September 2004, for more information about last year's appropriations bill.

New Legislation

1. Financial Data Protection Act of 2005 (H.R. 3997). Introduced by Rep. LaTourette (R-Ohio) on October 6, 2005.

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

This legislation would require consumer reporters to develop procedures that ensure the confidentiality of sen-

sitive consumer financial information. The bill defines a consumer reporter as a consumer reporting agency, financial institution, or any person who receives compensation for assembling, evaluating, or furnishing consumer reports. Once a consumer reporter becomes aware of a breach of data security, it is required to determine the nature and scope of the breach, the specific financial information that was involved, and the potential harm the consumer may suffer as a result. If a consumer reporter believes that a consumer is likely to suffer great harm or inconvenience, the consumer reporter must notify its federal regulator, the U.S. Secret Service, the consumer's financial institutions, each nationwide credit reporting agency, and any other crucial third party. In addition, the consumer reporter must also attempt to repair the breach and restore security.

If a consumer reporter receives or maintains financial data on behalf of a third party and believes that a breach of security has occurred, the consumer reporter is required to notify the third party, conduct a coordinated investigation with the third party, and notify the affected consumer. If a third party is unwilling to submit to these conditions, consumer reporters are not permitted to maintain financial data for, or submit financial data to, the third party.

Upon learning of a breach of data security, a consumer reporter's notice to affected consumers must describe the nature and scope of the breach, including naming the specific information involved, and provide a phone number for consumers to call to receive more information. At the

request of a law enforcement agency, consumer reporters may delay notifying consumers of a breach if doing so would disrupt a criminal or civil investigation.

Within 90 days of receiving notification of a breach of data security, a consumer may request that the consumer reporter provide, for at least six months, a credit monitoring service that monitors nationwide credit activity. This service is to be provided at no cost to the consumer.

The bill requires the Secretary of the Treasury, the Board of Governors of the Federal Reserve System, and the Federal Trade Commission to jointly issue rules to implement this law, and all federal banking regulators are required to enforce it.

2. Deficit Reduction Omnibus Reconciliation Act of 2005 (S. 1932). Introduced by Sen. Gregg (R-N.H.) on October 27, 2005.

Status: Passed the Senate; Conference Report agreed to in the House.

The Deposit Insurance Reform Act of 2005 constitutes one section of this lengthy bill. Both the House and the Senate introduced separate deposit insurance reform bills in 2005 (see *Banking Legislation and Policy*, April-June 2005, and *Banking Legislation and Policy*, July-September 2005) that are largely similar to the version included in this legislation. The bill would merge the Bank Insurance Fund and the Savings Insurance Fund into one 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 causes a decrease in deposit insurance coverage, no adjustment is 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 is adjusted every five years to account for inflation. The adjustment is derived in the manner described above and would also be rounded to the nearest \$10,000. The bill extends deposit insurance to provide pass-through coverage for deposits of employee benefit plans. Institutions that are not at least adequately capitalized are not permitted to accept deposits of employee benefit plans.

The bill permits the FDIC 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 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.

SUMMARY OF FEDERAL REGULATIONS

Board of Governors of the Federal Reserve System

Truth in Lending (10/17)

The Board of Governors of the Federal Reserve System (the Board) issued an advanced notice of a proposed rule, requesting comments on ways to update Regulation Z, which implements the Truth in Lending Act (TILA). A similar proposed rulemaking was issued in December of 2004 (see *Banking Legislation and Policy*, October-December 2004) as part of the Board's regular review of its regulations. Soon after, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (see *Banking Legislation and Policy*, April-June 2005) became law. It made several amendments to the TILA, causing the Board to seek additional comments on the law's effects on Regulation Z.

Specifically, the Board sought comments on the following: 1) introductory rate disclosures; 2) Internet-based credit card solicitations; 3) disclosures related to payment deadlines and late payment penalties; 4) disclosures for mortgage loans that may exceed the dwelling's fair-market value; and 5) a prohibition on terminating accounts for failure to incur finance charges. In addition, the Board sought

comment on minimum payment disclosures, including whether some accounts should be exempt from them and whether they must explain the method that was used to calculate the minimum payment.

Comments on this proposed rule were due December 16. For more information, see 70 *Federal Register*, pp. 60235-44.

