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HIGHLIGHTS

This issue contains detailed descriptions of the following developments:

- Legislation to reform the regulation of housing finance government-sponsored enterprises
- Subprime mortgage lending regulation and legislation
- Revisions to Regulation Z—improving the disclosure of the terms of credit cards and other open-end consumer credit
- Supreme Court ruling on Watters v. Wachovia Bank N.A.—OCC preemption of state law applies to national banks' mortgage subsidiaries

In addition to these descriptions, it summarizes other notable legislative, regulatory, and judicial developments that occurred during the second quarter of 2007.

Government-Sponsored Enterprise Reform

On May 22, the House of Representatives passed the Federal Housing Finance Reform Act of 2007 (H.R. 1427), a bill that would create a new regulator for housing finance government-sponsored enterprises (GSEs). This new regulator, the Federal Housing Finance Agency (FHFA), would oversee the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the 12 Federal Home Loan Banks. The Bush administration expressed support for the House bill before it was passed, although an amendment limiting the proposed regulator's power may have jeopardized that support. A separate bill to reform GSE regulation (S. 1100) was also pending in the Senate but, as of June 28, had not moved beyond the Committee on Banking, Housing, and Urban Affairs.

Background

A government-sponsored enterprise is a hybrid of a private-sector business and a government organization. GSEs are federally chartered and thus possess some special privileges and responsibilities, but they are privately owned, for-profit firms. They were chartered separately by Congress throughout the 20th century to generate liquidity in targeted capital markets by issuing stock and debt instruments, guaranteeing mortgage-backed securities, and purchasing and holding loans, among other activities. In particular, GSEs are intended to improve efficiency and enhance the flow of credit to the agriculture, home finance, and education sectors.

Seven GSEs exist today. Fannie Mae, which was established in 1938 as part of the New Deal, purchases home mortgages and then repackages and resells them as securities. Freddie Mac was established in 1970 to compete against Fannie Mae and weaken its monopoly power. Since their establishment in 1932, the 12 Federal Home Loan Banks have provided funds to financial institutions to issue mortgages and conduct other types of economic development lending. The Federal Agricultural Mortgage Corporation, also called Farmer Mac, was established in 1988 to generate a secondary market for agricultural loans. The Farm Credit System, which has been evolving since the early 20th century, makes agricultural loans through a network of borrower-owned cooperative financial institutions. Two additional GSEs, the Financing Corporation and the Resolution Funding Corporation, are not operating companies and were established for federal budget purposes. Sallie Mae, the largest student lender in the United States, was another major GSE until it became a fully private company in 2004.

The Federal Home Loan Banks and the Farm Credit System are owned cooperatively by their borrowers; all other GSEs are owned by private investors. Each GSE is governed by a board of directors with a privately elected majority, and its employees are employed by the company itself, rather than by the federal government, allowing the corporation significant operational flexibility.

Despite a relatively high level of operational independence, GSEs' federal charters limit their activities and direct their objectives. The companies are also linked to the government through some benefits they receive. For example, both Fannie Mae and Freddie Mac are authorized to borrow up to $2.25 billion from the Treasury. Neither of the two is required to pay local or state taxes, nor are they required to register their securities dealings with the Securities and Exchange Commission, although Fannie Mae did so voluntarily in 2003.

It is important to note that the privileges provided by the federal government do not include any explicit backing of GSEs' liabilities. Nonetheless, many investors perceive the companies' federal charters as an implicit federal guarantee, and, as a result, GSEs are able to borrow money at significantly lower interest rates than can fully private companies. This advantage generates a large effective subsidy for GSEs, which the Congressional Budget Office valued at $13.6 billion for the year 2000 alone.[1] The GSEs do not actually receive any federal funds—the subsidy comes only from investors' perception of their elevated creditworthiness.

The housing finance GSEs are regulated by a few different agencies. The Office of Federal Housing Enterprise Oversight (OFHEO), an independent branch of the Department of Housing and Development (HUD), examines Fannie Mae and Freddie Mac for financial soundness, sets risk-based capital standards, and monitors executive compensation, among other duties. HUD itself further ensures that the companies' activities remain in line with their stated missions, sets affordable housing goals, and approves new programs. In addition, Fannie Mae has been required to file periodic financial disclosures with the Securities and Exchange Commission since it registered its common stock with the agency in March 2003. The Federal Home Loan Banks are supervised by the Federal Housing Finance Board (FHFB), which replaced the Federal Home Loan Bank Board in 1989 in the wake of the savings and loan crisis.

While GSEs have done much to increase liquidity and credit flow in targeted sectors, they are also the subject of some public concern for several reasons. First, there is potentially a strong tension between a GSE's public policy goals and the profit-seeking objectives of its private employees. For example, Fannie Mae's major

[1] Dan L. Crippen, CBO Director, Testimony before Congress, May 23, 2001.

charter objective, facilitating homeownership for lower-income families, could clash with its management's financial responsibility to shareholders. Second, some fear that the large size of GSEs poses an unacceptable risk to the financial system. Fannie Mae and Freddie Mac's combined debt outstanding, which totaled $2.9 trillion in 2006, is widely held, both domestically and overseas, and some observers fear that the failure of a large GSE could have severe and widespread economic effects.[2] Third, some critics believe that the effective subsidy to GSEs gives them an unfair advantage over private firms and could reduce market efficiency. Recent accounting scandals have also strengthened demand for tighter GSE regulation.

Federal Housing Finance Reform Act of 2007 (H.R. 1427)

The Federal Housing Finance Reform Act was introduced in the House of Representatives on March 9 by Rep. Barney Frank (D-Mass.). The bill's co-sponsors include Rep. Richard Baker (R-La.), Rep. Gary Miller (R-Calif.), Rep. Melvin Watt (D-N.C.), Rep. Carolyn Maloney (D-N.Y.), and Rep. Lee Terry (R-Neb.), and it was passed on May 22 by a vote of 313-104. The version of the bill that the House passed also included a few significant amendments that were approved after lengthy debate.

The bill would eliminate the OFHEO and the FHFB and replace them with the Federal Housing Finance Agency (FHFA), which would become a consolidated regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The FHFA would set and enforce standards for the GSEs' internal controls and audits, risk management, and executive oversight. The FHFA's director would also be required to establish and revise risk-based capital requirements for the companies, as well as standards to ensure that their portfolio holdings and rates of growth are consistent with their mission and financial soundness. The GSEs would be required to investigate and report potentially fraudulent loans to the FHFA and to establish programs to include women and minorities in their business activities, among other measures.

The bill would also alter the conforming loan limit, which is a ceiling on the size of the mortgages that Fannie Mae and Freddie Mac are permitted to buy. In most areas of the U.S., the conforming loan limit for 2007 is $417,000. In Alaska, Hawaii, and Guam, the limit is 150 percent of that of the rest of the country, based on the assumption that building costs will be higher because of the areas' remoteness. H.R. 1427 would increase the conforming loan limit in metropolitan areas with high housing prices in an attempt to equalize the distribution of GSEs' benefits. Under the bill, the conforming loan limit in high-cost areas—those with housing prices higher than the national median—would equal the lesser of (1) 150 percent of the current foregoing limit or (2) the median price in the area. Using 2006 data, it appears that the limit would rise mostly in California, the New York City area, and the Washington, D.C., area.

