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Recent Developments

Supreme Court Will Hear OCC Federal Preemption Case

On June 19, the U.S. Supreme Court agreed to hear a case that tests the extent to which national laws and regulations preempt state laws that govern state-licensed operating subsidiaries of national banks (*Watters v. Wachovia Bank, N.A.*, No. 05-1342). The granted petition for a writ of certiorari, a request for judicial review, was filed by Michigan’s commissioner of the Office of Financial and Insurance Services, Linda Watters. Watters maintains that, in addition to other requirements, Michigan law requires mortgage lenders to have a state lending registration in order to conduct business in the state. However, Wachovia

Mortgage, a subsidiary of national banking association Wachovia Bank, surrendered its registration in 2003, claiming that the state’s laws were preempted by the National Banking Act and the Office of the Comptroller of the Currency’s regulations. In December, the U.S. Court of Appeals for the Sixth Circuit ruled that the Michigan laws do not apply to national banks’ operating subsidiaries because they do not apply to national banks. Therefore, Wachovia Mortgage was permitted to conduct business in the state without being registered. (See *Banking Legislation and Policy*, October-December 2005 for more information about the appellate court’s opinion.)

NACHA Approves Rules for Back-Office Check Conversion

The electronic payments association, NACHA, has approved a rule that allows retailers and bill payment centers that accept checks at the point-of-sale or at manned bill payment locations to convert eligible checks to automated clearinghouse (ACH) debits in the back office. They are also permitted to convert eligible checks received in image files to ACH debits. Hard-copy and image file checks are ineli-

gible for conversion if they are written for amounts greater than \$25,000. To complete back-office conversions, retailers must take steps consistent with the Federal Reserve's Regulation E, which requires retailers to notify customers if their checks will be converted, ensure that their checks are properly converted, provide customer service contact information, and allow customers to opt out of having their checks converted.

SUMMARY OF FEDERAL LEGISLATION

New Legislation

1. National Insurance Act of 2006 (S. 2509). Introduced by Sen. Sununu (R-N.H.) on April 5, 2006.

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

This bill will create the Office of National Insurance, within the Department of the Treasury, whose activities will be funded by assessments paid by federally chartered insurance companies. In addition to a main office in Washington, at least six regional offices will be established. The office will be headed by the commissioner of national insurance, appointed by the president, with the advice and consent of the Senate, and will serve a term of five years. Among other duties, the commissioner will be responsible for issuing national charters and licenses, regulating and supervising insurers with a national charter, and establishing a national guarantee association for federally chartered insurance companies.

Federally chartered insurance companies will be required to submit financial statements to the office on a quarterly and annual basis and will receive an on-site exam at least once every 36 months. A firm may have its federal charter revoked if it poses an unnecessary risk to its policyholders, is in poor financial condition, or if it violates any laws or regulations. The commissioner may place a federally chartered insurance company into receivership if it is found to be insolvent; has a substantial dissipation of assets; has violated cease-and-desist orders; is found to be in a condition that could harm policyholders, creditors, or the public; conceals records from the Office of National Insurance; or is unable to pay its creditors. Once an insurer has been placed in receivership, an automatic stay will be placed on its assets, and the receiver will either rehabilitate or liquidate it.

Federally chartered insurance companies will be required to participate in the guarantee associations of states whose associations do not discriminate against federally chartered insurance companies or their customers (these are called qualified states). The act establishes a national guarantee association and requires federally chartered insurance companies to participate in this association when

offering insurance in states that are not qualified.

Federally chartered insurance companies will be able to apply for either a life insurance license or a property/casualty insurance license. The first license will also permit the firm to offer annuities, disability, long-term care, and health insurance. The second license also permits the firm to offer health insurance. The commissioner may also issue reinsurance licenses to firms that are not national insurers.

Federally chartered insurance companies will be exempt from state licensing, examination, and reporting requirements. They will also be exempt from state regulations that apply to the sale, marketing, or underwriting of insurance; securitization; claims adjustment and settlement; their financial condition or solvency; or holding company transactions. But they will be subject to state unclaimed property, escheat, corporate governance, and tax laws. (Escheat laws govern a state's receipt of property when there are no legal heirs to inherit it.) States will be able to require firms with a national charter to participate in mandatory joint underwriting arrangements (to provide coverage to those unable to obtain it in the private market) so long as they do not restrict pricing or result in rates that do not cover the long-run exposure to losses. Unlike state-chartered insurance firms, federally chartered insurance companies would be subject to most federal antitrust laws.

