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Recent Developments

FDIC Imposes Six-Month Moratorium on ILC Deposit Insurance Applications

On July 28 the Federal Deposit Insurance Corporation (FDIC) announced that it would not consider industrial loan companies' (ILCs) applications for deposit insurance until January 31, 2007. Industrial loan companies originated in the early 1900s as small loan companies for industrial workers, but they are now state-chartered depository institutions that have many of the same powers as state commercial banks.

While ILCs satisfy the definition of banks under the Federal Deposit Insurance Act (which requires that these

firms' deposits be insured), they are not considered banks under the Bank Holding Company Act. This means that some activities that are prohibited for banks under the Bank Holding Company Act are permissible for ILCs. In particular, ILCs and their parent companies (unlike banks and bank holding companies) may engage in commercial activities, and their consolidated business may not be supervised by a federal banking regulator. Because of this distinction, ILCs have become a popular vehicle by which some companies enter the banking industry, and the FDIC has received an increasing number of applications for deposit insurance for ILCs. Additionally, the FDIC has

observed an increase in the number of notices of a change in bank control affecting ILCs.

The FDIC imposed a six-month moratorium on the consideration of applications by ILCs for deposit insurance or notices of change in control. During this period, the FDIC will study the risk ILCs may pose to the deposit insurance fund. The FDIC will also study whether ILCs should receive additional regulatory supervision in order to protect the deposit insurance fund. (For more information on the moratorium, see 71 *Federal Register*, pp. 43482-4.)

Credit Card and Debit Card Issuers Settle Foreign Currency Conversion Fee Case

Several large credit card and debit card issuers

agreed to pay \$336 million to settle a federal class-action lawsuit that claimed they broke antitrust and disclosure laws when charging customers for transactions denominated in foreign currency or with a foreign merchant. The \$336 million settlement will be used to compensate eligible holders of Visa, Interlink, Plus, MasterCard, Cirrus, and Maestro cards issued by the defendants (Visa, MasterCard, Bank of America, Bank One/First USA, Chase, Citibank, Diners Club, HSBC/Household, MBNA, and Washington Mutual/Provident). The settlement also requires new disclosures to be made by the defendants. On November 8, the United States District Court for the Southern District of New York granted preliminary approval of the settlement (MDL No. 1409, ML 21-95).

SUMMARY OF FEDERAL LEGISLATION

Enacted Legislation

1. Credit Rating Agency Reform Act of 2006 (S. 3850). Introduced by Sen. Shelby (R-Ala.) on September 6, 2006.

Status: Signed into law by President George W. Bush; Became Public Law No. 109-291.

This bill permits credit rating agencies (CRAs) to apply to become nationally recognized statistical rating organizations (NRSROs). Ratings issued by NRSROs carry particular weight in financial markets because they are sometimes referenced in regulations issued by the SEC and federal banking regulators.

A CRA's application must include any conflicts of interest that would interfere with its credit ratings, the method it uses to assign credit ratings, its record of past performance in assigning ratings, a list of its 20 largest customers (which is to remain confidential), and a description of the company's organizational structure. In order to be eligible to become an NRSRO, a CRA must have been in business for at least three years prior to applying. Within 90 days after a CRA submits its application, the SEC must either approve the firm's registration or notify the agency of its intent to deny the application, at which point the CRA may opt for a hearing to challenge the registration's denial.

An NRSRO is responsible for updating its registration as soon as any information included in its initial application becomes inaccurate — except for information about its performance metrics, which can be updated at the end of each year. At the end of each year, an NRSRO must certify to the SEC that all of the information in its application is accurate, and it must list all material changes that occurred in the past year to its performance metrics. The SEC is entitled to take action against any NRSRO found to derive credit ratings in a manner different from the method described in its application materials.

New Legislation

1. Industrial Bank Holding Company Act of 2006 (H.R. 5746). Introduced by Rep. Gillmor (R-Ohio) on July 10, 2006.

Status: Referred to the House Committee on Financial Services.

This bill requires all industrial bank holding companies to register with the Federal Deposit Insurance Corporation (FDIC) within 90 days of their creation. As part of their registration, industrial bank holding companies must submit information to the FDIC about their financial condition, ownership, operations, management, and intercompany relationships (of the holding company and its subsidiaries).

The bill also permits the FDIC to examine industrial bank holding companies and their subsidiaries. The FDIC may share the results of its exams with other federal and state regulators and, if it chooses, use the other regulatory agencies' examination reports in lieu of completing its own exams.