One of the most controversial aspects of H.R. 1427 is the inclusion of an affordable housing fund provision. Each year until 2011, the bill would require Fannie Mae and Freddie Mac to contribute 1.2 basis points of the average value of their mortgage portfolios to the grant-making fund, which would aim to increase homeownership among lower-income families, as well as housing investment and supply in lower-income areas. In the first year, revenues from the fund would be distributed to victims of hurricanes Katrina and Rita. Some members of Congress vigorously objected to the fund's inclusion in the bill, and several of the amendments that were proposed during debate would have eliminated or modified it, but the amendments were defeated and the bill

[2] Office of Federal Housing Enterprise Oversight, Report to Congress, 2007.

includes the affordable housing fund measure in its original form.

On May 22, the House approved an amendment proposed by Rep. Tom Price (R-Ga.) that would require the occupants of homes built using contributions from the affordable housing fund to prove that they are legal residents of the United States. The House also approved an amendment by Rep. John Doolittle (R-Calif.) that would bar GSEs from purchasing a mortgage held by anyone without a Social Security number. Finally, the House approved an amendment that would allow the FHFA to restrict the size of a GSE's portfolio based only on risk to the GSE's own safety and soundness, rather than on risk to the greater financial system. Some predicted that this amendment, which was proposed by Rep. Melissa Bean (D-Ill.) and Rep. Randy Neugebauer (R-Texas), would jeopardize crucial White House support for the bill.

Federal Housing Enterprise Regulatory Reform Act of 2007 (S. 1100)

On April 12, Sen. Chuck Hagel (R-Neb.) introduced the Federal Housing Enterprise Regulatory Reform Act of 2007 (S. 1100), a bill similar in some ways to that passed by the House. Like the House bill, this proposal would establish a new, consolidated regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. This regulator, the Federal Housing Enterprise Regulatory Agency (FHERA), would ensure that the housing finance GSEs operated in a sound manner, adhered to their missions, and maintained adequate levels of capital. The FHERA would also be authorized to request periodic reports from the GSEs, and GSEs would be required to report fraudulent loans.

Unlike the House proposal, however, the Senate bill does not require specific contributions to an affordable housing fund. Instead, it requires only that the GSEs' portfolios focus "to the maximum extent possible" on mortgages that will meet their affordable housing objectives. The Senate bill would not raise the conforming loan limit for high-cost areas, but it would call for the Government Accountability Office to study the effectiveness of potentially doing so in the future.

Subprime Mortgage Lending Regulation and Legislation

In recent months, the subprime mortgage market has attracted significant regulatory and legislative attention. While subprime lending has created new opportunities for homeownership among underserved communities, it has also increased the risk of default and foreclosure among homeowners, which has in turn jeopardized the financial stability of subprime mortgage issuers; several major lenders have recently failed or filed for bankruptcy. In addition, as nontraditional subprime mortgages have become more popular, policymakers fear that some borrowers might not fully understand these products or be able to repay their obligations.

On May 31, several federal regulatory agencies issued a set of illustrations designed to help potential borrowers understand the terms and consequences of nontraditional mortgage products. The agencies also released on June 29 a final Statement on Subprime Mortgage Lending, which sets guidelines to help banks offer adjustable-rate mortgage products "in a safe and sound manner" and clarifies the agencies' expectations for disclosures to borrowers.

In the Senate, two major bills that would affect the subprime market are currently pending. The Borrowers' Protection Act (S. 1299), introduced by Sen. Charles Schumer (D-N.Y.), would increase mortgage brokers' responsibilities to borrowers and require them to examine more diligently borrowers' ability to repay their loans. Sen. Jack Reed's (D-R.I.) Homeownership Protection and Enhancement Act (S. 1386) would strengthen consumer disclosure requirements and attempt to prevent foreclosures by establishing state

counseling agencies to assist homeowners in default.

In addition, a bill to prevent housing foreclosures (H.B. 1083) was introduced in the House of Representatives of the Pennsylvania General Assembly on April 18. It was forwarded to the Committee on Commerce and awaits further action.

Background

By their simplest definition, subprime mortgages are mortgages issued to consumers with weak credit histories. More specifically, a mortgage is often considered subprime when the borrower exhibits one or more of the following characteristics: a history of recent payment delinquencies; a judgment, foreclosure, repossession, or chargeoff within the past two years; one or more bankruptcy filings in the past five years; a low credit score; or a high debt-service-to-income ratio. The prevalence of subprime mortgages has been rising in the United States since the mid-1990s—they comprised about 5 percent of mortgage originations in 1995, and by 2005, that proportion had risen to about 20 percent.

The rise of subprime lending has had some positive effects. Many subprime borrowers probably would not have been able to obtain mortgages at all 10 or 15 years ago due to their perceived lack of creditworthiness. By giving these consumers access to credit, subprime lenders have broadened access to homeownership, particularly among the elderly and minorities, two historically underserved segments of the population.

On the negative side, however, the mortgages have increased subprime borrowers' debt burdens, and the rate of foreclosure has risen significantly in some sectors of the market. Between 1998 and 2006, at least 3 percent of subprime loans were in foreclosure, over three times the proportion of prime loans that were in foreclosure during the same period. There is also a risk that subprime lending can be predatory when the borrower either does not understand the loan terms or is unaware of the alternative products available.

Of special concern to policymakers is the complexity of some mortgage products that subprime lenders frequently offer. These mortgages, in contrast to standard fixed-rate products, often feature changing monthly payment amounts and interest rates. One of the most popular types of nontraditional mortgage products is the so-called 2/28 or 3/27 mortgage, which features a relatively low, fixed interest rate for the first two or three years of repayment. After that period is over, the interest rate becomes adjustable, which can increase borrowers' monthly payments significantly over the mortgage's remaining decades. In many cases, subprime borrowers do not adequately understand how the interest rates that will be used to set their adjustable rates behave.

Under an interest-only mortgage, which is a type of nontraditional loan sometimes offered to subprime borrowers, the first payments cover only the loan's interest. Later, when the borrower begins to pay off the loan's principal, payments rise. Similarly, negative amortization loans allow borrowers to start out paying less than the current interest due, but later in the loan's term payments rise significantly. Finally, payment option mortgages allow borrowers to choose between a few different types of payments, such as a principal and interest payment, an interest-only payment, or a small minimum payment, each month during the first few years of the mortgage. After this period is over, borrowers may have to increase their monthly payments in order to compensate for small payments made during the initial period.