The bill permits state-chartered insurance companies to convert to a federal charter, subject to approval from the commissioner. The new national entity will be considered to be a continuation of its state-licensed predecessor and will continue to exercise the powers it enjoyed under state law just prior to the conversion. Similarly, a federally chartered insurance company may convert to a state charter with approval from the state's insurance regulator and retain the powers it enjoyed under its federal charter just prior to the conversion.

Federally chartered insurance companies must obtain prior approval before establishing or acquiring subsidiaries in a new line of insurance or investing more than 20 percent of their assets in a subsidiary in the same line of business. The commissioner also approves mergers and acquisitions involving a federally chartered insurance company. If the merger also involves a state-chartered insurer, the

surviving firm must obtain a national license for the products it offers and may not retain its state licenses. If a state-chartered insurer acquires a federally chartered insurance company, the national subsidiary retains all the privileges associated with its national charter and licenses.

If an insurance policy or other product offered by a federally chartered insurance company does not specify a jurisdiction, the terms of the contract will be interpreted according to the law of the state where the policy or product was delivered. Alternatively, the contract may specify the jurisdiction of the company's main office or its principal place of business.

2. Expanding American Homeownership Act of 2006 (H.R. 5121). Introduced by Rep. Ney (R-Ohio) on April 6, 2006.

Status: Referred to the House Committee on Financial Services.

This legislation updates the Federal Housing Administration's (FHA) single-family home mortgage insurance program to make it more reflective of the risk in the mortgage market. The bill also increases the loan limits for single-family mortgage insurance. First, a home will be eligible for FHA insurance as long as it does not cost more than the median home price in its area. This represents an increase from the previous limit of 95 percent of the median home price. The home price also must not exceed the home's appraised value plus service charges, cost of appraisal, and other fees. Further, the bill increases, from 35 to 40 years, the maximum amortization period for a mortgage to qualify for FHA insurance.

The bill also allows the FHA to have more flexibility in setting mortgage insurance premiums. For all mortgage applications received on or after October 1, 2006, the FHA may establish a premium structure that has a single premium payment collected before the insurance is granted, multiple periodic payments, or both. These premiums can vary during the mortgage term, as long as the standards for changing the premium are established before the mortgage is executed.

The bill will still allow the FHA to insure loans that will help to rehabilitate one- to four-family residences. These loans will be drawn from a new source, the Mutual Mortgage Insurance Fund, which would be created by this bill.

Finally, the bill permits the FHA to insure up to 100 percent of a mortgage's principal if the house is located in a disaster area declared by the president. In order to qualify, the home's price must not exceed the median average home price and must not exceed 100 percent of the home's appraised value plus service charges and fees. The FHA may continue to offer insurance for up to 100 percent of the principal for three years after the area was declared a disaster area.

3. Seasoned Customer Currency Transaction Report Exemption Act of 2006 (H.R. 5341). Introduced by Rep. Bachus (R-Ala.) on May 10, 2006.

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

This bill exempts depository institutions from filing currency transaction reports for their "seasoned customers." Currency transaction reports are used to detect and investigate financial crimes, including money laundering and financing terrorism. The goal of the bill is to impose the reporting requirement only in circumstances in which the value of the information obtained exceeds the burden of creating and filing these reports. This bill would allow depository institutions to file an exemption notice for each eligible customer. After filing the notice, an institution would no longer file currency transaction reports for that customer's transactions. To be eligible, a customer must be a U.S. firm or authorized to conduct business in the United States. Also, the customer must have had a deposit account at the institution for at least 12 months, during which time the account was used for multiple currency transactions for which the filing of currency transaction reports is required.

The secretary of the treasury is charged with developing and enforcing regulations to implement the bill. The secretary will also determine circumstances under which a customer's exemption will be revoked and when a customer's exemption can be transferred from one depository institution to another in the event of a merger or acquisition between the two institutions.

4. Financial Services Regulatory Relief Act of 2006 (S. 2856). Introduced by Sen. Crapo (R-Idaho) on May 18, 2006.

Status: Passed the Senate and received in the House.

The bill requires Federal Reserve Banks to pay interest on banks' reserve balances at least once per calendar quarter. (Depository institutions are required to hold reserve balances, or a portion of their customer deposits, at a Federal Reserve Bank.) The bill will also allow the Board of Governors of the Federal Reserve System to establish a reserve ratio that is less than 3 percent (and which may be 0) for the portion of a bank's transaction accounts that are \$25 million or less. Currently, this ratio is fixed at 3 percent. Also, the reserve ratio for the portion of a bank's transaction accounts in excess of \$25 million may range between 0 and 14 percent. Previously, the ratio could not be less than 8 percent.