The bill prohibits industrial banks from being controlled by commercial firms, which are defined as companies that earned at least 15 percent of their consolidated gross annual revenue from nonfinancial activities in at least three of the four previous calendar quarters. Exemptions are provided, however, to industrial banks that existed before October 1, 2003, or those that had no change in control after September 30, 2003. Commercial firms will be exempted from this prohibition if they acquired an industrial bank holding company between October 1, 2003, and June 1, 2006; if they had no change in control after June 1, 2006; and if they did not acquire any other depository institution after May 31, 2006. These institutions will continue to be exempted as long as they do not expand their business

activities or the states in which they operate after May 31, 2006.

Pending Legislation

1. Internet Gambling Prohibition and Enforcement Act (H.R. 4411). Introduced by Rep. Leach (R-Iowa) on November 18, 2005.

Status: Passed by the House; Referred to the Senate.

This bill makes it illegal to engage in Internet gambling transactions that occur within, originate in, or culminate in the United States. The bill prohibits people from using the Internet to make bets, providing information to help others place bets, or arranging to receive compensation from those activities. Further, it makes it illegal to accept credit, electronic fund transfers, or checks as payment for placed wagers or for information that was given to assist other bettors. The bill instructs depository institutions to seize the funds from depository accounts that are owned by an illegal Internet gambling business, or if they include proceeds from or are used to fund illegal gambling transactions.

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

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

This bill 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. It also increases the loan limits for single-family mortgage insurance.

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 is an increase from the previous limit of 95 percent of the median home price. The home price also may 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 establishes a maximum up-front premium amount of 3 percent of the insured principal (or 2.25 percent for borrowers with a credit score of 560 or higher) and a maximum annual premium of 1 percent. Alternatively, a lender may charge the maximum annual premium amount of 2 percent (or 0.55 percent for borrowers with a

credit score of at least 560) and a maximum up-front premium of 1.5 percent. The bill also creates an incentive for borrowers to make timely payments by requiring the FHA to lower the annual premium to 0.55 percent for all borrowers who have submitted payments on time in each of the preceding five years.

The bill permits the FHA to insure loans that will help to rehabilitate one- to four-family residences. This insurance will be drawn from a new source, the Mutual Mortgage Insurance Fund, which will 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. 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 is declared a disaster area.

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

Status: Passed the House and the Senate.

This 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 (the Board) to establish a reserve ratio that is less than 3 percent (and which may be zero) for the portion of a bank's transaction accounts that are \$25 million or less. Currently, this ratio is fixed at 3 percent. The reserve ratio for the portion of a bank's transaction accounts in excess of \$25 million may be between 0 and 14 percent. Previously, the ratio could not be less than 8 percent.

The bill simplifies the way in which national banks pay dividends, stipulating that they may 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 streamline bank processes. First, federal banking agencies can 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 a bank 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.

Also of significance, a provision of the bill requires the Board and the Securities and Exchange Commission

to jointly issue a rule to define “broker” for banks’ broker-dealer registration requirements imposed by the Gramm-Leach-Bliley Act.

4. Financial Netting Improvements Act of 2006 (H.R. 5585). Introduced by Rep. McHenry (R-N.C.) on June 12, 2006.

Status: Passed the House and the Senate.

This bill would make it easier for companies to net out their debts on derivative contracts and reduce the risk of loss in the event of a counterparty going bankrupt. Counterparties to derivative contracts (such as swaps, forwards, and repurchase agreements) would be permitted to offset their obligations to one another in the event of one party’s failure.

5. John Warner National Defense Authorization Act for Fiscal Year 2007 (H.R. 5122). Introduced by Rep. Hunter (R-Calif.) on April 6, 2006.

Status: Passed the House and the Senate.

The 2007 military budget for the departments of Defense and Energy includes a provision that limits the amount of interest that lenders can charge military personnel and their dependents. Specifically, consumer loans to military personnel and their dependents may not have an annual percentage rate (APR) of more than 36 percent. Lenders must also disclose the APR and the expected payment obligations, as well as any other disclosures required by the Truth in Lending Act, before issuing credit to military personnel and their dependents.

The bill also prohibits lenders from charging prepayment penalties or requiring arbitration to settle disputes. Lenders cannot extend credit to repay or refinance another loan that the borrower has with the same creditor. In addition, creditors cannot access a borrower’s financial account or use the title of the borrower’s car to secure a loan. Finally, creditors cannot require borrowers to waive their right to legal recourse in order to obtain a loan.

SUMMARY OF FEDERAL REGULATIONS

Board of Governors of the Federal Reserve System

New Basel Capital Accord (9/25)

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (together, the Agencies) issued a proposed rule to implement the New Basel Capital Accord (Basel II). Among other things, the accord specifies international standards for setting the minimum amount of capital banks are required to hold against the risk of unexpected credit, market, or operational losses.