Remotely Created Checks (11/28)

The Board of Governors of the Federal Reserve System (the Board) issued a final rule to define remotely created checks and to transfer warranties for them to the bank that presents the check for payment. A remotely created check is created by someone other than the paying bank, and it does not bear a signature applied by the customer on whose account it is drawn. An example is when a customer authorizes a check over the phone with an entity other than the bank where his or her account is held.

When the payee bank (the bank that is to receive payment) presents a remotely created check to the paying bank (the bank at which the customer's account is held), the payee bank warrants the check. This means that the

payee bank accepts responsibility for the check's legitimacy, attesting that the paying bank's customer authorized the check for the amount payable. Should the paying bank file a breach of warranty, the payee bank can defend itself by offering evidence that the customer authorized the check.

This final rule will become effective on July 1. For more information, see 70 *Federal Register*, pp. 71218-26.

Home Mortgage Disclosure (12/21)

The Board of Governors of the Federal Reserve System (the Board) issued a final rule to increase the asset-size threshold under which depository institutions are exempt from collecting data on their housing-related lending activity in 2006. In 2006, institutions with assets of \$35 million or less are exempt from collecting these data and reporting them to federal regulators and the public. The Board increased the threshold to correspond with the increase in the consumer price index for urban wage earners and clerical workers.

This final rule became effective on January 1. For more information, see 70 *Federal Register*, pp. 75718-9.

Office of the Comptroller of the Currency

Risk-Based Capital (10/6)

The Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (together, the Agencies) issued a proposed rule to revise the existing risk-based capital framework to enhance risk sensitivity. These revisions would apply to Basel I-based capital regulations, which deal mostly with credit risk, rather than the Basel II framework, which, among other things, takes into account operational risk.

The Agencies propose making several changes to the existing Basel I framework. Currently, there are five risk-weight categories: 0, 20, 50, 100, and 200 percent. The Agencies propose increasing the number of categories to nine, adding 35, 75, 150, and 350 percent. Risk weights are multiplied by an institution's assets to determine its risk-weighted assets. A percentage of a bank's risk-weighted assets must be held as a minimum level of capital.

Next, the Agencies are considering using credit ratings by nationally recognized statistical rating organizations (NRSROs) to help determine the risk-based capital charge for NRSRO-rated exposures. If an exposure has multiple, differing NRSRO ratings, the exposure will be assigned the risk weight that corresponds with the lowest NRSRO rating. The Agencies propose assigning a 20 percent risk weight to exposures rated AAA/AA; 35 percent to A; 50 percent to BBB+; 75 percent to BBB; 100 percent to BBB-; 200 percent to BB+, BB, and BB-; and 350 percent to exposures rated B or lower. The Agencies plan to retain the 0 percent risk weight for U.S. government and agency exposures and the 20 percent risk weight for U.S. government-sponsored entities. The Agencies reserve the right to override the use

of ratings on certain exposures, either on a case-by-case basis or through additional regulation.

The Agencies also plan to expand the list of collateral that would qualify an exposure for a lower risk weight. Currently, the only forms of collateral that are accepted are cash on deposit at the organization; securities issued or guaranteed by U.S. government agencies, government-sponsored enterprises, or central governments of countries that are members of the Organization for Economic Cooperation and Development; and securities issued by multilateral lending institutions or regional development banks. The expanded list would include short- or long-term debt securities (like mortgage-backed securities) that are rated at least investment grade by an NRSRO. The security would then be assigned a risk weight corresponding to the NRSRO rating, using the same conversions that are outlined above. To take advantage of the expanded list of collateral, institutions would be required to have collateral management systems capable of tracking collateral and readily determining its value.

Currently, one- to four-family, first-lien mortgages receive a 50 percent risk weight. However, the Agencies are considering several alternatives that would allow the weights to be adjusted according to the level of risk. One alternative involves using the loan-to-value ratio (LTV) to assign a risk weight. The LTV would be determined by a private mortgage insurance issuer with an NRSRO rating of A or higher. An LTV ratio of 91 to 100 would be assigned a 100 percent risk weight; 81 to 90, a 50 percent risk weight; 61 to 80, a 35 percent risk weight; and 60 or below, a 20 percent risk weight. The Agencies are also considering another option that, in addition to the LTV, would take into consideration a person's credit score. Furthermore, the Agencies are considering assigning higher risk weights to interest-only loans.

For multifamily residential mortgages, the current rules require a 100 percent risk weighting, but some mortgages can qualify for a 50 percent risk weighting. The Agencies are considering lowering the risk weight for all multifamily residential mortgages to below 100 percent.