Federal Regulation

Illustrations of Consumer Information for Nontraditional Mortgage Products

On May 31, the Office of the Comptroller of the Currency, the Federal Reserve Board of

Governors, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration released final illustrations to help consumers understand nontraditional mortgage products. The three illustrations are intended to help lending institutions implement the consumer protection measures that were included in the Interagency Guidance on Nontraditional Mortgage Product Risks,[3] which was issued in October 2006. On the same day that the agencies issued the interagency guidance, they also released a proposed version of the illustrations. The illustrations are meant to serve only as guidelines; if an institution prefers, it can choose instead to provide potential borrowers with the same information in an alternate format.

The first illustration provides basic bullet-point information on interest-only and payment option mortgages, defining the two types of mortgages in simple terms. It also alerts consumers about prepayment penalties and points out that reduced documentation loans often feature higher interest rates.

The second illustration is a chart comparing a simple fixed-rate mortgage with two nontraditional mortgages—a five-year adjustable-rate mortgage and a payment option adjustable-rate mortgage—for a hypothetical loan using sample interest rates. The chart highlights the increase in required payments that occurs as each of the nontraditional mortgages matures, as well as the total amount owed and home equity accumulated after five years of payment.

Illustration 3 is a table that institutions can include with monthly statements for payment option adjustable-rate mortgages. It presents borrowers with the three payment options—principal and interest, interest only, and some other minimum payment—and the monthly payment due under each option. The table also indicates each option's effect on the principal and interest remaining to be paid.

Statement on Subprime Mortgage Lending

On June 29, the same agencies that issued the illustrations also issued a final Statement on Subprime Mortgage Lending. The guidance is intended to help institutions provide nontraditional mortgage products safely while clearly disclosing the risks that the products pose to borrowers, and it is the final version of proposed guidance that was released on March 8. The statement specifically focuses on adjustable-rate mortgages that exhibit one or more of the following risky characteristics:

- Low initial payments based on a fixed introductory rate that expires after a short period and then adjusts to a variable index rate plus a margin for the remaining term of the loan;
- Very high or no limits on how much the payment amount or the interest rate may increase on reset dates;
- Limited or no documentation of borrowers' income;
- Product features likely to result in frequent refinancing to maintain an affordable monthly payment; and/or
- Substantial prepayment penalties and/or prepayment penalties that extend beyond the initial fixed interest rate period.

The agencies explain that loans exhibiting these characteristics are not necessarily predatory, but that institutions should not engage in predatory lending practices such as issuing loans based on the liquidation or foreclosure value of a borrower's collateral rather than on his or her repayment ability under the mortgage's terms; inducing a borrower to refinance frequently in order to charge him or her high fees; or concealing a loan's true conditions from an "unsuspecting or unsophisticated borrower."

The guidance also requires lenders to use the fully indexed rate, rather than a low "teaser"

[3] Summarized in *Banking Legislation and Policy*, Volume 25, Number 4.

rate, in underwriting a loan. The agencies encourage institutions to cooperate with borrowers to try to avoid default and foreclosure, and the guidance includes a provision that borrowers should be able to refinance their loans within 60 days of the reset period without incurring any penalties.

Also included is a section on consumer protection. Again, the agencies stress that institutions should approve loans based on borrowers' ability to repay them in full, and they emphasize that communication with consumers should clearly explain the risks and benefits of different loan products. Specifically, consumers should be informed about payment shock and potential payment increases, prepayment penalties, balloon payments, the higher cost of reduced documentation loans, and any tax and insurance responsibilities. Finally, the guidance states that institutions should implement control systems to ensure that they are acting in accordance with the guidelines, and it reminds institutions that the agencies will continue to monitor and take action against predatory lenders.

Federal Legislation

Borrowers' Protection Act of 2007

Sen. Charles Schumer (D-N.Y.) introduced the Borrowers' Protection Act of 2007 (S. 1299) on May 3. The bill, which was co-sponsored by Sen. Sherrod Brown (D-Ohio), Sen. Robert Casey (D-Pa.), and Sen. Barbara Mikulski (D-Md.), would make brokers more directly responsible for the loans they originate by establishing a fiduciary relationship between mortgage brokers and consumers. Brokers would be required to "act with reasonable skill, care, and diligence" and "in good faith" in their lending practices. Under the bill, a mortgage issuer would be required to calculate a borrower's ability to repay a loan based on the maximum interest rate allowable under the loan agreement, and the issuer would be required to examine the borrower's income and financial documentation before underwriting the loan. The issuer is also forbidden from steering a customer toward rates or terms that will not be "reasonably advantageous" for him or her. If a reasonably advantageous loan is not available, the issuer must direct the consumer to another lender. This bill was referred to the Committee on Banking, Housing, and Urban Affairs, where it awaits further action.

Homeownership Protection and Enhancement Act of 2007

On May 14, Sen. Jack Reed (D-R.I.) introduced the Homeownership Protection and Enhancement Act of 2007 (S. 1386) in the Senate with co-sponsors Sen. Robert Casey (D-Pa.) and Sen. Sheldon Whitehouse (D-R.I.). Under this bill, mortgage lenders would be required to inform potential borrowers of the availability of pre-purchase and post-purchase homeownership counseling. The bill, which would amend the Housing and Urban Development Act of 1968, would also allow the government to use competitive grant funds to set up state homeownership protection centers (SHPCs), which could provide one-time emergency home preservation loans to homeowners in default and refer them to other sources of assistance. Lenders would also be required to report borrowers who were more than 60 days late on any payment to the SHPC. Under the bill, mortgage lenders would be required to engage in "reasonable loss mitigation" activities as an alternative to foreclosure, and it would forbid lenders from foreclosing on consumers who had applied for home preservation loans from SHPCs. Finally, the bill would require the government to monitor and maintain a national database on mortgage defaults and foreclosures. Like the Schumer bill, this bill is currently pending in the Committee on Banking, Housing, and Urban Affairs.

State Legislation

A similar bill that would provide for a Homeowner's Emergency Assistance Program was introduced in the House of Representatives of the General Assembly of Pennsylvania on April 18, but it has not progressed beyond the Committee on Commerce. Under this bill, a lender would be prohibited from foreclosing on a defaulting borrower's property until the Housing Finance Agency had made a final decision on his or her application for emergency mortgage assistance payments. Lenders would also be required to refer defaulting borrowers to consumer credit counseling agencies, and borrowers seeking counseling would be protected from foreclosure for 30 days.

Regulation Z Revisions

On May 23, the Board of Governors of the Federal Reserve System requested comment on proposed revisions to Regulation Z, the set of rules that implements the Truth in Lending Act (TILA). The Fed issued a first advance notice of proposed rulemaking (ANPR) in December 2004,[4] followed by a second ANPR in October 2005[5] that was issued in response to TILA amendments included in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The final revisions will represent the first comprehensive overhaul to TILA rules since 1981.

The newly proposed changes to Regulation Z are the product of three years of deliberation. With the December 2004 ANPR, the Federal Reserve Board began its review of the regulation by collecting comments on potential methods of action. In addition, the Fed conducted extensive consumer testing to gauge the effectiveness and consumer comprehension of different model disclosure forms in mid-2006. The Fed also gathered data in focus groups on the types of information that consumers use and find helpful when making decisions about credit card use.