The proposed rule consists of three sections, or pillars. The second and third pillars establish standards for supervisory review and public disclosures by banks. These have not changed significantly from the August 2003 advance notice of a proposed rule (see *Banking Legislation and Policy*, July-September 2003). The first pillar, which governs banks’ minimum capital requirements, has changed in a number of important ways.

The proposed rule distinguishes between three categories of banks: “core” banks, “opt-in” banks, and all other banks. The first two categories of institutions will eventually calculate their minimum capital requirements using “advanced methods” that rely in part on risk parameters estimated by a bank’s internal models and data. The minimum capital requirements of the other banks will continue to follow the rules promulgated to implement the 1988 Basel Accord, but the agencies expect to make some modifications to those in a separate rule.

An institution is a core bank if it, or its holding company, has consolidated assets (excluding the assets of insur-

ance underwriting subsidiaries) of \$250 billion or more, or has a consolidated (on balance sheet) foreign exposure of \$10 billion or more. Core banks will be required to use advanced methods, subject to the approval of their primary supervisor. Banks may voluntarily opt in to the advanced methods, again subject to the approval of their supervisor. The agencies expect 11 of the largest internationally active banks to satisfy the definition of core banks and another 10 institutions to opt in.

Core and opt-in banks will eventually use advanced approaches to calculate their risk-weighted assets (the denominator of the minimum risk-based capital requirement ratio). The risks being measured include credit, market, and operational risk. Operational risk is defined as the risk of losses resulting from inadequate or failed internal processes, people, or external events, but excludes strategic and reputational risks.

Before adopting the advanced approaches, a bank must first develop an implementation plan. Opt-in banks may do this at any time, but core banks must adopt a plan within six months after the proposed rule is finalized. For these banks, the plan must incorporate a start date for the phase-in period (see below) and set a date for using its internal models within 36 months after the proposed rule becomes final. For at least four consecutive quarters, a bank would conduct a “parallel run,” calculating its required capital under the advanced approaches but remaining subject to the current risk-based capital requirements. A bank may not begin its parallel run prior to January 1, 2008.

The bank’s supervisor will determine when an institution is ready to use the advanced methods to calculate its required capital. This is followed by a three-step phase-in

period that limits the degree to which a bank may reduce its minimum capital requirements. In the first step the bank's risk-based capital requirement cannot be less than 95 percent of the existing risk-based capital requirements; in the second step the floor is relaxed to 90 percent; and in the third step it is reduced to 85 percent. Each step will last at least four consecutive quarters and a bank's supervisor will determine when it is ready to graduate to the next step.

Advanced Approaches

Under the advanced approach, risk-weighted assets will be calculated using parameters estimated from the bank's own models and data. The proposed rule departs significantly from the 2003 advance notice in that the minimum capital requirements for credit risk will be calculated to absorb *unexpected* losses up to the 99.9th percentile of the distribution of credit losses. Expected losses should be absorbed by the bank's reserves for loan losses. If the bank's reserves exceed its expected losses, it can credit the excess reserves equally to tier 1 and tier 2 capital, up to a limit of 0.6 percent of the bank's credit risk-weighted assets. If expected losses exceed the bank's loan loss reserves, the difference must be deducted equally from tier 1 and tier 2 capital.

There are several steps in the process of calculating a bank's risk-weighted assets. The bank first divides its exposures into four categories: wholesale (loans to corporate, individual, sovereign, or government entities), retail (residential mortgages, qualifying revolving loans, and other loans to consumers), securitization, and equity. Retail exposures will be assessed at the level of homogeneous risk groups, while wholesale exposures are evaluated at the level of individual obligors (for the probability of default) and individual exposures (for loss given default and other parameters). Ratings for individual wholesale obligors must be reviewed at least once a year. The assignment of individual retail exposures to risk segments must be reviewed at least quarterly.

Thus key ingredients in the calculations are the bank's segmentation of obligors into different categories of risk and the resulting estimates of several risk parameters: probability of default (PD), exposure at default (EAD), expected loss given default (ELGD), loss given default (LGD), and in some instances an adjustment (M) for the remaining maturity of the exposure. These estimated parameters are used as inputs in a set of formulas provided by agencies to calculate the bank's minimum capital requirements.

