BANKING LEGISLATION & POLICY

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Recent Developments

Anti-Money Laundering Legislation Enacted

On October 26, President Bush signed into law the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, or the USA PATRIOT Act of 2001 (Public Law 107-56). This law is a combination of three different bills: a House anti-terrorism bill (H.R. 2975), a House money laundering bill (H.R. 3004), and a Senate money laundering bill (S. 1510). Title III of the USA PATRIOT Act is the part of the anti-terrorism package aimed at eliminating money laundering.

The act specifies new due diligence standards for U.S. banks that deal with foreign banks; new powers for the government (the Treasury secretary in particular) to impose stricter standards on countries, institutions, transactions, and jurisdictions that are of "primary money laundering concern"; and new information sharing between the public and private sector in regard to money laundering and terrorism investigations. The major provisions of the act are outlined under **Summary of Federal Legislation.**

Court Rules Against Visa and MasterCard In Antitrust Case

On October 9, the U.S. District Court for the Southern District of New York returned a mixed decision in the Department of Justice's (DOJ) antitrust suit against Visa and MasterCard (*U.S. v. Visa U.S.A. Inc., S.D.N.Y., No. 98 Civ. 7076*(BSJ), 10/9/01). The court ruled that the DOJ had proven the exclusionary rules of the Visa and MasterCard associations to be anti-competitive. The court went on to say that these exclusionary rules should be abolished. However, the court ruled that the DOJ had not proven that the governance structures of the Visa and MasterCard associations were having adverse effects on competition in the payment cards

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industry or on consumer welfare.

The DOJ claimed Visa and MasterCard had blocked competition from American Express and Discover through their use of exclusionary rules. Under the rules of the Visa and MasterCard associations, member banks of either association may issue Visa and MasterCard credit and charge cards but may not issue American Express or Discover cards. The penalty for issuing Discover or American Express cards is that the bank may no longer issue Visa or MasterCard credit and charge cards. The court found that these rules "raise the cost to a member bank of issuing American Express and Discover credit cards to prohibitively high levels and make it practically impossible for American Express and Discover to convince banks…to issue cards on their networks." The court ordered the Visa and MasterCard associations to abolish their exclusionary rules and ruled that individual banks currently locked into agreements with Visa and MasterCard are now allowed to negotiate issuing arrangements with American Express and Discover.

The DOJ initially filed the lawsuit against Visa U.S.A. and MasterCard International in October 1998, charging them with anti-competitive practices in violation of Section 1 of the Sherman Act. The DOJ claimed that the "governance duality" of the associations had diminished the incentive for Visa and MasterCard to invest in or implement new technologies and programs that would benefit card-holders at the expense of one of the associations. The DOJ defines governance duality as a governance structure that allows banks to have "formal decision-making authority in one system while issuing a significant percentage of its credit and charge cards on the rival system." Thus, a bank that primarily or exclusively offers VISA cards could appoint a director to the MasterCard board, or vice versa. However, the court found that the evidence presented by the DOJ failed to show that dual governance had significant adverse effects on competition and innovation in the credit and charge card industry. The court also noted that dual governance was a thing of the past anyway. Banks that primarily or exclusively deal in only one card look to appoint directors only to that organization. Thus, the court found in favor of Visa and MasterCard on count one.

SUMMARY OF FEDERAL LEGISLATION

Enacted Legislation

1. USA Patriot Act of 2001 (H.R. 3162). Introduced by Rep. Sensenbrenner (R-WI) on October 23, 2001.

Status: Signed into law by the President on October 26, 2001. Public Law 107-56.
Related Bills: H.R. 2975, H.R. 3004, H.R. 1114, S. 398, and S. 1510.

The USA PATRIOT Act of 2001 is an anti-terrorism law that was passed in response to the terrorist attacks of September 11, 2001. Title III of the USA PATRIOT Act of 2001, called the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (the act), will have a substantial impact on the financial services industry as well as on financial regulation in the future. The act is made up of three major parts, each containing numerous provisions. They are as follows: 1) International Counter Money Laundering and Related Measures, 2) Bank Secrecy Act Amendments and Related Improvements, and 3) Currency Crimes.