This set of proposed changes to Regulation Z would apply solely to open-end, nonhome-secured (generally, credit card) credit accounts, requiring lenders to disclose and summarize an account's terms more clearly in solicitation and application material, at the time of its opening, and when specific account terms change. The Board is currently conducting a separate review of disclosures for home-secured credit. Comments are due by October 12, 2007, 120 days after the proposed rules were published in the Federal Register.

Truth in Lending Act

The Truth in Lending Act[6] (TILA), first implemented in 1968, is intended to protect borrowers by requiring lenders to disclose key terms and costs of open-end (revolving) and closed-end (installment) consumer credit arrangements. The two main purposes of this law are to facilitate the comparison of credit offerings by borrowers by ensuring clear and meaningful disclosure of credit terms and to protect borrowers from "inaccurate and unfair credit billing and credit card practices." The Federal Reserve Board of Governors implements TILA through Regulation Z. TILA authorizes the Board to issue regulations that are "necessary or proper" to the law's enforcement, make specific types of transactions exempt from TILA rules, add or modify required disclosures, and require disclosures in advertising and solicitations.

Proposed Regulation Z Reforms

Credit Card Applications and Solicitations

The Federal Reserve Board cites the "Schumer box" table format required in applications and solicitations as one of the most effective means of disclosure currently in use.

[4] See *Banking Legislation and Policy*, Volume 23, Number 4.
[5] See *Banking Legislation and Policy*, Volume 24, Number 4.

[6] 15 USC 1601 et seq.

Therefore, the Board proposes that in addition to listing penalty fee APRs in the table, creditors should be required to include in the table a description of the actions that can incur penalty fees, the balances to which the penalty APR will apply, and when (or if) the penalty APR will expire. In addition, creditors would no longer be able to substitute the term "default rate" for "penalty APR," as tests indicated that consumers found the former term confusing.

Additionally, the Board proposes that the table format be revised to include information on fees for late payment, charging over the limit, cash advances, balance transfers, and returned payment. The proposed rules would also add information on payment allocation methods to the table—for example, creditors that allocate payments to low-interest balances first will be required to disclose this information. However, the proposed rules would move information on the account's balance computation method from inside the table to outside the table to avoid distracting borrowers from information that is considered to be more important.

Consumer testing suggested that few borrowers make use of currently required information on methods of adjusting variable interest rates. In response to this finding, the proposed revisions suggest that advertising for variable-rate accounts indicate simply that the APR varies "with the market," along with a simple description of the type of index used. Moreover, if the advertisement mentions a minimum monthly payment, it must also include a disclosure of how long it will take a borrower to pay off his or her balance by paying only the minimum required amount. Creditors would additionally be required to include a reference to the Board of Governors' website, which features information for consumers comparing credit offerings.

The proposal also includes a special provision for subprime credit cards, which are offered to consumers with low credit scores. Credit card issuers often charge large fees to open subprime accounts, and under the proposed rules, any issuer charging fees or security deposits that totaled 25 percent or more of the account's minimum credit limit would be required to explain in solicitation and application materials how much of the credit limit would remain available after the payment of these large initial fees.

Account Opening

At an account's opening, the proposed rules would require creditors to provide a disclosure table similar to those required in applications and solicitations but with additional information, such as currency conversion fees. The table would include information on the account's interest, minimum charges, transaction fees, annual fees, and late payment penalties, as well as details such as fees on foreign transactions. Creditors are permitted to orally disclose less important fees, such as charges for expedited payment and expedited delivery, at some point before the consumer becomes required to pay them.

Periodic Statements

The rules proposed by the Board for periodic billing statements would no longer require creditors to classify fees and charges to the account as "finance charges" and "other charges." However, focus group participants tended to understand the difference between interest charges and other fees, so grouping fees together in that way, rather than interspersing them chronologically among other transactions, appeared to increase comprehension. Therefore, under the proposed rules, creditors would be required to group all charges together and to classify them under simple terms—as "interest charges" and "fees," for example. Creditors would also be required to list the total dollar amounts of fees and interest over the billing period, as well as for the year to date.

The Board sought comment on two approaches to disclosing the *effective* APR, which includes various finance charges in addition to the interest included in the simple APR. Creditors have argued that disclosure of the *effective* APR should no longer be required because the statistic confuses customers, is difficult to explain, and is "inherently inaccurate" because it amortizes charges over one month, even if the consumer takes longer to pay the charges off. Consumer groups agree that the concept can be confusing, but they maintain that the effective APR communicates important information to borrowers nonetheless. The Board suggested two options: (1) eliminating the disclosure of *effective* APR on billing statements; or (2) retaining the *effective* APR disclosure but adding information to make this calculation more relevant to consumers. If the *effective* APR disclosure requirement is retained, the revised rules would newly include ATM fees and foreign transaction fees in its calculation.

In accordance with the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, the proposed rules would require creditors to include information in each periodic statement about the financial implications of making only the minimum required payments, as well as the earliest date on which a late payment fee can be charged. In disclosing minimum payment information, creditors can (1) include a statement on the consequences of making minimum payments, an illustration of this principle using hypothetical account information, and a toll-free number that borrowers can call to find out how long it will take to pay off their own account balances by making minimum payments, or (2) provide information on the actual repayment period that will be required if the consumer makes minimum payments.

Under the proposed revisions, creditors would also be required to move to the front of the statement the date and time by which a consumer must make a payment to avoid finance charges, because testing showed that it would be more readily noticed there.

Changes in Account Terms

Regulation Z currently requires creditors to inform borrowers 15 days in advance of changes in most terms of their accounts. Under the proposed rules, the required advance notice would increase to 45 days to allow borrowers more time to explore and consider switching to alternative lenders or plans. If one of the terms summarized in the account-opening summary table changed, the creditor would be required to provide the borrower with a new version of the table. Under the current rule, there is no advance notice requirement for interest rate increases or other penalties triggered by a borrower's delinquency or default. The proposed rule would require an advance notice 45 days before such changes would take effect. The Board requested public input on whether a period of less than 45 days would be more appropriate for these cases. Advance notification still would not be required for other actions, such as lowering the borrower's credit limit or suspending his or her credit privileges.

Watters v. Wachovia Bank N.A.

On April 17, the Supreme Court issued a key decision on *Watters v. Wachovia Bank N.A.*, ruling that a Michigan law subjecting mortgage lenders to state licensing and inspection did not apply to a mortgage lender that was an operating subsidiary of a national bank. In the 5-3 decision, the Court affirmed two lower courts' rulings by declaring that federal regulations issued by the Office of the Comptroller of the Currency (OCC) preempt state law in managing the real estate lending business of banks' operating subsidiaries, just as they do for the banks themselves.

Case Background

In 2003, Wachovia Mortgage Corporation, a North Carolina-based real estate lending

corporation that was licensed to do business in Michigan, alerted state authorities that it had become a wholly owned operating subsidiary of federally chartered Wachovia Bank and therefore surrendered its state registration. If Wachovia Mortgage Corporation had retained its Michigan license after becoming a Wachovia operating subsidiary, it would have been required to pay a yearly fee, file a yearly report, and allow state examiners to inspect its records. Michigan Office of Financial and Insurance Services Commissioner Linda A. Watters then informed the organization that, without a license, it would no longer be authorized to issue mortgages in the state.