Probability of default is the long-run average one-year default rate for obligors (wholesale exposures) or the risk segment (retail exposure) that is estimated over a mix of economic conditions (including an economic downturn). The minimum amount of data required to estimate this parameter is five years.*

Exposure at default is the value of an exposure (including interest and fees) at the time of default. EAD should reflect an estimate of any additional principal drawn before the default would occur during a period of economic

downturn. For wholesale exposures, the minimum amount of data required to estimate this, and the other loss parameters, is seven years, including a period of economic downturn. For retail exposures, five years of data, including a period of economic downturn, are required to estimate these loss parameters.

Expected loss given default is the percentage of exposure at default expected to be lost in a default within one year. This parameter is estimated over a mix of economic conditions, including a period of economic downturn. ELGD is used to calculate expected credit losses, which are compared to the level of the bank's reserves. In contrast, loss given default is an estimate of the percentage of exposure at default expected to be lost in a default within one year during a period of economic downturn. LGD is used in the calculation of unexpected losses that are incorporated in the minimum capital formulas.

To calculate risk-based capital for operational risk, banks will be required to use the advanced methods approach (AMA), which allows them to use their own internal operational risk management systems to assess exposure to operational risk. The proposed rule gives banks a lot of flexibility in calculating their operational risk and does not require them to use a specific methodology. However, they will be required to demonstrate their systems' accuracy by producing an estimate of operational risk exposure that meets a one-year, 99.9th percentile soundness standard. Banks must estimate both expected and unexpected operational loss.

The proposal also contains details about disclosures required under Pillar III of the accord. These include details on the design of the bank's internal models, the resulting parameter estimates, and a comparison of previous estimates with actual outcomes.

Comments on this proposed rule are due January 23, 2007. For more information, see 71 *Federal Register*, pp. 55829-78.

Bankers' Banks (8/14)

The Board of Governors of the Federal Reserve System (the Board) issued a proposed rule that expands the range of customers with which bankers' banks may do business. Bankers' banks are a special type of depository institution with a limited range of customers — other depository institutions.

Bankers' banks are entitled to different regulatory treatment. For example, they are exempt from reserve requirements. To qualify for this exemption, these banks must be organized to do business solely with financial institutions, be owned primarily by the financial institutions with which they do business, and must not do business with the general public. In the past, the Board has issued

* For this and all the other parameters, if a bank's data do not include a period of economic downturn, the estimates must be adjusted to take this into account.

interpretations of this rule to clarify what types of customers are permissible, including subsidiaries of depository institutions and directors, officers, or employees of depository institutions.

The Board proposes to expand this definition by allowing certain other categories of customer on a case-by-case basis, as long as not more than 25 percent of a bank's capital is owned by nondepository institution customers and its business with nondepository institution customers is not more than 10 percent of its total assets and liabilities.

Comments on this proposed rule were due September 13. For more information, see 71 *Federal Register*, pp. 46411-2.

Electronic Fund Transfers (8/30)

The Board of Governors of the Federal Reserve System (the Board) issued an interim final rule to revise Regulation E, which implements the Electronic Fund Transfer Act. The rule requires merchants to notify check-paying customers at the point of sale if they plan to collect fees for insufficient funds electronically. A customer can then decide whether to engage in the transaction. Beginning in 2007, merchants must post this notice in a prominent place near the register and provide a copy to the customer. Also, beginning in 2008, the notice must disclose the dollar amount of the insufficient funds fee and an explanation of how the fee is calculated.

This interim final rule becomes effective on January 1, 2007. Comments on it were due September 19. For more information, see 71 *Federal Register*, pp. 51451-7.

Payroll Cards (8/30)

The Board of Governors of the Federal Reserve System (the Board) issued a final rule to clarify that payroll card accounts are subject to Regulation E, which implements the Electronic Fund Transfer Act. A payroll card is generally a magnetic-stripped card, similar to a credit card, that is "loaded" with an employee's wages. Employees can use the card to withdraw money at automated teller machines or to make purchases at the point of sale, in the same manner as they use debit or credit cards. These payroll cards can be managed by the employer, a third-party payroll processor, or a depository institution.

The final rule permits depository institutions to have some flexibility in providing account information to payroll cardholders. Depository institutions need not provide periodic account statements if they make account information available via telephone, provide Internet access to information on the most recent 60 days of account activity, and provide written copies of this information at the request of the account holder. Employers and third-party service providers are not subject to these rules as long as they do not hold the accounts or provide electronic fund transfer services to account holders.

Payroll cardholders may report errors in their account summaries up to 60 days after they electronically access the account (provided the error is reported at that time) or after

they receive a written history that includes the error. If a financial institution is unable to track when the customer electronically accesses his or her account, the institution must allow the customer to report errors for up to 120 days after the error is reported.