Under current rules, delinquent loans also receive a risk weight of 100 percent. However, the Agencies propose assigning a higher risk weight to loans that are 90 days or more past due and those in nonaccrual status. The risk weight may be reduced by any reserves specifically allocated to cover potential losses on the exposure.

The Agencies are also considering changing the risk weights assigned to commercial real estate exposures and small business loans. Specifically, acquisition, development, and construction (ADC) commercial real estate loans may be assigned risk weights that are higher than the current 100 percent level. However, ADC loans could still be assigned a 100 percent risk weight if the exposure meets the Interagency Real Estate Lending Standards regulations and if the project is supported by a substantial amount of borrower equity for the duration of the facility.

Small business loans are also currently assigned a 100

percent risk weight, but the Agencies are considering lowering the risk weight to 75 percent for consolidated loans under \$1 million made to a single borrower. The loans would also be subject to several other underwriting, performance, and collateralization requirements in order to qualify.

Finally, the Agencies are also considering applying a risk-based capital charge to securitizations of retail credit exposures with early amortization clauses, which require debt to be paid off more quickly if certain negative events occur. This could be done either by assessing a flat conversion factor (such as 10 percent) or by applying an early amortization capital charge based on key indicators of risk (such as excess spread levels, which are finance charge collections minus certificate interest, fees, and charge-offs) to determine the appropriate risk weights.

Comments on this proposed rule were due January 18. For more information, see *70 Federal Register*, pp. 61068-78.

Community Reinvestment Act (11/10)

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 notice of a proposed rule that revises Community Reinvestment Act (CRA) regulations. Among the changes is a proposal to extend the length of time an area will be considered a designated disaster area. For one year after an area's disaster status expires by law, the Agencies will continue to reward CRA "community development" credit to lenders who help to stabilize or revitalize the area.

Comments on this proposed rule were due January 9. For more information, see *70 Federal Register*, pp. 68450-6.

Senior Examiners (11/17)

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 final rule to impose restrictions on the employment of senior bank examiners 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.

This final rule became effective on December 17. For more information, see *70 Federal Register*, pp. 69633-41.

Assessment of Fees (11/17)

The Office of the Comptroller of the Currency (OCC) issued an interim final rule to revise the process of assessment collection. Currently, banks are required to calculate their assessment payments and submit them to the OCC. Under the new rules, the OCC will determine each bank's

assessment amount based on its recent call report. The semiannual payments are due March 31 and September 30 each year. These due dates are two months later than the current ones, January 31 and July 30.

This interim final rule became effective on December 19. Comments on this rule were due the same date. For more information, see *70 Federal Register*, pp. 69641-4.

Medical Information Sharing (11/22)

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration (together, the Agencies) issued a final rule to implement sections of the Fair and Accurate Credit Transactions Act (see *Banking Legislation and Policy*, October-December 2003) that govern the use of medical information sharing. The rule defines medical information as any information that relates to the past, current, or future health of a consumer, including any health care that was provided to the consumer or any payments the consumer made for the provision of health care. In general, the rule forbids creditors from using medical information in any decision about a consumer's eligibility for credit. The rule does not prohibit using medical information in decisions about a person's qualification for employment, insurance (except credit insurance products), or other noncredit products or services.

A creditor is not in violation of this rule if it receives unsolicited medical information, as long as the information is not used in any determination about a consumer's eligibility for credit. However, this does not prohibit creditors from using the information in credit decisions if the information is the type that is routinely used in credit decisions (such as information about debts, expenses, benefits, or income) and if the information is used in the same manner and to the same extent as nonmedical information. And, as always, creditors may not take a consumer's physical, mental, or behavioral health into consideration when making decisions about eligibility for credit.

Creditors may use medical information in decisions about credit in the following circumstances: 1) to determine whether a person has the legal capacity to make decisions or whether power of attorney is necessary; 2) to comply with applicable laws and regulations; 3) to determine, at the request of the consumer, if he or she qualifies for special credit programs; 4) to identify and prevent fraud; 5) to determine whether a person is eligible for credit for medical products or services; 6) if the consumer or his or her attorney requests the information to be used; and 7) to determine if the consumer's medical condition triggers provisions of a forbearance program, debt cancellation contract, debt suspension agreement, or a credit insurance product.