Although two Michigan laws—the Mortgage Brokers, Lenders, and Services Licensing Act and the Secondary Mortgage Loan Act—exempt national and state banks from state mortgage lending regulation, the state requires that their subsidiaries remain subject to state registration and supervision. This requirement directly conflicts with OCC regulation 12 C.F.R. § 7.4006, which states that "unless otherwise provided by Federal law or OCC regulation, State laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank."

In 2005, Wachovia filed suit against Commissioner Watters in the United States District Court for the Western District of Michigan. Watters argued that Wachovia Mortgage Corporation was not exempt from state licensing requirements as a subsidiary of a national bank and that regulation 12 C.F.R. § 7.4006 violated the 10th Amendment to the U.S. Constitution.[7] Both the district court and, subsequently, the U.S. Court of Appeals for the Sixth Circuit rejected Watters's arguments, ruling that federal laws preempted state requirements for subsidiaries like Wachovia Mortgage Corporation.[8]

The two courts arrived at their decisions using the *Chevron* test,[9] which uses a two-pronged approach to determine whether an agency's construction of a federal law that it administers is valid. First, if Congress has spoken clearly and unambiguously on the issue being argued, the courts must defer to that interpretation. If an unambiguous and precise congressional interpretation does not exist, courts will defer to the agency's interpretation if it is reasonable and permissible. Using the second condition, both lower courts deferred to the OCC's interpretation of the law and ruled in Wachovia's favor. Watters again appealed the decision, and it was argued before the Supreme Court on November 29, 2006.

Questions of preemption in bank regulation arise from the dual nature of the American banking system. Since 1863, when Congress authorized a system of federally chartered banks to help finance the Civil War, federally chartered and state-chartered banks have existed simultaneously. An individual bank can opt to be chartered at either the federal or state level; it can also switch from one type of charter to the other after it has been established. State-chartered banks are regulated primarily by state agencies. Federally chartered, or national, banks are regulated primarily by the OCC under laws set forth in the National Bank Act,[10] although they are also subject to some state laws. In addition, both state- and federally chartered members of the Federal Reserve System are subject to inspection by the Federal Reserve Board, while holders of deposit insurance are subject to inspection by the FDIC.

Under the Supremacy Clause of the Constitution, federal law can preempt, or overrule,

[7] The 10th Amendment reads, "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

[8] 334 F. Supp. 2nd 957, 966 (WD Mich. 2004); 431 F. 3d 556 (2005).

[9] *Chevron U.S.A. v. National Resources Defense Council*, 467 U.S. 837 (1984).

[10] 12 U.S.C. § 1 *et seq.*

state laws with which it conflicts. Under the Commerce Clause of the U.S. Constitution, the federal government has the ultimate authority to regulate national banks, although the Supreme Court has acknowledged that national banks "are subject to the laws of the State, and are governed in their daily course of business far more by the laws of the State than of the nation."[11]

In matters of national banking, state law is preempted under circumstances where its enforcement would "forbid, or impair significantly, the exercise of a power that Congress explicitly granted," according to the frequently cited language of *Barnett Bank of Marion County v. Nelson*,[12] which allowed national banks to sell insurance in small Florida towns despite the practice's prohibition under Florida state law. The *Barnett* opinion emphasizes that state law can retain precedence as long as it does not significantly limit national banks' ability to exercise powers granted by federal law.

Although they have ruled in favor of state law in some cases, courts have tended to favor federal law in regulating national banks. For example, in *Marquette National Bank of Minneapolis v. First Omaha Service Corporation*, 439 U.S. 299 (1978), the Supreme Court ruled that a national bank could charge interest rates set under its home state's laws to customers in another state under the National Bank Act,[13] even if those rates were prohibited by the second state's usury law. In recent years, courts have also ruled that federal law and OCC regulations preempt state law in matters of insurance sales and licensing[14] and the charging of ATM fees,[15] among other issues.

In a few cases closely related to the issues raised by *Watters v. Wachovia*, federal courts of appeal have ruled in favor of the OCC as the primary supervisor for the subsidiaries of national banks, in addition to national banks themselves.[16] According to OCC regulation,[17] state laws apply to national bank subsidiaries to the same extent that they apply to national banks themselves. Therefore, since the OCC enjoys exclusive supervisory power over national banks,[18] courts have consistently ruled that it also does so over their subsidiaries.

Supreme Court Opinion

Justice Ruth Bader Ginsburg wrote the majority opinion in Wachovia's favor, while Justice John Paul Stevens, supported by Chief Justice John G. Roberts and Justice Antonin Scalia, wrote a dissent favoring Commissioner Watters. In the majority opinion, Justice Ginsburg echoes the language used in *Barnett Bank* and related decisions, writing that "state law may not significantly burden a national bank's own exercise of its real estate lending power, just as it may not curtail or hinder a national bank's efficient exercise of any other power, incidental or enumerated under the NBA." Michigan law does respect this requirement on a basic level—national banks themselves are not subject to state supervision. However, Justice Ginsburg proceeds to explain that the Court has treated operating subsidiaries as "equivalent to national banks with respect to powers exercised under federal law," so to subject a national bank's operating subsidiary to duplicative state supervision significantly and illegally burdens the bank's mortgage lending activities. Whether mortgage lending is carried out by a national bank or its subsidiary, the lender

[11] *National Bank v. Commonwealth*, 9 Wall. 353, 362 (1870).
[12] *Barnett Bank of Marion County v. Nelson*, 517 U.S. 25, 33.
[13] 12 U.S.C. § 85.
[14] *Cline v. Hawke*, 51 Fed Appx. 391, 2002 WL 31557392 (4th Cir. 2002); *Association of Banks in Insurance, Inc. v. Duryee*, 270 F. 3d 397 (6th Cir. 2001).
[15] *Bank of America v. City and County of San Francisco*, 309 F. 3d 551 (9th Cir. 2002), *Metrobank v. Foster*, 193 F. Supp. 2d 1156 (D. Iowa 2002).
[16] *National City Bank of Indiana v. Turnbaugh*, 463 F. 3d 325 (CA4 2006); *Wachovia Bank, N.A. v. Burke*, 414 F. 3d 305 (CA2 2005); 431 F. 3d 556 (CA6 2005); *Wells Fargo Bank N.A. v. Boutris*, 419 F. 3d 949 (CA9 2005).
[17] 12 C.F.R. § 7.4006.
[18] 12 U.S.C. § 484.

should be protected from "significant interference by state regulators."

The Supreme Court opinion rejects two additional arguments that Watters sets forth. First, it rejects Watters's claim that the OCC does not have the right to issue regulation 12 CFR §7.4006 (2006), which mandates that state laws be applied equally to national banks and to their operating subsidiaries. While the two lower courts applied the *Chevron* test to confirm the OCC's authority to issue the regulation, Justice Ginsburg finds the test unnecessary. She writes that since the regulation's message is already effectively conveyed by the National Bank Act, the question of whether states must defer to the regulation is merely "academic."