International Counter Money Laundering and Related Measures

The act gives the secretary of the Treasury, in consultation with the State Department and various financial regulators, the authority to require domestic financial institutions to report on all transactions in a specified account or class of accounts, including identifying the owner of the accounts or other parties to the transaction, where there is a primary money laundering concern. In particular, these new requirements are mandated for financial institutions' dealings with payable-through and correspondent accounts. Payable-through accounts are accounts opened in the U. S. by a foreign banking institution on behalf of its customers. Also, the secretary of the Treasury may prohibit domestic institutions from establishing or maintaining correspondent accounts with any foreign bank.

The act mandates the secretary of the Treasury to formulate regulations, within 120 days of the law being enacted, which will promote cooperation among financial institutions, financial regulators, and law enforcement authorities in their efforts to investigate terrorist and money laundering activities. The act waives a financial institution's liability resulting from the sharing of information (with other financial institutions) for the purpose of identifying and reporting on activities that may involve money laundering or terrorist acts. However, the Department of the Treasury would first have to be notified of any information sharing. The act also instructs the secretary of the Treasury, the secretary of State, and the Board of Governors of the Federal Reserve System to engage in negotiations with their counterparts in foreign countries to promote international cooperation in dealing with money laundering. The act amends the Bank Holding Company Act and the Federal Deposit Insurance Act by requiring the Federal Reserve Board to "take into consideration the effectiveness of the company or companies in combating money laundering activities, including in overseas branches" when considering applications for mergers and acquisitions.

The act pays particular attention to correspondent relationships between domestic financial institutions and foreign banks. The secretary of the Treasury can require new record keeping and reporting requirements in connection with correspondent accounts. Financial institutions are required to establish due diligence procedures that will detect and report instances of money laundering through private banking or correspondent banking accounts involving foreign persons. With respect to a correspondent account with a foreign bank (that has an offshore banking license or is licensed by a "noncooperative" country), at a minimum, this will require the verification of the bank's owner, as well as the identity of any other banks with which it has a correspondent relationship. With respect to private banking accounts, at a minimum, this will require ascertaining the identity of the nominal and beneficial owners of the funds as well as the source of the funds deposited. A beneficial owner is a person who enjoys the benefits of ownership of an account even though the title is in another name. Furthermore, the act prohibits financial institutions from establishing, overseeing, or maintaining correspondent accounts on behalf of a shell bank. A shell bank is one that does not have a physical location in any country. Also, financial institutions are directed to be vigilant with correspondent accounts that are being used indirectly for the benefit of a shell bank.

The act calls upon the secretary of the Treasury to draw up new minimum guidelines for identifying customers when they establish new accounts with financial institutions. The secretary is also called upon to encourage foreign ministers to establish guidelines that will identify and provide the names of the originators of wire transfers into the United States. The secretary of the Treasury is also given the power to regulate concentration accounts if the secretary believes they are being used to obscure the identity of the beneficial owner or the movement of funds between the customer and the beneficial owner. A concentration account is a single centralized account into which funds collected at regional locations are transferred.

The act establishes specific legal measures and guidelines that are to be used with regard to money laundering cases. First, the act amends federal criminal law to include foreign corruption offenses, like bribery, as money laundering crimes. Next, the act allows the federal courts to consider evidence in lawsuits contesting property forfeiture brought against the U.S. government "that is otherwise inadmissible under the Federal Rules of Evidence, if the court determines that the evidence is reliable, and that compliance with the Federal Rules of Evidence may jeopardize the national security interests of the United States." The act establishes federal jurisdiction over foreign money launderers and over money that is laundered through a foreign bank. The court may issue a restraining order on any assets held in the United States of a defendant in a money laundering case in order to satisfy judgment of the case. Finally, the act prescribes criminal penalties for federal employees or officials that accept or seek bribes in association with the person's office or title.

Bank Secrecy Act Amendments and Related Improvements

Financial institutions would be permitted to avoid civil liability under the Bank Secrecy Act if they disclose information concerning suspicious activity by their customers to intelligence and security agencies. In addition, this section allows financial institutions to include in written employment references instances of suspicious illegal activity by an employee (current or former).

The act amends a number of federal laws related to privacy to foster information sharing during counter-terrorism investigations. In particular, the act amends the Right to Financial Privacy Act to allow financial records to be transferred among government agencies if the agencies are engaged in a terrorism (or counter-terrorism) investigation where the records are relevant. The act amends the Fair Credit Reporting Act by requiring consumer reporting agencies to transfer all the information in a consumer's file at the request of a government agency that is involved in a counter-terrorism investigation (if the files are relevant to the investigation).