This final rule becomes effective on July 1, 2007. For more information, see 71 *Federal Register*, pp. 51437-51.

Office of the Comptroller of the Currency

Identity Theft Red Flags (7/18)

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, the National Credit Union Administration, and the Federal Trade Commission (together, the Agencies) issued a proposed rule to help financial institutions and creditors detect instances of identity theft.

All financial institutions and creditors are required to develop identity theft prevention programs to help them recognize and investigate red flags—patterns, practices, and activities—that indicate the possible risk of identity theft. Red flags include fraud and active duty alerts appended to a consumer's credit report, an address discrepancy, a pattern of activity that is inconsistent with the customer's usual activity, an increased volume of credit inquiries, or other suspicious patterns. The program must list procedures for spotting identity theft red flags, evaluating which red flags present the most risk to the firm's accounts, and mitigating the risks posed by the red flags.

In its mitigation procedures, the firm must explain how it will verify the identity of a person opening an account, check for red flags, and determine whether the red flag is evidence of identity theft. An institution should address the risk of identity theft by monitoring the account, contacting the customer, considering changing the password or security code, assigning a new account number, or closing the account.

If the financial institution contracts with a service provider to handle the account on its behalf, the firm must ensure that the service provider complies with the firm's identity theft prevention program. The firm's board of directors or senior management must oversee the development and implementation of its identity theft prevention program, and the board must be given an annual report that evaluates the effectiveness of the program.

The rule also requires firms to verify their customers' identities if a consumer reporting agency notifies the firm of a discrepancy between the address the customer provided and the address on file with the consumer reporting agency. If the firm verifies the customer's identity, it is required to furnish the correct address, as confirmed by the customer, to the consumer reporting agency that notified it of the discrepancy.

Comments on this proposed rule were due September 18. For more information, see 71 *Federal Register*, pp. 40786-826.

Gift Card Disclosures (8/14)

The Office of the Comptroller of the Currency (OCC) issued a guidance to national banks about gift card marketing and disclosures. The guidance divides gift cards into two main categories: retail gift cards, which are offered by a retailer and can be used only at establishments owned by that retailer, and bank-issued gift cards, which generally bear the logo of a payment card network, such as Visa or MasterCard, and can be used wherever the payment card is accepted. Because a gift card is not ordinarily used by the person who bought it, gift-card-issuing banks must ensure that the disclosures are clear to the recipient.

Basic information should be included on the card and should disclose the card's expiration date, the amount of any maintenance or other fees, and a way in which the recipient can receive more information about the card. Other important disclosures, such as the name of the issuing bank or how to receive a replacement card, should be included on material that is designed to be given with the card, such as its packaging. National banks should also avoid deceptive marketing claims, such as claiming a card has no expiration date when it has service and maintenance fees that are, in effect, the same as having an expiration date.

For more information about this guidance, see the OCC's bulletin, *OCC 2006-34*.

FACTA Information Collection (8/31)

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, the National Credit Union Administration, and the Federal Trade Commission (together, the Agencies) issued a notice of their plan to assemble a panel of creditors and other users of consumer reports. The Agencies plan to survey the panel about their information-sharing habits every three years. The Agencies are required by the Fair and Accurate Credit Transactions Act (FACTA) to study the information-sharing practices of financial institutions and creditors (for more information about FACTA, see *Banking Legislation and Policy*, October-December 2003). The Agencies will choose the panel based on factors that include whether a potential respondent has affiliates with which it can share information and whether it is likely to use credit reports.

Comments on this notice were due October 30. For more information, see 71 *Federal Register*, pp. 51888-91.

Federal Deposit Insurance Corporation

Deposit Insurance Assessments (7/24)

The Federal Deposit Insurance Corporation (FDIC) issued a proposed rule to make deposit insurance assessments more sensitive to risk. Currently, the FDIC places depository institutions into one of only three categories of risk based on their leverage and risk-based capital ratios: "1" for well capitalized, "2" for adequately capitalized, or "3" undercapitalized. Then the FDIC uses

information provided by the depository institution's primary regulator to divide the categories into subgroups, with "A" assigned to financially sound organizations with a few weaknesses, "B" to institutions with weaknesses that, if not corrected, could put the deposit insurance fund at increased risk, and "C" to institutions that have a high probability of loss to the insurance fund unless corrective action is taken. This system allows for a total of nine risk categories, with a 1A bank being the least risky and a 3C bank being the most risky. These levels of risk are then used to calculate deposit insurance assessments.