Next, Justice Ginsburg responds to Watters's claim that the OCC regulation violates the 10th Amendment to the Constitution. Since the court has previously ruled that the Commerce and Necessary and Proper clauses grant Congress the power to regulate national bank operations, states cannot claim that power, and the 10th Amendment does not apply.

In his dissenting opinion, joined by Chief Justice Roberts and Justice Scalia, Justice Stevens argues that Congress did not intend the National Bank Act to preempt the state laws at issue and exempt national banks' operating subsidiaries from state supervision. Justice Stevens believes that Congress intentionally neglected to extend the "preemptive blanket" of 12 U.S.C. § 484 to the subsidiaries of national banks. Moreover, he notes that Congress has not even explicitly authorized state-chartered national bank subsidiaries to perform traditional banking activities, nor has it authorized the OCC to license such entities—Congress has simply "acquiesced" to the OCC regulations.

Stevens further argues that, while Congress may have authorized the OCC to license banks to enter into business "incidental" to banking, Congress has not authorized the OCC "to immunize banks or their subsidiaries from state laws regulating the conduct of their competitors." Stevens also rejects the notion that the OCC regulation should merit *Chevron* deference because the regulation could "so easily disrupt the federal-state balance."

Federal Legislation

Passed in the House of Representatives

Data Privacy

Taxpayer Protection Act. On April 17, the House passed the Taxpayer Protection Act of 2007 (H.R. 1677) by a vote of 407-7. This bill is intended to protect taxpayers against identity theft and tax fraud and also contains provisions to regulate refund anticipation lenders. The bill was co-sponsored by House Oversight Subcommittee Chairman John Lewis (D-Ga.) and Ways and Means Committee Chairman Charles Rangel (D-N.Y.) and would require the Treasury to alert taxpayers whose identities were being used fraudulently, prohibit the payment of taxpayer refunds to predatory refund anticipation lenders, and extend the period of time during which the IRS can return wrongfully levied property, among other measures. The bill was referred to the Senate Committee on Finance, where it awaits further action.

Financial Regulation

Industrial Bank Holding Company Act. On May 21, the House of Representatives passed the Industrial Bank Holding Company Act of 2007 (H.R. 698) by a vote of 371-16. The bill would bar many commercial firms from establishing or acquiring industrial loan companies (ILCs), which are state-chartered financial companies that

can perform many bank-like functions. It would also increase the regulatory power that the FDIC, the Federal Reserve Board, the OTS, and the SEC could exert on the actions of ILCs. Sen. Sherrod Brown (D-Mo.) and co-sponsors introduced an identical bill (S. 1356) in the Senate on May 10. The Senate bill is currently pending in the Committee on Banking, Housing, and Urban Affairs.

Other Legislation

Small Business Lending Improvement Act. On April 25, the House of Representatives passed the Small Business Lending Improvement Act (H.R. 1332) by a 380-45 vote. The bill would allow the Small Business Administration to help cover borrower and lender fees on 7(a) business start-up loans. It would also include provisions to encourage lending to small businesses in rural and low- or moderate-income areas, as well as to small businesses owned by women, Native Americans, and economically disadvantaged individuals under the Community Express Program. The bill was introduced by Rep. Melissa L. Bean (D-Ill.).

Student Loan Sunshine Act. The House passed the Student Loan Sunshine Act (H.R. 890) on May 9 by a vote of 414-3. The bill would require college financial aid officers to select preferred lenders based only on their effectiveness in aiding students; it would also prohibit lenders from giving college financial aid officers perquisites in exchange for preferred lender status, among other measures. It was introduced by House Education and Labor Committee Chairman George Miller (D-Calif.) and was referred to the Senate Committee on Health, Education, Labor, and Pensions, where it awaits further action.

New Legislation

Data Privacy

Personal Data Protection Act. On April 24, Sen. Jeff Sessions (R-Ala.) introduced the Personal Data Protection Act of 2007 (S. 1202), a bill that would set guidelines for the protection of consumers' sensitive personal information. It would also mandate the prompt notification of individuals whose personal information was compromised. The bill was referred to the Committee on the Judiciary and now awaits further action.

Identity Theft Prevention Act. On April 25, the Senate Commerce Committee approved the Identity Theft Prevention Act (S. 1178). The bill would require companies and other organizations to develop programs to protect their consumers' sensitive personal information and report breaches to the affected consumers and government agencies. The bill was introduced by Commerce Committee Chairman Daniel Inouye (D-Hawaii), and its co-sponsors include Sen. Bill Nelson (D-Fla.), Sen. Mark Pryor (D-Ark.), Sen. Gordon Smith (R-Ore.), and Sen. Ted Stevens (R-Alaska).

Federal Agency Data Breach Protection Act. Rep. Tom Davis (R-Va.), ranking minority member of the House Oversight and Government Reform Committee, introduced the Federal Agency Data Breach Protection Act (H.R. 2124) on May 3. The bill would set guidelines for federal agencies' response to a data security breach in which sensitive or potentially harmful personal information was disclosed. Specifically, agencies would be required to notify those affected in a "timely" manner. The bill was referred to the House Committee on Oversight and Government Reform, where it awaits further action.

Student Financial Aid Data Privacy Protection Act. On May 15, Sen. Mike Enzi (R-Wyo.) introduced the Student Financial Aid Data Privacy Protection Act (S. 1401). This bill would require the Education Department to

strengthen its data security protocol by monitoring lender use of the national student information database and protecting personally identifiable student information, among other actions. The bill was referred to the Committee on Health, Education, Labor, and Pensions, where it awaits further action.

Electronic Funds Transfer Equal Consumer Protection Act. On June 28, Rep. Gary Ackerman (D-N.Y.) introduced the Electronic Funds Transfer Equal Consumer Protection Act (H.R. 2911), which would require banks to protect debit card transactions at the same level as credit card transactions. Specifically, a bank would be required to issue a provisional credit to a debit account within one day of a fraudulent or incorrect charge and finish investigating the charge within 60 days. The bill was referred to the House Committee on Financial Services.

Credit Cards

Universal Default Prohibition Act of 2007. On May 3, Rep. Keith Ellison (D-Minn.) introduced the Universal Default Prohibition Act of 2007 (H.R. 2146), a bill that would amend the Truth in Lending Act to bar creditors from raising interest rates on borrowers' credit card accounts because of late payments on other accounts, a practice known as universal default. Sen. Jon Tester (D-Mont.) introduced a companion bill in the Senate (S. 1309). Both bills await further action in committee.