The bill would permit national banks to pay dividends, as long as they did not exceed the total net income for the bank in that year or the bank's retained net income for the previous two years.

The bill contains a number of provisions that stream-

line bank processes. First, federal banking agencies may eliminate the requirement that a banking institution file reports of condition or they may reduce the number of reports that are required (currently, reports of condition must be filed four times a year). Also, the bill increases the limit for banks to be considered "small" and therefore eligible for the 18-month examination schedule instead of the normally required 12-month schedule. Currently, banks with up to \$500 million in total assets (instead of \$250 million) are eligible for the 18-month examination schedule.

The House of Representatives passed a similar reform measure in March. See *Banking Legislation and Policy*, January-March 2006 for more information.

5. Data Security Act of 2006 (S. 3568). Introduced by Sen. Bennett (R-Utah) on June 26, 2006.

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

This bill requires financial institutions to develop and enforce procedures to ensure the security of sensitive consumer account information. This includes safeguarding the information it maintains or communicates, as well as the information that another entity communicates on its behalf. The bill also requires financial institutions to notify consumers exposed to substantial harm as a result of a security breach. Service providers that maintain or communicate such information on behalf of a financial institution are required to notify the institution when a security breach has been discovered. The bill would preempt most state legislation in this area.

The bill defines a breach of data security as the unauthorized acquisition of sensitive account or personal information but excludes instances in which the data cannot be used to make fraudulent transactions or to commit identity theft, such as when data have been encrypted.

Sensitive account information is defined as an account number, together with any security code that might be required to access or use the account. Sensitive personal information is defined as a person's name, address (or telephone number), together with either his or her Social Security number, driver's license number, or tax payer ID number. The definition excludes information that is publicly available and which has not been divulged illegally.

Under the bill, the primary obligation of financial institutions would be to develop and enforce procedures to prevent unauthorized use of a consumer's sensitive account or personal information that is reasonably likely to result in substantial harm or inconvenience to the consumer.

Substantial harm or inconvenience is defined as a material financial loss or civil or criminal penalties that result

from unauthorized use of the information. It would also include the expenditure of significant time and effort by the consumer to either avoid material financial loss or correct erroneous information that results from unauthorized access to the information. But the bill explicitly excludes from this definition simply closing an account or changing the account number and any harm that is not the result of account fraud or identity theft.

If an institution suspects that a security breach has occurred, it must conduct an investigation to determine, among other things, if the compromised information is reasonably likely to be used in a way that will cause substantial harm or inconvenience to the affected consumers. In making this determination, the financial institution may take into account the likelihood that any resulting fraudulent transactions will be prevented by other security features in place. The institution must also take reasonable steps to restore the security of its data.

If the financial institution determines that the breach is reasonably likely to result in substantial harm or inconvenience to the affected consumers, it must notify, among others, its primary federal regulator, the appropriate law enforcement agency, and the affected consumers. The notice to consumers must include a summary of their right (under the Fair Credit Reporting Act) to dispute inaccurate information in their credit reports and to place a fraud alert in their credit file. If the breach involves 5,000 or more consumers, the institution must also notify each of the national credit reporting agencies.

Institutions may notify consumers in writing, by telephone, or by electronic mail. The notice must include a description of the information that was compromised, a summary of the steps taken to restore the security of the information, and a description of the victim's rights that are prescribed under the Fair Credit Reporting Act.

The bill specifies that implementing regulations shall be issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Credit Union Administration, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Department of Housing and Urban Development, and the Federal Trade Commission. Federal agencies are also required to implement procedures to protect the security of sensitive account and personal information they maintain or transmit and to notify consumers in the event of a breach that is likely to cause them substantial harm or inconvenience.

Finally, the bill preempts state legislation that sets standards for (1) protecting the security of information about consumers, (2) notifying consumers in the event of a breach, or (3) mitigating any loss or harm resulting from unauthorized access to the information.

Board of Governors of the Federal Reserve System

Complex Structured Finance Activities (5/16)

The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the Securities and Exchange Commission (together, the Agencies) issued a notice of a proposed rule that will help depository institutions identify and protect against risks arising from the use of complex structured finance agreements. Examples of structured finance transactions include financial derivatives for market and credit risk, asset-backed securities with customized cash flows, and specialized financial conduits that manage pools of assets. The Agencies advise depository institutions to develop clear policies for identifying complex structured finance agreements that present a high level of risk to the institution or to its relationship with its customers.