The FDIC proposes to change this method of deposit insurance assessment. First, the nine categories of risk will be reduced to four, designated I, II, III, and IV. These categories generally correspond with the old categories, with I being the same as the 1A category under the old system; II consisting of the old 1B, 2A, and 2B categories; category III comprising the old 3A, 3B, 1C, and 2C categories; and category IV matching the old 3C category.

Within category I, the FDIC proposes separate ways of determining risk for small and large institutions, as long as they have been in existence for at least seven years. (For the purposes of this rule, an institution will be considered large if it has at least \$10 billion in total assets.) For small institutions, the FDIC proposes to use the institution's CAMELS* rating and its current financial ratios to determine its assessment rate. For large institutions, the FDIC will use the CAMELS rating plus its long-term debt issuer ratings and financial ratios to determine the appropriate assessment rate. New institutions (those that have been in existence for less than seven years) will be assessed at the maximum rate applicable to category I institutions.

The FDIC published a base schedule of assessment rates but acknowledged that the actual rates put into effect may vary. The FDIC proposes that the base assessment rate for category I institutions would be a minimum of two basis points and a maximum of four basis points; for category II institutions, the rate would be seven basis points; for category III, 25 basis points; and for category IV, 40 basis points. The FDIC retains the right to adjust rates uniformly up to a maximum of five basis points higher or lower than the base rates.

Comments on this proposed rule were due September 22. For more information, see 71 *Federal Register*, pp. 41910-76.

Industrial Loan Companies (8/23)

The Federal Deposit Insurance Corporation (FDIC) issued a notice that it is accepting comments on industrial loan companies (ILCs) and industrial banks, including the benefits, any detrimental effects, risks, and supervisory is-

* CAMELS is an acronym for component ratings assigned in a bank examination: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. A composite CAMELS rating combines these component ratings and can range from 1, the best rating, to 5.

sues associated with the industry. The FDIC is concerned that because of their special regulatory treatment, ILCs may pose additional risk to the deposit insurance fund. In addition to seeking comments on the industry, the FDIC also imposed a six-month moratorium on ILC applications and notices of change in control (see the *Recent Developments* section of this publication) in order to examine the risks posed to the deposit insurance fund.

Comments on this notice were due October 10. For more information, see 71 *Federal Register*, pp. 49457-9.

Deposit Insurance (9/12)

The Federal Deposit Insurance Corporation (FDIC) issued a final rule to change insurance coverage amounts for some deposits. First, the rule allows the maximum deposit insurance amount (currently \$100,000) to be adjusted for inflation using a cost-of-living adjustment every five years beginning on April 1, 2010. Next, the rule increases the deposit insurance limit from \$100,000 to \$250,000 for some retirement accounts. Accounts eligible for the increased insurance include traditional individual retirement accounts, self-directed defined contribution plan accounts, deferred compensation plan accounts, and Keogh plan accounts, which are designed for the self-employed. All IRA products must be held in the form of deposits at FDIC-insured depository institutions to be eligible for FDIC deposit insurance coverage. The rule also provides per-participant coverage to employee benefit plan accounts, even if the depository institution at which the deposits are placed is not authorized to accept employee benefit plan deposits.

This final rule became effective on October 12. For more information, see 71 *Federal Register*, p. 53547.

Office of Thrift Supervision

Second-Tier Operating Subsidiaries (7/20)

The Office of Thrift Supervision (OTS) issued a legal opinion that federal preemption of state licensing, registration, and lending laws would apply to a federal savings association's second-tier operating subsidiary to the same extent that they are applicable to the savings association. The opinion came in response to a thrift's inquiry about whether its newly developed second-tier mortgage company subsidiary could export its home state's interest rates under the "most favored lender" provision of the Home Owners' Loan Act.

The OTS ruled that as long as the subsidiaries are approved as operating subsidiaries by the OTS, they are granted the same rights and privileges as their savings association parent. (Operating subsidiaries may only engage in activities that are permissible for savings associations.) For that reason, the OTS affirmed that a savings association's second-tier subsidiary may export its home state's interest rates to other states, regardless of the other states' interest rate laws.

For more information about this ruling, see OTS legal opinion P-2006-6.

Financial Accounting Standards Board

Fair Value (9/15)

The Financial Accounting Standards Board (FASB) issued a statement clarifying the definition of fair value and expanding the disclosures about fair value measurements. According to the statement, fair value should be interpreted as the market's "exchange price" for the asset or liability. In other words, an asset's fair value is the price that the company would expect to receive if it sold it, and a liability's fair value is the price a company would expect to pay to transfer it. These are known as the exit prices.