The act transfers authority over the Financial Crimes Enforcement Network (FinCEN) exclusively to the Department of the Treasury. The director of FinCEN will be appointed by the secretary of the Treasury. The act amends the Federal Reserve Act by calling for an increase in the protection of Federal Reserve facilities.

The act increases the civil and criminal penalties associated with money laundering. The maximum civil penalty is increased from $10,000 to $1 million. The maximum for criminal fines is increased from $250,000 to $1 million. In addition, the minimum for both civil penalties and criminal fines is established as double the amount of the illegal transaction.

Currency Crimes

The act increases the penalties for bulk cash smuggling. Smuggling and/or knowing concealment in excess of $10,000 in monetary instruments is now considered a bulk cash smuggling felony. In addition, forfeiture of all property involved in money laundering cases is no longer up to the court's discretion but is now mandatory as part of a criminal sentence. The act also amends federal criminal code to allow for fines and imprisonment for operating or owning an unlicensed money transmitting business. The act modifies the definition of the term "counterfeiting" to include the making or acquiring of an analog, digital, or electronic image of an obligation or security issued by the U.S.

New Legislation

1. Home Ownership Expansion and Opportunities Act of 2001 (H.R. 3206) Introduced by Representative Roukema (R-NJ) on November 1, 2001.

Status: Referred to the House Committee on Financial Services. Related Bills: S. 1260.

This bill would allow the Government National Mortgage Association (Ginnie Mae) to buy and securitize privately insured home mortgage loans. Currently, Ginnie Mae can only securitize mortgages guaranteed by the U.S. government. In fiscal year 2002, Ginnie Mae would be allowed to securitize up to $50 billion in conventional private mortgages. If the bill is enacted, Ginnie Mae would become a competitor to Fannie Mae and Freddie Mac.

This bill would establish criteria for what type of privately insured home mortgage loans Ginnie Mae would be allowed to securitize. Such loans must: 1) be secured by a property comprising one- to four-family dwelling units, 2) have a term of not longer than 30 years, 3) have a loan-to-value ratio of 85 percent or higher, and 4) have an original principal obligation that does not exceed the conventional mortgage limit (currently set at $250,000). Private mortgage insurance must cover at least 25 percent of the loan if the loan-to-value ratio is between 85 and 95 percent. This increases to 30 percent coverage for loan-to-value ratios between 90 and 95 percent, and to 35 percent if the loan-to-value ratio exceeds 95 percent. Additionally, the secretary of Housing and Urban Development and the director of Ginnie Mae are required to formulate minimum underwriting standards for the securities that are to be backed by conventional private mortgages.

2. Access and Openness in Small Business Lending Act of 2001 (H.R. 3372). Introduced by Representative McGovern (D-MA) on November 29, 2001.

Status: Referred to the House Committee on Financial Services.

This bill would revise the data collection requirements of the Community Reinvestment Act so that they are identical to the requirements contained in the Home Mortgage Disclosure Act (HMDA). Lenders would be required to collect data on whether the borrower is a minority- or woman-owned business. Also, the data would include information on the type and purpose of the loan, the amount of the loan, the action taken by the lender, the census tract the business is located in, and the gross annual revenue of the business.

Borrowers would have a right to refuse to divulge any or all of this information. Also, institutions not subject to HMDA would be exempt from collecting information on small-business loans. Finally, the information on whether the business is minority- or woman-owned would not be accessible by any person at the banking institution involved in deciding whether to approve the loan.

3. Community Choice in Real Estate Act (H.R. 3424). Introduced by Representative Calvert (R-CA) on December 6, 2001.

Status: Referred to the House Committee on Financial Services.

This bill would prohibit bank regulators from designating real estate management and brokerage business as financial in nature under the Gramm-Leach-Bliley Act. That would prevent financial holding companies (FHCs) from engaging in these activities. There is an exception for property owned by an FHC. The bill is in response to the expectation that the Board of Governors and the Treasury Department are soon going to pass rules that will allow financial holding companies and national banks into the real estate business.

Pending Legislation

1. Financial Services Antifraud Network Act (H.R. 1408). Introduced by Representative Rogers (R-MI) on April 4, 2001.

Status: Passed House on November 6, 2001, by a vote of 392 to 4; measure was received in the Senate on November 7, 2001.