First, institutions should identify new types of agreements, considering whether they contain structural or pricing terms that are different from existing products, raise new legal issues, or are targeted to a new group of customers. If an institution decides that a product is new, it should be reviewed to determine whether it poses an elevated level of risk. During the review process, a firm should consider whether the product lacks economic substance or a business purpose, is designed for questionable accounting, regulatory, or tax treatment, and whether it involves circular transfers of risk, in addition to other factors. In general, the firm should conduct as stringent a review as is necessary for the type and level of risk that the product might pose.

Once a product is found to have an elevated level of risk, it should be analyzed by the business's product line group and its control group before being approved. The firm should develop consistent practices for analyzing complex structured finance transactions, and it may be helpful to designate a senior management committee to study each new product. The Agencies also suggest that the institution keep careful and complete records to ensure compliance and consistency. Specifically, it should document the terms of the transaction, the obligations of the counterparty, the disclosures made to customers, and a verification that the institution's policies have been followed.

If a financial institution determines that the product poses significant legal or reputational risks, it should either take steps to mitigate the risks or decline to enter into the transaction. A mitigating factor might include making the transaction conditional on some commitments from the counterparty. A financial institution should not agree to a transaction solely because another financial institution will take part or because of the size or sophistication of the customer or counterparty.

Finally, the institution should periodically review its procedures to be sure they are effective. This includes having the internal audit department regularly review the

institution's adherence to its policies.

Comments on this notice of a proposed rule were due June 15. For more information, see 71 *Federal Register*, pp. 28326-34.

Commodity Derivatives (5/15)

The Board of Governors of the Federal Reserve System (the Board) issued a legal opinion stating that volumetric production payment (VPP) transactions do not count toward the limited amount of physical commodity trading in which a bank holding company may engage. A VPP is a royalty interest, typically in a hydrocarbon reserve (such as oil or natural gas) that requires the holder to make an upfront payment in exchange for receiving hydrocarbons on a regular basis over the life of the VPP contract. In 2004, the Board ruled that physical commodity trading is similar in nature to commodity derivatives activities, and it granted that UBS AG, the Switzerland-based financial services firm, could hold physical commodities as long as they did not exceed 5 percent of the company's tier 1 capital. UBS AG then requested that VPP transactions not be counted toward this 5 percent limit.

Because UBS AG had been authorized to engage in physical commodity trading, it had already entered into two VPP transactions. To carry out the transactions, UBS AG set up a special-purpose entity to collect hydrocarbons in exchange for cash. UBS AG has no control over the production of the oil or gas and relies on the counterparty meeting its obligation to produce the hydrocarbons on schedule. At a later date, UBS AG arranges to sell the hydrocarbons back to the customer or to another bidder in the marketplace. These VPP transactions generally act as loans to provide funding to customers.

Given these conditions, the Board's legal opinion finds VPP transactions to be a form of permissible lending activity. However, the legal opinion ruled that any hydrocarbons UBS AG receives from a VPP transaction must be sold immediately or else be subject to the 5 percent limit. In addition, the Board advised UBS AG to develop procedures to identify whether a VPP presents a business or reputational risk. The transaction should also be analyzed to determine whether it meets a business purpose and to ensure that it is not designed to evade accounting, regulatory, or tax standards.

For more information, see the Board's legal opinion at www.federalreserve.gov/boarddocs/legalint/BHC_ChangeInControl/2006/default.htm.

Bank Employees' Credit Card Use (5/22)

The Board of Governors of the Federal Reserve System (the Board) issued a legal opinion to clarify the conditions under which a bank insider's use of a bank-owned credit card is considered an extension of credit in violation of Regulation O.

The legal opinion said that Regulation O permits the

use of a bank credit card by a bank insider for the purpose of purchasing items or paying for expenses incurred on behalf of the bank. In addition, Regulation O permits credit card expenses of up to \$15,000 incurred by a bank insider on an ordinary credit card. For these reasons, the Board said that the issuance of a bank-owned credit card to a bank insider is not a violation of Regulation O, even if the line of credit on the card exceeds \$15,000. Furthermore, it is not believed to be an extension of credit to the individual if the card is to be used to make purchases on behalf of the bank. The bank would be in violation of Regulation O, however, if the bank-owned credit card was used to make personal purchases, and if the same line of credit, carrying the same terms and interest rate, was not made available to noninsiders.