To determine fair value, a firm may need to take into account factors likely to affect the willingness of market participants to engage in transactions. In order of preference, a company may use observable inputs (based on market data obtained from independent sources), followed by unobservable inputs (the reporting entity's own assumptions) when there is little market activity to account for these factors. For example, expected sale prices should reflect the concerns of market participants about risk or any restrictions on the sale of an asset. Firms should use these assumptions to make adjustments to the fair market value of an asset or liability if market participants would do so in pricing the asset or liability.

Fair value disclosures must focus on the inputs used to determine the fair value, especially for unobservable inputs, which are not derived independently. In particular, companies must disclose changes in their valuation of net assets that are due to a modification in the assumptions about factors that are not observable in market data.

This guidance is applicable to all financial statements issued for fiscal years beginning after November 15, 2007. For more information, please see the full statement at www.fasb.org/pdf/fas157.pdf.

Supreme Court Will Review Case on Insurance Adverse Action Notices

On September 26 the U.S. Supreme Court agreed to review a case involving an insurance company's failure to notify a customer that he was being charged a higher rate for his insurance policy because of his credit score (*GEICO General Insurance Co. v. Edo*, No. 06-100). The case stems from plaintiff Ajene Edo's claim that his insurance company, GEICO Casualty Company, charged him more for his insurance policy because of his credit information. Edo claims that GEICO violated the Fair Credit Reporting Act (FCRA) when it failed to notify him of this "adverse action" taken in response to information found in his credit report. GEICO claimed that it did not violate the law because Edo was charged the standard rate, even though a better credit history might have led to his receiving a better rate. So, in effect, GEICO argued that Edo's credit information had no effect on his rate, rather than having either a positive or negative effect.

The U.S. Court of Appeals for the Ninth Circuit ruled in favor of Edo, saying that an insurance company is required to send a notice to a customer any time it charges a higher rate because of information contained in a credit report, regardless of whether the rate is charged in the initial policy or whether the company has previously charged the same rate. In other words, as long as a more favorable rate could be obtained by having more favorable credit information, an insurance company must notify the consumer. GEICO appealed this ruling, and the Supreme Court agreed to review the case to determine whether the Ninth Circuit inappropriately expanded the FCRA's requirements.

A Presenting Bank Must Indemnify an Issuing Bank for Altered Checks, Even When the Original Check Has Been Destroyed

The U.S. Court of Appeals for the Seventh Circuit ruled that a bank whose customer alters a check must indemnify the bank whose customer wrote the check, even if the original check has been destroyed and cannot be examined for signs of alteration (*Wachovia Bank v. Foster Bancshares*, No. 05-3703). Wachovia Bank sued Foster Bank after one of Foster's customers, Sunjin Choi Choi, fraudulently deposited into her personal account a check for \$133,026. The check was written by one of Wachovia's customers, and it did not name Choi as the payee. Wachovia Bank filed a suit to request that Foster Bank indemnify Wachovia for the amount of the check.

The Uniform Commercial Code says that when a bank (Foster, in this case) presents a check for payment, it warrants to the issuing bank (Wachovia) that the check has not been altered. Foster argued, however, that Wachovia could not prove the check was altered because it destroyed the original check and replaced it with an electronic image of the check. Therefore the court had to consider whether the check was most likely altered, in which case Wachovia

would win, or forged, which would make Foster Bank the winner.

The court ruled that because changing the payee's name is the most common form of alteration, the check was most likely altered instead of forged. Further, the court noted that Foster Bank could have taken precautionary measures given the size of the check, including temporarily banning withdrawal of the funds until an investigation could verify the legitimacy of the check. Instead, because Foster could not show any reason to believe the check had been forged, the court ruled that Foster must indemnify Wachovia for the check as though it were altered.

State Laws Are Preempted for National Banks and Their Operating Subsidiaries

The U.S. Court of Appeals for the Fourth Circuit ruled that a national bank's real estate lending subsidiaries are not subject to state laws (*National City Bank of Indiana v. Turnbaugh*, No. 05-1647). National City Bank of Indiana is a national bank with two operating subsidiaries that make real estate loans in Maryland, some of which are adjustable rate mortgage (ARM) loans with prepayment penalties. When the Maryland commissioner of financial regulation received complaints about these loans, he notified the subsidiaries that prepayment penalties on ARMs are prohibited by the Maryland Mortgage Lender Law. However, National City argued that Congress permits only the Office of the Comptroller of the Currency (OCC) to regulate national banks and their subsidiaries. Further, the OCC permits national banks to charge prepayment penalties on ARM loans.