Stop Unfair Practices in Credit Cards Act. On May 15, Sen. Carl Levin (D-Mich.), chairman of the Senate Permanent Subcommittee on Investigations, introduced the Stop Unfair Practices in Credit Cards Act (S. 1395) in the Senate. The bill is intended to protect credit card users by limiting over-the-limit fees and increases in interest rates and by prohibiting interest charges on fees. It also contains measures to prevent deceptive marketing and other practices. Sen. Claire McCaskill (D-Mo.), Sen. Richard Durbin (D-Ill.), and Sen. Patrick Leahy (D-Vt.) co-sponsored the bill, which was referred to the Committee on Banking, Housing, and Urban Affairs.

Financial Regulation

Industrial Bank Holding Company Act of 2007. On May 10, Sen. Sherrod Brown (D-Ohio), Sen. Wayne Allard (R-Colo.), and Sen. Tim Johnson (D-S.D.) introduced the Industrial Bank Holding Company Act of 2007 (S. 1356) in the Senate. The bill, intended as a companion for the Industrial Bank Holding Company Act that the House passed on May 23, would prohibit commercial firms from controlling industrial loan companies under most circumstances and would subject industrial loan companies to FDIC supervision, among other measures. The bill was referred to the Committee on Banking, Housing, and Urban Affairs, where it awaits further action.

Community Banks Serving Their Communities First Act. Sen. Sam Brownback (R-Kan.), Sen. Pat Roberts (R-Kan.), and Sen. Tom Coburn (R-Okla.) introduced on May 16 the Community Banks Serving Their Communities First Act of 2007 (S. 1405), a bill that would reduce filing requirements for banks with assets of $1 billion or less. The bill would also exempt certain banks from some Sarbanes-Oxley requirements and annual customer privacy reports. The bill was referred to the Committee on Finance, where it awaits further action. House Small Business Committee Chairwoman Nydia Velazquez (D-N.Y.) introduced a similar measure on April 17; the House bill remains pending in the committees on Financial Services, Ways and Means, and Small Business.

Insurance

National Insurance Act. On May 24, Sen. John Sununu (R-N.H.) and Sen. Tim Johnson (D-S.D.) introduced the National Insurance Act of 2007 (S. 40), a bill that would emulate the dual federal-state banking system by creating an optional federal insurance charter.[19] The bill would also create a new federal insurance regulator within the Treasury Department. The bill was referred to the Committee on Banking, Housing, and Urban Affairs, where it awaits further action.

Terrorism Risk Insurance Revision and Extension Act. Rep. Michael Capuano (D-Mass.) introduced the Terrorism Risk Insurance Revision and Extension Act of 2007 (H.R. 2761) in the House on June 18. The bill would extend the Terrorism Risk Insurance Act, originally passed in 2002, for 10 years. The Terrorism Risk Insurance Act provided a reinsurance mechanism for insurers in case of terrorist events. The bill was referred to the House Committee on Financial Services, where it awaits further action.

Other Legislation

Internet Gambling Regulation and Enforcement Act. On April 26, House Financial Services Committee Chairman Barney Frank (D-Mass.) introduced the Internet Gambling Regulation and Enforcement Act of 2007 (H.R. 2046), which would repeal restrictions that were placed on Internet gambling last year as part of the Security and Accountability for Every Port Act. Under the new bill, the Treasury's Financial Crimes Enforcement Network (FinCEN) would license and supervise Internet gambling sites. The bill was co-sponsored by Rep. Peter King (R-N.Y.), and it was referred to the committees on Financial Services and on Energy and Commerce.

Small Business Lending Reauthorization and Improvements Act of 2007. On May 2, Sen. John Kerry (D-Mass.) and Sen. Olympia Stowe (R-Maine) introduced the Small Business Lending Reauthorization and Improvements Act of 2007 (S. 1256). This bill would reauthorize the 7(a) and 504 lending programs overseen by the Small Business Administration and, among other measures, would establish a preferred lenders program that would reduce paperwork for lenders with good records. On May 16, the Senate Committee on Small Business and Entrepreneurship ordered the bill to be reported favorably with an amendment.

College Cost Reduction Act. The House of Representatives Committee on Education and Labor approved on June 13 the College Cost Reduction Act (H.R. 2669), which would halve interest rates on need-based student loans for lower-income borrowers, increase Pell grants, and cut federal subsidies to student lenders. The committee passed the bill, which was introduced by Committee Chairman George Miller (D-Calif.), by a 30-16 vote, and the House of Representatives passed it on July 11.

National Affordable Housing Trust Fund Act of 2007. House Financial Services Committee Chairman Barney Frank (D-Mass.) introduced the National Affordable Housing Trust Fund Act of 2007 (H.R. 2895) on June 28. The bill would channel revenue generated under the affordable housing provisions of recent GSE and Federal Housing Administration reform bills into a fund that would produce and rehabilitate affordable housing units. The bill was forwarded to the House Committee on Financial Services, where it awaits further action.

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[19] This bill is similar to the National Insurance Act of 2006, which is summarized in *Banking Legislation and Policy*, Volume 25, Number 2.

Federal Regulation

Board of Governors of the Federal Reserve System

Regulation D Revisions

On April 4, the Federal Reserve Board of Governors released final revisions to its interpretation of Regulation D. Regulation D implements the exemption of so-called "bankers' banks" from reserve requirements, and the new revisions will allow the Fed to decide on a case-by-case basis whether other entities not expressly permitted can become customers of bankers' banks.

Regulation O Amendments

The Federal Reserve Board on May 29 issued final rules implementing the Financial Services Regulatory Relief Act of 2006. The new rules amend Regulation O to loosen reporting requirements for banks making loans to their executive officers and for banks whose executive officers receive large loans from other banks. The rules took effect on July 2.

Electronic Fund Transfer Rule Amendment

On June 28, the Federal Reserve Board announced its approval of a final amendment to Regulation E under which financial institutions will no longer be required to issue receipts for transactions of less than $15 at ATM and POS terminals. The Board issued its notice of proposed rulemaking on December 1, 2006, and the final rule took effect on August 6.

Department of Defense

Military Abusive Lending Protection

On April 9, the Department of Defense requested comment on a proposed rule that would protect members of the military from potentially abusive lenders. In particular, the rule would place limits on payday lenders, who offer small, closed-dollar loans at extremely high interest rates, by increasing required disclosures to borrowers and capping interest rates, among other measures. The Federal Trade Commission announced its support of the proposal on June 14.

Department of Housing and Urban Development

Down Payment Assistance Restrictions

The Department of Housing and Urban Development on May 11 requested comment on proposed guidelines that would prevent sellers and third parties that are reimbursed by sellers from offering down payment assistance to consumers purchasing homes. The guidelines address concerns that the cost of the "assistance" is often simply added to the selling price of the home, so it provides no real benefit to its recipient. Comments were due by July 10, 2007.

Federal Deposit Insurance Corporation

Assessment Rate Adjustment Guidelines

On May 8, the Federal Deposit Insurance Corporation approved final guidelines that clarify how it will calculate adjustments to quarterly assessment rates for large, well-capitalized financial institutions in Risk Category 1. The FDIC can make adjustments of up to 0.50 basis point based on institutions' risk levels.