This bill would create a computer network to streamline and facilitate the antifraud information-sharing efforts of federal and state regulators. The information shared would be concerning financial services professionals who have been convicted of fraud or have been the subject of enforcement actions by federal regulators. The information-sharing computer network, which would have to be in place two years after the bill is passed into law, would allow financial regulators to inform each other confidentially about the fraudulent activities of professionals in the financial and insurance industry.

SUMMARY OF FEDERAL REGULATIONS

Board of Governors of the Federal Reserve System

International Banking Operations
(10/26/01)
The Federal Reserve Board completed its review of Regulation K and issued a final rule on October 26, 2001. Regulation K governs international banking operations and is composed of four subparts (A through D). The final rule amends subparts A, B, and C. These changes were first proposed in December 1997 in the *Federal Register* (62 FR 68423). Before the proposed rule could be finalized, Congress passed the Gramm-Leach-Bliley Act (GLBA). The Board postponed implementing the proposed changes until GLBA could be implemented.

Subpart A: International Operations of U.S. Banking Organizations. This section amends Regulation K by making changes to six activities related to U.S. banking organizations' activities abroad. The changes will: 1) expand permissible government bond trading by foreign branches of member banks; 2) expand permissible equity underwriting activities abroad for well-capitalized and well-managed U.S. banking organizations; 3) implement a provision allowing member banks to invest up to 20 percent (previously, 10 percent was the limit) of capital and surplus in the stock of Edge and agreement corporations; 4) streamline procedures for establishment of foreign branches by U.S. banking organizations; 5) expand general consent authority for well-capitalized and well-managed U.S. banking organizations; and 6) amend the debt/equity swaps authority to reflect changes in circumstances of eligible countries.

U.S. banks operating in foreign countries have been allowed to underwrite and deal in obligations of the host country of the bank. This final rule will amend the current regulations to permit foreign branches of U.S. banks to underwrite and deal in government bonds of countries other than the host country. However, these bonds must be investment grade, and the foreign branches must be soundly run and subject to a prudent regulatory system.

Under the final rule, a financial institution's first investment in a foreign subsidiary or joint venture must receive prior consent by the Board. The rule also amends Regulation K to permit a U.S. bank to establish branches in its first two foreign countries after providing 30 days' prior notice to the Board of Governors (previously each bank had to seek specific consent from the Board). Bank holding companies, member banks, and Edge and agreement corporations that already have a branch in a foreign country do not need to give prior notice when further branching is done in that country. Next, U.S. banks that have already established branches in two foreign countries need to give only 12 days' prior notice (used to be 45 days) before establishing branches in a country for the first time and where no other affiliates have a presence already. Finally, nonbanking subsidiaries may open a branch in a new country without prior notice even when none of its affiliates has a presence there.

Regulation K establishes limits for each bank's foreign subsidiary when underwriting equity securities. Under this rule, well-capitalized and well-managed banking organizations would be subject to a limit of 25 percent of tier 1 capital on their equity underwriting, although a maximum of 15 percent of the bank's tier 1 capital may be committed to the underwriting of a single organization's equity securities. Banking organizations not considered well capitalized and well managed by the Board are still subject to the original limit of $60 million. Banking organizations will have to provide 30 days' prior notice before commencing equity underwriting outside the U. S.

Regulation K also establishes limits

for international equity dealing by U.S. banking organizations. The final rule establishes an aggregate limit for equity dealing of 25 percent of tier 1 capital for bank holding companies and 20 percent for banks. Additionally, the rule establishes that an investor or affiliate can only hold up to 10 percent of its tier 1 capital (up to $40 million) in the shares of a single organization. The rule also specifies how positions can be netted and when banks can use their internal hedging models to calculate their net exposure for the purpose of compliance with this limit.

Through Regulation K, the Board was required to review all foreign investments made by U.S. banks above a certain level. To streamline the process, the rule institutes a general consent process based upon the investment's size relative to the bank's tier 1 capital (expressed in percentage terms). General consent means that a bank that is considered well capitalized and well managed does not need to seek the Board's approval before making a particular investment. Bank holding companies, banks, and bank subsidiaries all have varying limits for receiving general consent, depending on the investment. For example, a bank holding company can invest up to 10 percent of its tier 1 capital in a subsidiary and receive general consent for the investment. If the bank holding company were investing in a joint venture, the limit would be 5 percent of its tier 1 capital. Also, the final rule will regulate the total size of a banking organization's investment portfolio by setting aggregate limits for the general consent process. For example, bank holding companies can invest up to 20 percent of their tier 1 capital and still receive general consent from the Board. All of these new limits for general consent from the Board apply only to banking organizations classified as well capitalized and well managed.