National City Bank sued the commissioner, claiming that its subsidiaries, National City Mortgage and First Franklin Financial, were not subject to Maryland's state laws for two reasons. First, the Maryland law in question conflicts with federal law, meaning the state law is preempted for national banks. Second, because the law is preempted for national banks, it must also be preempted for the national banks' subsidiaries, because the OCC ruled that national bank subsidiaries are subject to state laws to the same extent as their national bank parents are. The court agreed with National City Bank, saying that the Maryland law is preempted for national bank subsidiaries.

A Check Issuer Can Sue a Depository Bank For Negligence

The Maryland Court of Appeals, Maryland's highest court, ruled that an issuer of a check can sue a depository bank for negligence even if the issuer is not a customer of the bank (*Chicago Title Insurance Co. v. Allfirst Bank*, No. 80). The case was brought by First Equity, which settled the mortgage refinancing of Mark Shannahan in 1997. In settling the refinancing, First Equity issued two checks to Shannahan, one to cash out the equity in his home, and the other made payable to Farmers Bank to pay off the re-

maining balance on his mortgage. Shannahan took both checks to Farmers Bank and deposited them in his personal account, but he never paid off his existing mortgage with Farmers. First Equity later became aware that Farmers still had a lien on Shannahan's home, and it sued Farmers for allowing Shannahan to deposit a check that was not made payable to him into his personal account. Farmers argued that First Equity's lawsuit was prohibited by Maryland's Uniform Commercial Code, which does not allow common law actions.

The Maryland Court of Appeals ruled that the suit was permissible because the Uniform Commercial Code barred suits of conversion but did not address suits of negligence. The court went on to say that Farmers could be found to be negligent in its dealings with First Equity even though it did not have any direct or indirect contract relationship. If a court concludes that an "intimate nexus" existed between the parties and that Farmers' actions resulted in economic loss to First Equity, Farmers could be found negligent.

SUMMARY OF THIRD DISTRICT DEVELOPMENTS

New Jersey—The New Jersey Supreme Court published two opinions in the third quarter that dealt with mandatory arbitration clauses in contracts involving consumers. In the first case (*Muhammad v. County Bank of Rehoboth Beach*, No. A-39-05), the plaintiff, Jaliyah Muhammad, obtained a short-term \$200 loan from County Bank of Rehoboth Beach, Delaware. The loan carried a \$60 finance charge (an APR of 608.33 percent), which when extended twice resulted in the plaintiff's paying \$180 in finance charges. Before accepting the loan, Muhammad signed an agreement to individually arbitrate all disputes and not to bring, join, or participate in class actions. However, in 2004 Muhammad filed a class-action lawsuit against County Bank, claiming that it had charged illegal interest rates. Although the plaintiff acknowledged that he had signed the agreement to submit to mandatory individual arbitration, he argued that the arbitration clause was unconscionable. The Supreme Court agreed with the plaintiff, reversing rulings by two lower courts, and held that the contract's prohibition of classwide arbitration is unconscionable and unenforceable. The court made one additional argument against the enforceability of the contract. It concluded the contract was "adhesive," meaning that the binding arbitration clause was presented as a "take-it-or-leave-it" offer, and it left no room for the plaintiff to negotiate.

The second opinion (in *Delta Funding Corp. v. Harris*, No. A-44-05) was written as a companion to *Muhammad v. County Bank*. In this case, Delta Funding Corp. extended a mortgage loan to plaintive Alberta Harris, an elderly

woman with little financial sophistication. In agreeing to the loan, Harris consented to allow either party to elect binding arbitration to resolve any claims. After Harris obtained the loan, which was for \$37,700 with a 14 percent APR, she soon found herself unable to make the payments. In the meantime, Delta transferred the loan to Wells Fargo. Wells Fargo initiated foreclosure proceedings, and Harris responded with a third-party complaint against Delta that alleged violations of the Truth in Lending Act. Delta then moved to compel arbitration.

The New Jersey Supreme Court found that Harris's loan contract contained two clauses that are ambiguous and could be unconscionable and unenforceable, depending on how they are interpreted by an arbitrator. The first clause requires each party to bear its own fees and costs, no matter who prevails. The court ruled that if this clause served to prevent Harris from recovering discretionary fees and costs that are available under the Real Estate Settlement Procedures Act, then it is unconscionable. The second clause requires the appealing party to bear the costs of an appeal regardless of its outcome. The court ruled that this, too, could be unconscionable if it would prevent Harris from being awarded costs if she won her appeal, or if it required her to pay all of the costs if she lost the appeal. The court went on to say that if an arbitrator found these clauses unconscionable, the remainder of the contract could still be enforceable as long as these clauses were severed from the contract.

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