If a depository institution receives medical information about a consumer from one of its affiliates or a consumer reporting agency, the institution is prohibited from disclosing the information to any other party, except when

it's necessary in order to achieve the purpose for which the information was originally disclosed.

This final rule becomes effective on April 1. For more information, see 70 *Federal Register*, pp. 70664-96.

Nontraditional Mortgage Products (12/29)

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration (together, the Agencies) proposed a guidance to help institutions assess and manage risks associated with nontraditional mortgage products. The guidance defines nontraditional mortgage products as mortgage loans that allow borrowers to defer the payment of principal and sometimes interest. These types of loans include "interest-only" mortgages and "payment option" adjustable-rate mortgages and are sometimes combined with other second-lien mortgages, all of which help consumers lower their initial payments but raise payments toward the end of the loan. The Agencies are concerned that institutions may be offering these products to some borrowers who are unaware of the risks. This guidance aims to help institutions offer nontraditional mortgage products in a safe and sound manner and to provide consumers with sufficient information about the risks involved with these products.

First, with regard to loan terms and underwriting standards, the Agencies suggest that institutions should consider a borrower's repayment ability before approving a nontraditional mortgage loan. The lender should also avoid the use of collateral-dependent loans, which result in the borrower's having to rely on selling or refinancing the property when loan amortization begins. In cases of risk-layering (when the use of a nontraditional mortgage loan is combined with reduced documentation or a second-lien mortgage), institutions must compensate for the increased risk by requiring higher credit scores, lower loan-to-value ratios, lower debt-to-income ratios, or some other mitigating factor. As more and more institutions are offering low- and no-documentation loans, they should be aware of increased credit risks and engage in more comprehensive verification procedures to determine the borrower's income and ability to repay debt. Furthermore, institutions should develop clear policies to govern the use of low- and no-documentation loans. Institutions should also be especially vigilant when extending nontraditional mortgage products to subprime borrowers, as risks increase for both the institution and the borrower.

Next, the guidance describes appropriate portfolio and risk management practices for institutions that offer nontraditional mortgage products. The guidance requires institutions to develop policies and internal controls to address product attributes, portfolio and concentration limits, third-party originations, and secondary market activities. Institutions should maintain performance measures and management reporting systems that warn of potential or

increasing risks. They should also keep an allowance for loan and lease losses (ALLL) at a level appropriate for the portfolio's credit quality and that takes into account any other conditions that might affect the institution's ability to collect on the loan.

Finally, institutions should ensure that consumers are aware of the relative benefits and risks associated with nontraditional mortgage products. This information should be disclosed to the consumer before he or she decides to accept a nontraditional mortgage loan. The guidance suggests that this information be made available on promotional materials and monthly payment statements. In addition, institutions should avoid practices that obscure the risks to the consumer, such as providing information about the low initial payments but not disclosing the higher payments at loan amortization.

Comments on this guidance are due February 27. For more information, see 70 *Federal Register*, pp. 77249-57.

Federal Deposit Insurance Corporation

Changes in Insured Status (10/14)

The Federal Deposit Insurance Corporation (FDIC) issued a proposed rule to require institutions to certify to the FDIC when all of their deposit liabilities have been assumed by another institution. Previous regulations were unclear about when certification was necessary, causing some institutions to believe that it was required for partial assumption of liabilities (such as when a branch of an institution is acquired). The FDIC clarified that certification is required only when all liabilities are assumed. Institutions are also required to certify when a series of partial assumptions, instead of one total assumption, results in all of the institution's deposits being assumed. Institutions in default are not required to certify the assumption of their liabilities when the FDIC is appointed as the receiver of them.

The proposed rule requires the transferring institution (rather than the assuming institution) to make the certification. The certification must be made on the institution's letterhead, and it must be signed by an authorized official. In addition, if the institution will no longer accept deposits, it must notify the FDIC of the day on which this policy takes effect and the manner in which it relinquishes its authority (such as by surrendering or canceling its charter). The FDIC will use this information to determine whether to cancel the institution's insurance.

If an institution decides to terminate its insurance with the FDIC without having its deposits assumed by another FDIC-insured institution, the institution must notify its depositors. The notice must be written on the institution's letterhead, bear the signature of an authorized officer, and it must include the date on which the institution's insured status will be terminated.

Comments on this proposed rule were due December 13. For more information, see 70 *Federal Register*, pp. 60015-9.