Internal Revenue Service

Guidance on Interest Accounting

On May 3, the Internal Revenue Service released Revenue Ruling 2007-32 and Revenue Procedure 2007-33. Revenue Ruling 2007-32 requires banks that use the accrual method of accounting and have a reasonable expectation of receiving future loan payments to include accrued interest in their gross income for the tax year in which the right to receive the interest becomes fixed. Revenue Procedure 2007-33 explains how a bank can change its accounting method to a safe harbor method based on its collection experience.

Office of the Comptroller of the Currency

Expanded Examination Cycle for Small Banks

On April 3, the Office of the Comptroller of the Currency, the Federal Reserve Board of Governors, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision requested comment on interim rules that would allow banks with total assets of less than $500 million to qualify for an 18-month on-site examination cycle, rather than the 12-month cycle currently required. The interim rules went into effect on April 10, and comments were due on May 10.

Nontraditional Mortgage Illustrations

On May 31, the Office of the Comptroller of the Currency, the Federal Reserve Board of Governors, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration released final illustrations to inform consumers about nontraditional mortgage products. The three illustrations include an explanation of nontraditional mortgage products, a comparison of interest-only loans and payment option adjustable-rate mortgages to traditional fixed-rate loans, and a table comparing the impact of various payment options on the balance of a payment option adjustable-rate mortgage. The illustrations are intended to help financial institutions implement the Interagency Guidance on Nontraditional Mortgage Product Risks, issued in 2006.

National Bank Derivative Sales

On June 1, the Office of the Comptroller of the Currency released a letter ruling confirming that national banks can sell derivatives to help their customers manage inflation risk. The letter was dated April 19 and was addressed to an unnamed national bank.

Overdraft Fees for Public Assistance Recipients

On June 29, the Office of the Comptroller of the Currency released a May 17 interpretive letter that confirmed banks' right to charge overdraft fees against public assistance received by their customers. The letter was written as a response to an unnamed bank that is undergoing two pending class action lawsuits brought by customers who receive public benefit payments.

Office of Federal Housing Enterprise Oversight

Conforming Loan Limit Calculation Guidance

The Office of Federal Housing Enterprise Oversight requested comment June 20 on proposed guidance governing the calculation of conforming loan limits, which cap the size of mortgages that Fannie Mae and Freddie Mac are permitted to purchase. The guidance addresses issues such as the rounding of dollar amounts in calculating the limits and the proper response to declines in housing prices. Under the proposal,

any decrease in the conforming loan limit due to falling housing prices would be deferred for a year. Comment on the proposed guidance was due on July 19.

Office of Thrift Supervision

Savings and Loan Holding Company Activity Expansion

On March 27, the Office of Thrift Supervision requested comment on a proposed rule that would expand the activities permissible for savings and loan holding companies to the full extent allowed by the Home Owners' Loan Act. Under the proposal, savings and loan holding companies would also be allowed to acquire other savings and loan holding companies as subsidiaries with OTS permission.

Savings and Loan Holding Company Rating System

On April 6, the Office of Thrift Supervision requested comment on a proposed rule that would alter its supervisory rating system for savings and loan holding companies. The proposal would change the component descriptions and rating scale used to describe the companies' financial condition and risk exposure.

Securities and Exchange Commission

Credit Rating Agency Reform Act Implementation

On May 23, the Securities and Exchange Commission approved final rules implementing the Credit Rating Agency Reform Act of 2006, which authorized the SEC to regulate and examine credit rating agencies. Among other measures, the approved rules will require agencies to register with and provide information regularly to the SEC and will forbid agencies to participate in "certain unfair, coercive, or abusive practices."

Brokerage Registration Exemption Extension

The Securities and Exchange Commission announced June 29 that banks and savings associations would remain exempt from brokerage registration requirements until September 28, rather than the previous deadline of July 2, to allow itself more time to consider comments on a proposed rule. The SEC issued the temporary exemption after releasing and requesting comment on the proposed Regulation R with the Federal Reserve Board in December.

Small Business Administration

7(a) Lender Fees

On May 4, the Small Business Administration (SBA) released a final rule allowing the SBA to charge fees to lenders operating under the 7(a) small business loan guarantee program to cover the costs of their examination and oversight. The rule went into effect on June 4.

Judicial Developments

Supreme Court Rulings

Adverse Action Consumer Notification

The Supreme Court released a ruling on June 4 that clarified the Fair Credit Reporting Act requirement that a financial institution notify a consumer if he or she is subject to adverse action as a result of his or her consumer credit report (*Safeco Insurance Co. of America v. Burr*, U.S., No. 06-84, 6/4/07). The court ruled in Safeco's favor,

deciding that the insurance company did not act willfully or recklessly when it failed to notify new consumers that their credit reports increased their initial premium rates.

Securities Antitrust Exemption
On June 18, the Supreme Court granted the securities market a wide exemption to antitrust laws, ruling that practices that might seem to violate the laws in other sectors were vital to the financial sector (*Credit Suisse Securities (USA) LLC, fka Credit Suisse First Boston LLC, et al v. Billing et al*, U.S., No. 05-1157, 6/18/07). The Court ruled that the securities laws enforced by the Securities and Exchange Commission preclude the antitrust laws at issue in the case.

Taxes on Out-of-State Businesses
The Supreme Court let stand on June 18 a West Virginia ruling that a state can impose income and franchise taxes on a business that did not have a physical presence in the state (*Tax Commissioner of the State of West Virginia v. MBNA America Bank N.A.*, WV, No. 33049, 11/21/06). This decision followed previous rulings that held that a state could not charge sales or use taxes under these circumstances.

Circuit Court Rulings
New Hampshire Gift Card Preemption Ruling
On May 30, the U.S. Court of Appeals for the First Circuit ruled that provisions of the New Hampshire Consumer Protection Act that ban gift card expiration dates and certain administrative fees are preempted by federal law for cards sold by national banks and thrifts (*SPGGC, LLC; Metabank; U.S. Bank, N.A. v. Ayotte*, No. 06-2326). The first circuit's ruling affirmed a previous decision by the U.S. District Court in New Hampshire.

District Court Rulings
Visa Enforcement Order
A June 15 judgment enforcement order issued by the U.S. District Court for the Southern District of New York (*U.S. v. Visa U.S.A., Inc.*, S.D.N.Y., No. 98 Civ. 7076 (BSJ), 6/15/07) allows banks that issue Visa debit cards to switch to MasterCard. The court found a Visa rule that effectively prohibited the action to be in violation of a 2001 ruling that became effective in 2004.

Third District Rulings
Mortgage Arbitration Clause Ruling
The Pennsylvania Supreme Court ruled on May 31 that an arbitration clause in a mortgage contract was not illegal. In the case (*Salley v. Option One Mortgage Corporation*, Pa. Sup. Ct., No. 50 EAP 2005, 5/31/07), a Philadelphia homeowner sued a subprime mortgage lender, claiming that the mortgage contract was predatory and that its arbitration clause, which prohibited the borrower from seeking judicial recourse but allowed the lender to do so, was unconscionable and unenforceable. The court ruled in the lender's favor.

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