Because of banking organizations' nonperforming, illiquid holdings of sovereign debt in the 1980s, Regulation K permitted bank holding companies (not banks or bank subsidiaries) to swap this illiquid sovereign debt from developing countries for equity interests in companies of any type. This authority, however, was limited to the sovereign debt of particular countries (those that had restructured their debt during the 1980s). But since the 1980s, for many of these countries a liquid secondary market has emerged for this debt. Consequently, the rule alters the definition of eligible countries to reflect existing conditions and redirect the regulations toward their original purpose, assisting banks with asset quality problems. The new definition for eligible countries for the debt / equity swap program is countries with currently sovereign impaired debt for which an allocated transfer risk reserve would be required under the International Lending Supervision Act and for which there is no liquid market.

A 1996 amendment to section 25A of the Federal Reserve Act increased the statutory limit on banks' investments in Edge and agreement corporations from 10 percent of capital to 20 percent of capital, subject to prior approval from the Board. This final rule implements the 1996 amendment to allow for member banks (with Board approval) to invest 20 percent in Edge and agreement corporations, and it establishes the criteria the Board will use to decide whether a member bank can do so.

Subpart B: Foreign Banking Organizations

This subsection specifies rules governing foreign banking organizations and their activities in the U. S. The final rule makes three changes to Regulation K: 1) it streamlines the application procedure for foreign banks to expand operations in the U.S., 2) it changes the qualifications necessary to be exempted from certain restrictions on nonbanking activities, and 3) it implements the provisions of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 that affect foreign banks.

Under the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA), for a foreign bank to open a branch, agency, or commercial lending company, the Board must determine that the bank is subject to comprehensive supervision on a consolidated basis (a CSS determination) by its home country regulator. However, the Board is only required to "take into account" the level of home country supervision of a foreign bank seeking to establish its first representative office in the U.S. Under the final rule the Board can approve an application for the establishment of a representative office if it makes a finding that "the applicant bank was subject to a supervisory framework that is consistent with the activities of the proposed office."

Next, the final rule amends the prior notice and general consent processes for foreign banks to establish additional offices in the U.S. The final rule permits foreign banks, which have previously been through a successful CSS determination under FBSEA, to establish their first branch, representative office, commercial lending company or agency with only 45 days' prior notice. In addition, the rule permits these same CSS-qualified foreign banks by general consent to establish additional representative offices in the U.S. without the 45-day prior notice.

The final rule allows the Board to suspend these new prior and general consent procedures for any foreign bank. Also, the final rule allows the Board to include an examination of the measures taken by a foreign bank's home country to prevent money laundering when processing an application for any new office of the foreign bank in the U.S.

Section 4 of the Bank Holding Company Act prohibits certain nonbanking activities for foreign banking organizations. Under Regulation K, foreign banking organizations were exempted from these prohibitions if they could show that at least half of their business is banking and that more than half of it was being done outside the U.S. This final rule amends Regulation K to allow foreign banks to count parent and sister organizations when they are seeking exempt status for nonbanking activities. This rule also allows the Board to review, on a case-by-case basis, applications for exemption by foreign banking organizations with special ownership structures.

In this rule, the Board addresses one particular nonbanking activity that foreign banks engage in: securities activities. Previously, foreign banks were allowed to control a maximum of 5 percent of a foreign company that, directly or indirectly (through a subsidiary), underwrites, sells, or distributes securities in the U. S. The final rule amends this regulation by allowing foreign banking organizations to hold a maximum of 10 percent in such companies.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Interstate Act) permitted interstate branching by foreign banks that previously had been restricted. Banks controlled by foreign banks had to be assigned a home state, which could only be changed once. The Board is amending this regulation to allow foreign banks to have one additional change in their home state. In addition, the Board removed its attribution rule, which required all of the banks under the control of a foreign bank to have the same home state. The Board also clarified its position on the process foreign banks must use to upgrade the status of one of their offices. To upgrade an office, a foreign bank must submit a full application to the Board or follow the prior-notice procedure mentioned earlier.