Interstate Banking (10/14)

The Federal Deposit Insurance Corporation (FDIC) issued a proposed rule to preempt certain state laws for FDIC-insured interstate banking organizations and their affiliates. The rule permits interstate banking organizations to follow their home states' laws even when conducting business in other states. The rule allows a bank's out-of-state branches to conduct any activity that is permissible in that state or in the bank's home state. Furthermore, when determining interest on loans, an interstate banking organization can adhere to interest rate laws of the state where the loan's approval, disbursement, and extension of credit occurred. When these activities occur in multiple branches in different states, the institution should adhere to the interest rate laws of the home state. As an alternative, when these activities occur in different states, the institution can choose to adhere to the interest rate laws of one of the other states, besides the home state, in which the functions occur, as long as the loan has a clear tie to that state.

Comments on this proposed rule were due December 13. For more information, see *70 Federal Register*, pp. 60019-31.

Corporate Powers (10/18)

The Federal Deposit Insurance Corporation (FDIC) issued an interpretive rule to permit insured state nonmember banks to offer certain savings and retirement accounts without prior approval from the FDIC. As long as the institutions are not exercising trust powers, they can offer self-directed traditional individual retirement accounts (IRAs), self-employed retirement accounts (Keogh Plan accounts), and other savings and retirement accounts, such as Coverdell Education savings accounts, Roth IRAs, and health savings accounts, without the FDIC's prior consent.

This rule became effective on October 18. Comments on the rule were due January 17. For more information, see *70 Federal Register*, pp. 60420-2.

Independent Audits (11/28)

The Federal Deposit Insurance Corporation (FDIC) issued a final rule that raises the asset threshold from \$500 million to \$1 billion for institutions to be subject to internal control assessments by management and external auditors. The management of all institutions must assess compliance with annual reporting requirements. However, institutions with more than \$1 billion in assets must submit to an assessment by management of the effectiveness of their internal control structures. In addition, an independent public accountant must review management's assessment about the internal control structures and financial reporting procedures.

All institutions are required to establish audit committees to review internal control assessments with management and independent public accountants. Institutions with more than \$1 billion in assets must establish a committee composed of its board of directors, all of whom must be outside directors who are independent of management.

Institutions with assets between \$500 million and \$1 billion must establish a committee composed of its board of directors, the majority of whom must be outside directors independent of management. If an institution has a hard time attracting or retaining outside directors, the FDIC may permit its board to be composed of less than a majority of outside directors.

This final rule became effective on December 28. For more information, see *70 Federal Register*, pp. 71226-33.

Large-Bank Deposit Insurance (12/13)

The Federal Deposit Insurance Corporation (FDIC) issued an advanced notice of a proposed rule that revises its process of determining deposit insurance for each depositor in the event of the failure of a large bank. For purposes of the rule, large banks are defined as banks with more than 250,000 deposit accounts and total domestic deposits of more than \$2 billion. The FDIC proposed three options for simplifying the process of determining insurance for each depositor. The first option requires large banks to install a program on their computer systems that, in the event of a failure, places a temporary hold on a percentage of balances in large deposit accounts and automatically transfers them to a bridge bank until the FDIC makes an insurance determination. This prevents uninsured deposits from being withdrawn at the time of failure. This option requires the institution to provide the FDIC with depositor data, including name, address, and tax identification number. The institution is required to establish a unique identifier for each depositor and to name the insurance category for each account.

The second option is similar to the first, except institutions are permitted to supply the FDIC with only the information they already possess. This means that the institution would not be required to establish a unique identity for each depositor or determine insurance categories for each account.

The final option requires the largest 10 or 20 institutions (in terms of the number of deposit accounts) to know the insurance status of their depositors at all times and have the capability to automatically place hard holds on uninsured funds, as directed by the FDIC, upon failure.

Comments on this proposed rule are due March 13. For more information, see *70 Federal Register*, pp. 73652-63

Department of Housing and Urban Development

Adjustable Rate Mortgages (12/6)

The Department of Housing and Urban Development (HUD) issued a final rule to permit the insurance of a new adjustable rate mortgage (ARM) product. The 5/1 ARM, which maintains a fixed interest rate for the first five years and then adjusts annually thereafter, will now be an FHA-insured product. The interest rates on the 5/1 ARM may adjust up to two percentage points annually, with a maximum lifetime adjustment of six percentage points.