For more information, see the Board's legal opinion at www.federalreserve.gov/boarddocs/legalint/federalreserveact/2006/20060522.pdf.

Fund Transfer Information (6/21)

The Board of Governors of the Federal Reserve System and the Financial Crimes Enforcement Network (together, the Agencies) issued a notice of a proposed rule to examine whether the threshold for reporting fund transfers should be lowered from its current level of \$3,000. Current rules require financial institutions to collect, retain, and transmit information on fund transfers and transmittals of funds in amounts of \$3,000 or more. The transmitter's financial institution must document the name and address of the transmitter, the amount that is transferred or transmitted, the date of the transaction, all payment instructions from the transmitter, and the identity of the recipient's financial institution. In addition, the recipient's bank is to record his or her name, address, account number, and any other identifying information. The Agencies are considering lowering the threshold to \$1,000 and are weighing the benefits to law enforcement agencies against the burdens to financial institutions.

Comments on this notice of a proposed rule are due August 21. For more information, see 71 *Federal Register*, pp. 35564-7.

Financial Crimes Enforcement Network

Business Check Cashing (3/31)

The Financial Crimes Enforcement Network (FinCEN) issued an advisory to help businesses determine if they meet the definition of a check casher or money services business under the Bank Secrecy Act. The advisory says that if a business cashes its employees' payroll checks, it is not considered to be a check casher, even if the business charges its employees a fee for the service. However, if the business cashes more than \$1,000 worth of checks for any one individual in any one day, and the checks are not the business's own, then the business is acting as a check casher under the Bank Secrecy Act.

Next, a business would not be considered a check

casher if it pays a nonemployee for goods or services with a check, at the request of the nonemployee, and then cashes the check. This interpretation applies even if the check is for an amount greater than \$1,000. And, finally, a tax preparation business is permitted to cash its own tax refund anticipation loan checks for its taxpayer customers.

For more information about this advisory, see www.fincen.gov/msb_faqs_guidance_03312006.html.

Federal Deposit Insurance Corporation

Assessments (5/18)

The Federal Deposit Insurance Corporation (FDIC) issued a notice of a proposed rule that would require depository institutions to pay quarterly assessments. Currently, the FDIC collects semiannual assessments paid in two installments, which is essentially like paying quarterly assessments at the beginning of each quarter. The new system will require institutions to pay assessments in arrears or after the quarter has ended. For example, the first quarter ends on March 31, at which time the assessment base is determined. On June 15 the assessment invoice is billed, and on June 30 the institution's assessment is due.

The rule would also permit changes in an institution's risk status to be reflected at the time of the change. Currently, institutions retain their supervisory risk rating throughout a semiannual period. By updating the risk rating as new information becomes available, the FDIC expects that an institution's assessment will more accurately reflect the current level of risk it poses to the insurance fund.

The FDIC also proposes changing the way in which an institution's assessment base is calculated. Under current rules, an institution's assessment base is derived using quarter-end deposits. The FDIC proposes that instead, the assessment base should be calculated using average daily balances over the quarter. This change will require modifications to the Call Report as institutions are not currently required to report average daily balances. Institutions with less than \$300 million in assets would have the option of using quarter-end balances or average daily balances to determine their assessment base. If an institution chooses to use average daily balances, however, it would not be permitted to switch back to using quarter-end balances.

Another modification would involve eliminating the float deduction that depository institutions can currently subtract from their assessment bases, since float has become less and less significant over time. (A float deduction is the amount of deposits that result from checks for which the institution has not yet received payment.)

Comments on this notice of a proposed rule were due July 17. For more information, see 71 *Federal Register*, pp. 28790-804.

One-Time Assessment Credit (5/18)

The Federal Deposit Insurance Corporation (FDIC) issued a notice of a proposed rule that would create a one-time deposit insurance assessment credit for eligible depos-

itory institutions. To be eligible, an institution (or its predecessor) must have been in existence on December 31, 1996, and it must have paid an assessment prior to that date. The FDIC estimates that approximately 7,400 active depository institutions could be eligible for the one-time credit. The assessment credit will be determined by dividing an institution's assessment base, as of December 31, 1996, by 0.105 percent of the combined aggregate assessment bases of the Bank Insurance Fund and the Savings Association Insurance Fund at the same time. This is estimated to be close to \$4.7 billion dollars. Once an institution's assessment base has been calculated, it will automatically be used to pay the institution's future assessments. In fiscal years 2008 and 2009, up to 90 percent of an institution's assessment can be covered by the one-time credit. Thereafter, the credit can be used to cover up to 100 percent of an assessment.