Subpart C: Export Trading Companies. This portion of Regulation K pertains to investments and participation in export trading companies (ETCs) by eligible investors, which include bank holding companies (BHCs), Edge and agreement corporations that are subsidiaries of BHCs, and qualifying foreign banks. An export trading company is a company whose purpose is to promote U. S. exports. Prior to this final rule, eligible investors had to submit in writing to the Board before investing any amount in ETCs. The Board has amended this rule with a general consent provision. Eligible investors that are wellcapitalized and wellmanaged may invest in ETCs without prior notification to the Board. The investors must submit some required information in a post-investment notification to the Board. For further information, see 66 *Federal Register*, pp. 54346-98. (Regulation K)

International Lending Supervision (10 / 26 / 01)
On October 26, 2001, the Board proposed to amend its rules regarding the accounting for fees for international lending. The current regulations set up an accounting framework that required banks to have a separate accounting treatment for each type of fee charged with regard to their international lending (e.g., agency fees, management fees, commitment fees, and others). Since that time, the GAAP rules for fee accounting for international lending have been amended, so the Board is proposing to amend Subpart D of Regulation K to eliminate the separate accounting treatment for each type of fee. The proposed rule would now require banking institutions to follow GAAP in accounting for international lending fees. Comments were due on December 1, 2001. For further information, see 66 *Federal Register*, pp. 54399-402.

Risk-Based Capital Guidelines; Deferred Tax Assets (11 / 27 / 01)
The Board proposed a rule on November 17, 2001, to amend its risk-based capital guidelines. The proposed rule would clarify how disallowed deferred tax assets are to be handled in determining a banking organization's risk-based capital requirement. For example, on a bank's income statement, provisions for loan losses reduce income, but they are not included when calculating income for tax purposes. For income tax purposes, losses are only recognized when they are actually charged off. As a result, banks add an entry, called a deferred tax asset, to reflect the value of the tax refund they expect to get when they charge off the loss. Currently, the Board's guidelines require an organization to deduct goodwill and other intangible assets from their tier 1 capital, but disallowed deferred tax assets are deducted from tier 2 capital. The other agencies also require disallowed deferred taxes to be deducted from tier 1 capital. This proposed rule would direct institutions to deduct these from tier 1 capital and would make the risk-based capital guidelines of the Board consistent (in regards to the treatment of disallowed deferred tax assets) with other federal banking agencies.

Comments were due December 27, 2001. For further information, see 66 *Federal Register*, pp. 59176–178.

Truth in Lending (12 / 20 / 01)
The Board issued a final rule amending the provisions of Regulation Z (Truth in Lending) that implement the Home Ownership and Equity Protection Act (HOEPA). The rule adjusts the annual percentage rate (APR) that qualifies a loan as being covered by HOEPA. For first-lien mortgages, the rule changes the qualifying APR from 10 percentage points to 8 percentage points above the rate for Treasury securities of a comparable maturity. Next, the rule amends Regulation Z to address " loan flipping," which is the repeated refinancing of loans over a short time when the transactions do not benefit the borrower. The rule also prohibits a creditor from refinancing a HOEPA loan that has been made in the last 12 months. The rule prohibits creditors from making HOEPA loans to home owners without regard to their repayment ability, by requiring documentation of the borrower's income and expenses. Finally, the rule revises the disclosures required by HOEPA during refinancings to include the total amount being borrowed. The rule requires disclosures for the refinancing of a HOEPA loan to include whether the total amount includes the cost of optional insurance. Currently, the cost of optional insurance does not have to be disaggregated from the total cost in these disclosures. The rule became effective December 20, 2001, and compliance becomes mandatory on October 1, 2002. For further information, see 66 *Federal Register*, pp. 65604-622. (Regulation Z)

Federal Deposit Insurance Corporation

Engaged in the Business of Receiving Deposits Other Than Trust Funds (10 / 30 / 01)
The FDIC made final a rule amending its regulations to clarify the meaning of the phrase "engaged in the business of receiving deposits other than trust funds," a necessary prerequisite for deposit insurance eligibility. The rule establishes that an institution must maintain one or more nontrust deposit accounts that total at least $500,000. Under this rule, any institution, other than a newly insured depository institution, that does not meet the $500,000 minimum on two consecutive call reports will have its federal insurance revoked.