This final rule became effective on January 5. For more

information, see 70 *Federal Register*, pp. 72696-7.

Office of Federal Housing Enterprise Oversight

Conforming Loan Limits (11/29)

The Office of Federal Housing Enterprise Oversight (OFHEO) announced the maximum conforming loan limits for mortgages purchased by Fannie Mae and Freddie Mac in 2006. Conforming loans have lower interest rates than nonconforming loans, and conforming loan limits represent the maximum size of home mortgage that Fannie Mae and Freddie Mac can purchase from thrifts, banks, and mortgage originators. The limits are adjusted annually based on the change in the national single-family

house price, which is determined by the Federal Housing Finance Board.

In 2006, the limit for a one-unit property is \$417,000. The limit for two-unit properties is \$533,850; three-unit properties, \$645,300; and four-unit properties, \$801,950. In high-cost areas, designated as Guam, Alaska, Hawaii, and the U.S. Virgin Islands, the limits are 50 percent higher, or \$625,500, \$800,775, \$967,950, and \$1,202,925, for one-to four-unit properties, respectively. The limit for second mortgages is \$208,500, or \$312,750 for second mortgages in high-cost areas.

For more information, see the OFHEO's letters to Fannie Mae and Freddie Mac at www.ofheo.gov/media/pdf/conforming2005ltrs.pdf.

SUMMARY OF JUDICIAL DEVELOPMENTS

Social Security Benefits May Be Seized to Cover Student Loan Debts

On December 7, the U.S. Supreme Court decided that the government can seize a person's Social Security benefits to repay his or her old federally insured student loan debts (*Lockhart v. United States*, No. 04-881). James Lockhart, the petitioner in the case, failed to repay federally insured student loans that he had incurred between 1984 and 1989. In 2002, the government began withholding a portion of his Social Security payments to offset his debt. Lockhart filed suit in 2004, claiming that since his debt had been delinquent for more than 10 years, the Debt Collection Act prohibited the offset of his Social Security payments. Furthermore, Lockhart contended that the Social Security Act prohibited Social Security benefits from being garnished.

The U.S. Supreme Court noted a provision of the Social Security Act that permits the garnishment of Social Security benefits if another law expressly references and contradicts the provision of the Social Security Act that bars it. In 1996, the Debt Collection Improvement Act expressly referenced that provision of the Social Security Act, permitting Social Security payments to be offset. In addition, while it is true that there is typically a 10-year limit on collecting old debts, the Higher Educational Technical Amendments of 1991 removed the 10-year limit, effectively making older debts subject to repayment. Therefore, the Supreme Court ruled that Lockhart's Social Security benefits could be offset to repay his old student loans.

Supreme Court Declines to Review Case Alleging FDIC's Breach of Fiduciary Duty

On November 7, the U.S. Supreme Court declined to hear claims brought by a failed bank's primary shareholder, alleging that the Federal Deposit Insurance Corporation (FDIC) breached its fiduciary duties as receiver

of the failed bank (*Golden Pacific Bancorp v. Federal Deposit Insurance Corporation*, No. 05-36). Golden Pacific Bancorp, the petitioner in the case, owned more than 90 percent of the shares of Golden Pacific National Bank at the time the Office of the Comptroller of the Currency ordered its closure due to reports that the bank was involved in money laundering. Because the bank's deposits were insured by the FDIC, it was appointed receiver of the bank. Under federal law, the FDIC, as receiver, was responsible for making insurance payments to depositors as soon as possible. To help do that, the FDIC solicited bids from financially healthy banks to purchase the failed bank's healthy assets and also serve as an agent making insurance payments to the depositors.

After paying the depositors, the FDIC was charged with paying the failed bank's creditors. The FDIC ended up being the failed bank's largest creditor, simply because it was subject to the claims of its depositors in its role as receiver of the bank. The FDIC calculated that it owed itself, as receiver, \$28 million (equal to 9 percent interest on all insurance payments made to depositors) and owed the other creditors about \$2.8 million. Because there were not enough assets left to cover these debts, the FDIC paid itself \$11.2 million and the other creditors \$1.4 million. Thereafter, the FDIC inactivated the receivership.

Golden Pacific Bancorp filed suit against the FDIC in 1995, alleging that the FDIC breached its fiduciary duties as receiver of Golden Pacific National Bank and, in the process, unjustly enriched itself and created corporate waste. Specifically, Golden Pacific said the FDIC improperly liquidated the bank when it was still solvent, used an expensive method to liquidate it and pay depositors, awarded itself interest on the insurance payments, and charged other expenses to the bank.