In cases in which an institution would be eligible but is no longer in existence and it has no successor, its one-time credit would be dispersed among the other eligible institutions. If an eligible institution is no longer in existence but does have a successor, the rule permits the credit to be transferred to the successor.

Comments on this notice of a proposed rule were due July 17. For more information, see 71 *Federal Register*, pp. 28809-19.

Office of Thrift Supervision

Community Reinvestment Act (4/12)

The Office of Thrift Supervision (OTS) issued a final rule to revise its definition of "community development" under its Community Reinvestment Act regulations. The revision will make the OTS's definition consistent with the other federal banking regulators' definitions of community development. (See *Banking Legislation and Policy*, July-September 2005 for more information on the other regulators' rules.) The FDIC's new definition of community development includes activities that revitalize or stabilize low- or moderate-income geographical areas, designated disaster areas, and distressed or underserved rural middle-income areas. The OTS will designate rural middle-income areas based on their poverty and unemployment rates and their population losses. The expanded definition provides more ways in which banks can satisfy the community development test.

This final rule became effective on April 12. For more information, see 71 *Federal Register*, pp. 18614-8.

Preemption of State Gift Card Rules (6/9)

The Office of Thrift Supervision (OTS) issued a legal opinion to clarify that federal law preempts state law restrictions on gift cards for federal savings associations and their operating subsidiaries. The opinion was written in response to a savings association's inquiry about its offering of "open loop" gift cards, which are accepted at any place where signature-based Visa or MasterCard debit cards are accepted. The cards are sold in amounts ranging from \$25

to \$500, and they carry with them several fees – one for the initial sale, a shipping fee, a monthly service fee, a fee for receiving the remaining funds by check, and a replacement fee for a card that is lost or stolen.

In offering these gift cards, the thrift questioned whether it was subject to five types of restrictive state laws. The state laws include provisions that (1) create licensing requirements for gift card issuers and sellers; (2) require disclosure about fees and expiration dates; (3) impose restrictions on issuance fees, inactivity fees, maintenance fees, and redemption fees; (4) regulate expiration date terms; and (5) require gift card issuers to exchange unused portions of the gift cards for cash.

The OTS ruled first that thrifts are permitted to issue gift cards, and they may charge a fee for the service. The OTS believes the issuing of gift cards is similar to deposit-taking activities, which are approved for savings associations. Next, the OTS noted that federal legislation and judicial precedent have determined that it is the regulator with the sole responsibility for regulating thrifts' deposit-taking activities. Therefore, all five categories of state laws that restrict gift cards are federally preempted for federal savings associations and their operating subsidiaries.

For more information about this legal opinion, see www.ots.treas.gov/docs/s/56218.pdf.

Department of Housing and Urban Development

Accelerated Claim and Asset Distribution Program (6/5)

The Department of Housing and Urban Development (HUD) issued a notice of a proposed rule to implement HUD's accelerated claim and asset distribution (ACD) program for single-family home mortgage insurance, which is a new HUD initiative. The ACD program is intended to increase the return to the Federal Housing Administration's insurance fund by reducing the amount of time that an asset, or defaulted mortgage, is held.

The program will require mortgage issuers to file a claim with the ACD program to be reimbursed for eligible defaulted mortgages (such as vacant homes). The mortgage would then be assigned to another party and the original mortgage issuer would receive payment for its claim. HUD is considering different methods of disposing of the defaulted assets. The agency has experimented with using joint ventures, which has been successful, but it is also considering assembling portfolios of assets and selling these to investors either in bulk or via a securitization.

Comments on this advance notice of a proposed rule were due August 4. For more information, see 71 *Federal Register*, pp. 32392-3.

Adjustable Rate Mortgages (6/19)

The Department of Housing and Urban Development (HUD) issued a proposed rule that would permit the London Interbank Offered Rate (LIBOR) to be used as an index for the rate of HUD-insured adjustable rate mortgage (ARM) products. Current regulations permit the interest

rates of HUD-insured ARMs to be adjusted using only the weekly average yield of U.S. Treasury securities, adjusted to a constant maturity of one year (known as the constant maturity Treasury index).

Comments on this proposed rule are due August 18. For more information, see 71 *Federal Register*, pp. 35370-1.