The FDIC published general counsel opinion No. 12 (See 65 *Federal Register* 14568) to clarify the FDIC's position in regard to this statutory requirement for federal deposit insurance. In the opinion, the FDIC's general council stated that the statutory requirement of being "engaged in the business of receiving deposits other than trust funds" can be satisfied by the continuous maintenance of one or more nontrust deposit accounts in the aggregate amount of $500,000. However, a federal district court rejected the interpretation that the FDIC set forth in the general council opinion in the case *Heaton v. Monogram Credit Card Bank of Georgia* (WL 15635 ED La. Jan. 5, 2001). The FDIC promulgated this regulation (which is accorded more deference by the courts than an FDIC interpretation) to establish a consistent and clear statutory requirement for depository institutions seeking federal deposit insurance. The rule became effective November 29, 2001. For further information, see 66 *Federal Register*, pp. 54645-51.

Payment of Post-Insolvency Interest in Receiverships with Surplus Funds
(12 / 18 / 01)
The FDIC has proposed a rule that would establish a uniform interest rate, calculation method, and payment priority for post-insolvency interest. This rule would apply in cases where a bank has entered receivership and where some funds remain after the full principal amount of all claims have been paid. In such cases, post-insolvency interest would be calculated from the date the receivership is established. Currently, it is addressed under common law, which specifies that it be paid pro rata to all creditors regardless of priority. The American Homeownership and Economic Opportunity Act of 2000 required the FDIC to issue rules to govern the payment of post-insolvency interest.

Under the proposed rule, the funds that remain after the principal claims have been paid will be paid to depositors first, then other creditors according to their priority (as listed in the Federal Deposit Insurance Act). The rule specifies that the interest rate to be used in these calculations will be based on the coupon equivalent yield of the average discount rate on the three-month Treasury bill. Finally, the proposed rule would establish how the interest rate would be adjusted (quarterly) and how the post-insolvency interest payments would be calculated (simple interest, not compound interest). The proposed rule was issued on December 18, 2001, and comments were due February 19, 2002. For further information, see 66 *Federal Register*, pp. 65144-46.

Office of the Comptroller of the Currency

Risk-Based Capital Guidelines
(11 / 29 / 01)
The OCC, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (referred to as "federal regulatory agencies") have jointly issued a final rule on the regulatory standards for the treatment of recourse obligations, residual interests, and direct credit substitutes. The final rule results from the combination of two proposed rules, a March 8, 2000, proposed rule on recourse obligations and direct credit substitutes and a September 27, 2000, proposed rule on residual interests. The goal of this rule is to establish consistent regulatory treatment for similar transactions across all of the federal regulatory agencies. Also, the final rule amends current regulations so capital requirements will reflect the credit risk exposure recourse obligations, residual interests, and direct credit substitutes impose on banking organizations.

When a banking organization sells an asset subject to recourse, it retains some or all of the credit risk associated with the asset, even though it no longer appears on its balance sheet. Residual interests are assets created when a bank sells a portion of a pool of financial assets (credit card receivables, for example) but remains exposed to a disproportionate share of any credit losses on those assets. This would include any asset retained on the balance sheet to provide credit enhancement during securitization. A direct credit substitute (or third-party enhancement) is when a bank assumes a portion of the credit risk associated with assets originated by another institution and subsequently sold to investors. An example of a direct credit substitute is a credit risk derivative.

The final rule implements a ratings-based approach to allow the federal regulatory agencies to determine a bank's relative credit risk exposure and what the proper risk-based capital requirement should be. The new system implemented by the final rule calls for a risk weight to be assigned (between 20 and 200 percent) based upon a rating that is assigned to recourse obligations, residual interests, and direct credit substitutes on a case-by-case basis. For example, a bank that is holding a recourse obligation rated by a private rating agency as speculative (BB) would be subject to a 200 percent risk weight to determine its capital level. The final rule allows banking organizations that hold unrated recourse obligations and direct credit substitutes to use their internal risk ratings systems subject to prior approval by their primary financial regulator. Unrated residual interests do not qualify for the ratings-based approach to risk-based capital determination. The final rule requires capital to be held dollar-for-dollar against any unrated residual interests.

The rule also imposes an absolute limit on one type of residual interests: retained or purchased credit-enhancing interest-only strips. These are assets created when an asset is sold but a portion of it is retained. Interest is collected on this portion of the asset, but the holder gives up it's pro rata claim in the event of default. Credit-enhancing interest-only strips are limited to 25 percent of tier 1 capital and are subject to a dollar-for-dollar (100%) capital requirement. Any amount of these that exceed 25 percent of tier 1 capital will be deducted from both tier 1 capital.