The U.S. Court of Appeals for the Second Circuit previ-

ously ruled that the FDIC was entitled to receive interest on the payments it made to depositors. Otherwise, the court said, the petitioner is essentially receiving an interest-free loan while the FDIC receives no compensation for advancing the money to pay depositors. The court of appeals also dismissed the petitioner's corporate waste claims, arguing that even if the court awarded the \$8 million in compensation that the petitioner was seeking, the petitioner would still owe \$11.7 million in outstanding tax liability, so it would recover nothing. Therefore, the court of appeals dismissed the claims, and the Supreme Court agreed with its decision, declining to hear the case.

Two Michigan State Laws Preempted for National Banks and Their Subsidiaries

On December 19, the U.S. Court of Appeals for the Sixth Circuit ruled that two Michigan state laws that conflict with federal laws and regulations are preempted for national banks and their subsidiaries operating in the state (*Wachovia Bank v. Watters*, No. 04-2257). Michigan state law requires mortgage lenders to register with the state and also permits the state to investigate consumer claims if the Office of the Comptroller of the Currency (OCC) neglects to do so. In addition, Michigan requires mortgage lenders to provide a financial statement annually, pay an annual operating fee, and maintain and retain documents to be examined by the commissioner of the Michigan Office of Insurance and Financial Services.

Wachovia Mortgage, a mortgage lender and subsidiary of national banking association Wachovia Bank, registered to make mortgage loans in Michigan. However, in 2003 it notified Michigan that it was surrendering its state lending registration. Upon this notification, Michigan informed Wachovia Mortgage that it was not authorized to engage in mortgage lending activities in the state. Thereafter, Wachovia filed suit against the state, claiming that the state's laws were preempted by the National Banking Act and the OCC's regulations.

The court of appeals determined that the state laws conflict with national laws and regulations and are therefore preempted by them. Because the state laws are preempted, national banks are subject only to the national laws and regulations. In addition, national bank subsidiaries are subject to the same laws and regulations that govern their national bank parent. This means that Wachovia Mortgage is not subject to the Michigan state mortgage lending laws that require registration, inspection, and annual dues and record-keeping.

Third-Party Auto Lenders May Access Credit Reports to Determine Credit Eligibility

On October 25, the U.S. Court of Appeals for the Seventh Circuit ruled that a third-party car lender does not violate the Fair Credit Reporting Act (FCRA) by reviewing potential borrowers' credit reports before deciding to extend a loan, even without the consumer's knowledge (*Stergiopoulos v. First Midwest Bancorp Inc.*, No. 04-2710). George

Stergiopoulos and Ivelisse Castro attempted to purchase automobiles from dealerships and needed financing. The dealerships contacted a third-party lender, First Midwest Bancorp, to try to arrange for loans. First Midwest requested and reviewed each of the consumers' credit reports, without their knowledge, before deciding not to extend loans to either one of them. Although this is a fairly common practice, Stergiopoulos and Castro allege that First Midwest violated the FCRA by accessing the reports without the consumers' knowledge or consent.

While each of the prospective borrowers signed contracts permitting the respective dealerships to access their credit scores, neither of the contracts mentioned that First Midwest might also access the credit reports. However, each contract did imply that other sources of financing might be sought. The plaintiffs argue that they were involved only in transactions with their respective dealerships and that any subsequent transactions with third parties were between the third party and the dealership exclusively. The court of appeals rejected this reasoning, saying that the plaintiffs requested financing and were aware that third-party lenders might purchase their auto loans. The court also said that the FCRA does not require consumers to approve each request for a report. Because they initiated the process of obtaining credit for their car loans and were aware that third-party lenders might buy the loan, they effectively granted permission to First Midwest to access the credit reports for the purposes of extending a car loan.