Financial Accounting Standards Board

Variable Interest Entities (4/13)

The Financial Accounting Standards Board (FASB) issued a staff position to clarify when an interest is a variable interest entity (VIE) under FASB Interpretation 46. Interpretation No. 46 instructs companies to consolidate VIEs, which are entities controlled by means other than voting interests, if the company is exposed to a majority of the risk of loss or is entitled to receive a majority of the VIE's residual returns. (For more information about FASB Interpretation No. 46, see *Banking Legislation and Policy*, April-June 2003.)

FASB notes that the cash flow method and fair value method are often used to determine variability, but sometimes neither can accurately portray whether an interest is a VIE. Further, some financial instruments can, throughout their lives, act as assets and liabilities, and currently institutions do not have a uniform method of determining whether an instrument is a creator of variability (which is not a VIE) or an absorber of liability (which is a VIE).

FASB suggests that institutions use a three-step pro-

cess to determine an instrument's variability. First, the institution should analyze the design of the contract by studying the nature of the risks in the interest and determining the purpose for which the entity was created and the variability (expected losses or expected residual returns) that it was created to pass along to its interest holders. The institution should consider the following risks: (1) credit risk; (2) interest rate risk, including prepayment risk; (3) foreign currency exchange risk; (4) commodity price risk; (5) equity price risk; and (6) operations risk.

When considering why the entity was created, an institution should analyze: (1) the activities of the entity; (2) the terms of the contracts the entity has entered into; (3) the nature of the entity's interests issued; (4) how the entity's interests were negotiated with or marketed to potential investors; and (5) which parties participated significantly in the design of the entity.

In general, assets and operations of an entity are considered assets that create variability, and they are not considered variable interests. On the other hand, liabilities and equity interests usually absorb the variability, and so they are typically considered variable interests. The design of an entity should dictate whether the interest creates or absorbs variability for the entity. The document includes six examples to illustrate how the techniques being described can be applied.

For more information about this staff position, see FASB Staff Position No. FIN 46(R)-6 at www.fasb.org/fasb_staff_positions/fsp_fin46r-6.pdf.

SUMMARY OF JUDICIAL DEVELOPMENTS

Banks Lack Property Interest in Earnings Generated on Reserve Deposits

On June 19, the U.S. Supreme Court declined to hear a case that ruled that a bank's federally mandated reserve deposits are not considered property interest of the bank (*Texas State Bank v. U.S.*, No. 05-1168). Texas State Bank, the petitioner in the case, claims that any income earned on a bank's reserve deposits should belong to the bank that made the reserve deposit.

Federal law requires all depository institutions to keep a balance of reserves in the Federal Reserve System. The Fed then uses the reserves to engage in open market operations, which generate revenue for the Fed. Texas State Bank contends that the earnings were its property, and that by directing the Federal Reserve to transfer its property to the Treasury, the United States committed a Fifth Amendment taking.

However, the U.S. Court of Appeals for the Federal Circuit ruled that Texas State Bank had no property interest in the income generated by the Federal Reserve through the Fed's open market operations. The court compared

Texas State Bank's reserve deposits at the Federal Reserve Bank to any other depositor at any other bank. The court said that when someone deposits money at a bank, the funds belong to the bank and become part of its general funds. Therefore, the reserve deposits could be used by the Fed in its open market operations, and Texas State Bank did not have any real property interest in their earnings. The court of appeals dismissed the claim, and on appeal, the Supreme Court declined to review the case.

Lender Who Failed to Note Extra Payments Cannot Be Sued for Violating RESPA

On May 26, the U.S. Court of Appeals for the Eleventh Circuit ruled that mortgage borrowers cannot sue their lender for failing to note extra monthly discretionary charges on their escrow account statements (*Hardy v. Regions Mortgage Inc.*, No. 05-14678). The plaintiffs, Dennis and Henrietta Hardy, enrolled in a shoppers discount program that charged a monthly fee of \$5. The Hardys elected to have the fee added to their mortgage payment each month. However, their mortgage lender, Regions Mort-

gage, failed to list the \$5 charge on their monthly escrow account statement. The Hardys alleged that this constituted a violation of the Real Estate Settlement Procedures Act (RESPA), and they wished to sue Regions Mortgage.

The U.S. Court of Appeals for the Eleventh Circuit explained that while Regions' omission did violate RESPA, it violated section 10 of the act, which does not allow for a private right of action. Specifically, the law says that a borrower's discretionary payment must be listed on mortgage statements, and a failure to comply with this provision constitutes a violation of section 10 of RESPA. RESPA's section 10 is enforced by the Department of Housing and Urban Development (HUD), and HUD's secretary punishes offenders by assessing penalties. Therefore, the court ruled that the Hardys could not sue Regions Mortgage for neglecting to list the charge on their escrow statements.