Bad-Debt Buyers May Charge the Same Rate of Interest as the Original Creditors

On December 9, the U.S. Court of Appeals for the Seventh Circuit determined that a loan assignee, or a buyer of delinquent loans, can charge the same rate charged by the original creditor, even if the assignee is not licensed to do so by the state in which it operates (*Olvera v. Blitt*, No. 04-3734). The case involves two borrowers, Enrique Olvera and Jeffrey Dawson, whose delinquent accounts were bought from the original creditor by bad-debt buyers. The original creditors charged Dawson 22.99 percent interest and charged Olvera at least 20.95 percent interest. Upon buying the loans from the original creditors, the assignees charged Dawson 19.7 percent interest and Olvera 18.2 percent interest, both of which were reduced rates in comparison with the original creditors' rates. However, Olvera and Dawson claimed that these rates, although lower, violated the Fair Debt Collection Practices Act (FDCPA).

The FDCPA forbids debt collectors from collecting "any amount (including any interest, fee, charge, or expense incidental to the principal organization) unless such amount is expressly authorized by the agreement creating the debt or permitted by state law." The plaintiffs argued that the assignees' rates were not permitted by state law, as the Illinois Interest Act prohibits nonlicensed creditors, except for banks, from charging interest higher than 9 percent.

The court ruled that while the plaintiffs made a tech-

nically good claim, based on semantics, their interpretation would make the credit market operate less efficiently, pushing debt collectors out of business and requiring credit card companies to collect their own bad debt, incurring higher costs in the process and passing them on to consumers. The court said that it is unreasonable for consumers to expect that if they default on a loan, their rates will fall. For these reasons, the court affirmed the district court's dismissal of the case.

National Bank Act Does Not Preempt State Age-Discrimination Law

On December 23, the U.S. Court of Appeals for the Ninth Circuit ruled that the National Bank Act does not preempt a Washington state law banning age discrimination (*Kroske v. US Bank Corp.*, No. 04-35187). The case stems from Kathy Kroske's termination from her assistant vice president position at US Bank. Kroske, a 51-year-old branch manager, claims that she was given fewer opportunities and advantages than her younger counterparts in other Washington branches. When her branch failed to consistently meet its targets, she was fired and replaced by a younger, less experienced person. Kroske claims that

her termination by US Bank violated the Washington Law Against Discrimination (WLAD), but US Bank contends that WLAD is preempted by the National Bank Act (NBA), which gives national banks permission to dismiss officers "at pleasure."

The court considered the case on appeal from the district court, which granted summary judgment to US Bank, finding that the NBA did, in fact, preempt the WLAD. On appeal, the court considered Congress's intent when it granted authority to national banks to dismiss officers at will. The court found that this provision of the NBA was not meant to completely preempt state employment laws for national banks. The NBA was established to ensure financial stability at banking institutions by allowing them to discharge employees who were believed to compromise the institution's integrity. Congress's intent was not to permit discrimination, which is further evidenced by its recent measures aimed at preventing it, specifically the Age Discrimination in Employment Act (ADEA). The WLAD is modeled after and similar to the ADEA. Therefore, the court ruled that Kroske's claim could not be dismissed because of preemption by the NBA.

SUMMARY OF THIRD DISTRICT DEVELOPMENTS

PA – The U.S. District Court for the Eastern District of Pennsylvania ruled that a mortgage insurer is not required to notify a consumer of an adverse action in cases when the consumer's credit score leads to the mortgage insurer's selling insurance to the mortgage lender at a level higher than the lowest level of insurance (*Whitfield v. Radian Guaranty Inc.*, No. 04-0111). Whitney and Celeste Whitfield purchased a home for which they financed 98 percent of the purchase cost with Countrywide Mortgage. Because the Whitfields were financing such a large portion of the cost and because of their credit score, Countrywide required them to pay mortgage insurance, which it obtained through Radian Guaranty. Radian Guaranty provided Countrywide with a grid displaying its insurance rates. Radian's rates are based on the borrower's credit score, the home's loan-to-value ratio, and the amount of coverage the lender wants. Based on these factors, Countrywide determined that the Whitfields would pay \$908.53 per month in mortgage insurance.

The Whitfields brought suit against Radian, claiming that the insurer was obligated to notify them of an adverse action taken against them as a result of their credit score. The Whitfields claimed that the level of insurance they were required to purchase, which was higher than the lowest level possible, represented an adverse action against them because of their credit score. Radian claimed that it was not an adverse action prohibited by the FCRA because there was no cancellation, change in coverage, or premium increase. Furthermore, Radian claimed that there was no adverse action against the Whitfields when it sold mortgage insurance to Countrywide because there was no credit transaction between Radian and the Whitfields. The court agreed with Radian's claims and ruled that it did not violate the FCRA in its transaction with Countrywide Mortgage.

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