Mortgage Loans Can Be Rescinded Even If the Loan Has Been Refinanced and the Original Lender Has No Security Interest in the Loan

On April 18, the U.S. Court of Appeals for the Sixth Circuit ruled that borrowers could rescind their mortgage loan in the legally mandated time frame, even if the loan was refinanced and the original lender no longer had a security interest in the property (*Barrett v. JP Morgan Chase*, No. 05-5035/5146). The borrowers in this case, William and Sandra Barrett, had two separate mortgage agreements with JP Morgan Chase. The first refinanced their previous mortgage loan that was held with another bank. A year later they entered into a second agreement with Chase in which they bundled their prior Chase mortgage agreement with their other debts. Within a year after entering into the second mortgage agreement with Chase, the Barretts again refinanced their mortgage, this time with another bank. At that time, JP Morgan Chase held no security interest in the Barretts' property. However, the Barretts requested that JP Morgan Chase rescind its earlier loan agreements, because the Barretts alleged that the bank violated provisions of the Truth in Lending Act (TILA). The Barretts claimed that the bank required them to purchase credit life insurance to obtain the first loan, and it did not provide accurate information about how to rescind the second loan, both of which are violations of the TILA.

JP Morgan Chase argued that it would be impossible to rescind the loan because the bank no longer held any interest in the property since the loans had been refinanced. The Barretts countered that they could essentially rescind the loan by refunding the borrowers' prepayment penalties, mortgage filing fees, loan transaction fees, appraisal fees, and closing costs.

The court ruled in favor of the Barretts, saying that TILA grants borrowers who rescind loans the right to both void the security interest and the right to recover finance charges incurred in the transaction. Therefore, the Barretts could rescind the loans if violations of the TILA were discovered. The court remanded the case to district court,

where it will be determined whether JP Morgan Chase violated the TILA.

Bank Is Not Liable for a Loan Officer's Misuse of Customer Information

On March 29, the Ohio Supreme Court ruled that a bank is not liable for its loan officer's misuse of confidential customer information (*Groob v. KeyBank*, No. 2004-0214). The case arose from a prospective borrower's application for a loan to buy a business entity. The borrower visited KeyBank and met with the loan officer, at which time he presented confidential information about the proposed business he wished to purchase with the loan proceeds. KeyBank declined to offer a loan to the borrower, and later the borrower learned that one week after his loan application was denied, the loan officer with whom he met purchased the property he had intended to buy. The borrower alleged that KeyBank was liable for the loan officer's conduct, saying that KeyBank owed prospective borrowers a fiduciary duty, which would require the bank to act in the customer's best interest, even if it is to the bank's detriment.

The court ruled that a bank does not owe a fiduciary duty to each prospective borrower from whom it receives confidential information, unless the bank is aware of a special repose or trust. Since the proposed loan transaction was essentially standard, KeyBank did not have a fiduciary duty to the borrower. Furthermore, the court ruled that a bank is not responsible for the actions of its employees if they are outside the scope of their employment. Therefore, the bank was not liable for its loan officer's use of the prospective borrower's confidential information in this case.

Class Action Lawsuits Against Discover Bank Must Be Arbitrated under Delaware Law

On March 30, the California Supreme Court let stand a ruling that mandates that class action lawsuits against Discover Bank must be arbitrated under Delaware law, the state in which the bank is incorporated (*Discover Bank v. Superior Court*, No. S140411). The case arose from a credit cardholder's complaint that Discover Bank inaccurately explained when late fees and finance charges would be imposed on accounts. Specifically, the bank disclosed that payments would be considered late if they were not received by a certain date, but in practice, late fees and finance charges were assessed if payments were not received by 1 p.m. on the specified date. California borrower Christopher Boehr claimed that Discover Bank breached the terms of its credit agreement, and he moved to file a class action lawsuit along with other borrowers who were similarly situated.

Discover Bank's credit agreements include terms that prohibit both parties from participating in classwide arbitration. The agreements also contain a choice-of-law clause that designates Delaware as the governing state for contract disputes. Delaware law permits enforcement of these types of arbitration agreements. Boehr petitioned the California

court system to deem these types of clauses unenforceable, saying that California law prohibits arbitration clauses in credit agreements. However, the appeals court ruled that California did not have a materially greater interest in the

case than Delaware did, and the parties chose Delaware law to be the governing standard in the credit agreement, so the case is subject to Delaware law. Upon appeal, the California Supreme Court declined to hear the case.

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