The final rule reserves the right for federal regulatory agencies to review and alter the risk weights on a case-by-case basis, if necessary. The rule became effective January 1, 2002. For further information, see 66 *Federal Register*, pp. 59614-59667.

Office of Thrift Supervision

Lending and Investment (12 / 21 / 01)
The OTS issued a final rule that increases the flexibility of thrift institutions by modifying several current rules pertaining to lending and investment. The final rule makes adjustments to regulations concerning small-business lending, purchases of municipal bonds, and community development investment.

The rule increases the maximum dollar amount of what qualifies as a small-business loan from $1 million to $2 million. For farm loans, the amount would increase from $500,000 to $2 million. In addition to these investment limits, the rule, based on provisions in the Consolidated Appropriations Act – FY 2001, will allow thrifts the same authority as banks to invest in small business investment companies (SBICs). SBICs are privately owned and managed investment firms that use their own capital to make venture capital investments in small businesses. Thrifts will also be allowed to invest an aggregate amount of the higher of 1 percent of total capital or $250,000 (up from current limit of $100,000) in community development funds, community centers, and economic development initiatives in their communities.

Finally, the rule broadens the definition of real estate loans and expands the ability of thrifts to invest in state and local government obligations. First, the rule removes the requirement that real estate has to be the primary collateral for a loan to be classified as a real estate loan. Now it is sufficient for a loan to be classified as a real estate loan if it would not have been made under the same terms had it not been secured in part by some type of real estate. In regard to government obligations, thrift institutions will be allowed to invest in general obligations, without limit, and invest up to 10 percent of their total capital in investment-quality nongeneral obligation instruments from one issuer.

The rule became effective January 1, 2002. For further information, see 66 *Federal Register*, pp. 55131-38.

National Credit Union Administration

Regulatory Flexibility Program
(11/23/01)
The NCUA has issued a final rule that implemented a regulatory flexibility program designed to allow credit unions with significantly high net worth and strong supervisory records to avoid certain federal regulations. There are three requirements that credit unions have to meet in order to qualify for the regulatory flexibility program: 1) they must have received a CAMEL rating of 1 or 2 on the previous two exams, 2) they must have a net-worth-to-assets ratio of at least 9 percent, and 3) they must be considered well capitalized under the NCUA's guidelines. Credit unions that qualify need not conduct quarterly stress tests of their securities portfolio if they are already monitoring their balance-sheet exposure to interest-rate risk. Qualifying credit unions are not subject to limits on the share of their investments they can delegate to third parties. In addition, for qualifying credit unions, appraisals are only required for real estate loans in excess of $250,000. Credit unions that do not qualify must continue to have real estate loans in excess of $100,000 appraised. The NCUA can revoke a credit union's exemption at any time without prior notice. The final rule was issued November 23 and is effective March 1. For further information, see 66 *Federal Register*, pp. 58656-63.

SUMMARY OF JUDICIAL DEVELOPMENTS

On November 9, 2001 the U. S. Court of Appeals for the District of Columbia ruled in favor of the National Credit Union Administration (NCUA) in a suit brought by the American Bankers Association (ABA). The case (*American Bankers Association v. National Credit Union Administration*, D.C. Cir., No. 00-5195, 11/9/01) was originally filed in January 1999 by the ABA, which claimed that membership rules formulated by the NCUA went beyond what was permitted under the Credit Union Membership Access Act (1998). The U.S. District Court for the District of Columbia originally dismissed the case.

The Federal Credit Union Act (FCUA) allows for three types of credit unions: common-bond credit unions, which draw their members from a single group (for example, employees of a specific company); community credit unions, which can draw their members from a single area (for example, a city neighborhood); and multiple-bond credit unions, which can draw their members from several common-bond groups when no one of those groups is sufficiently large to form a common-bond credit union. The FCUA, as amended in 1998, limits multiple-bond credit unions to 3000 members. It also limits members of community credit unions to those within "reasonable proximity" of that credit union.

In implementing the 1998 amendments, the NCUA permitted close family members, household members, and pensioners to join multiple-bond credit unions and not be counted toward the 3000-membership limit. It also defined "reasonable proximity" to a community credit union as being within the service area of any electronic facility of the credit union except an ATM.

In its suit, the ABA attacked several parts of the NCUA's regulation, but the overall message of the suit was that the NCUA's rules were "too permissive with respect to credit union formation and growth." In particular, the ABA challenged that the new rules would allow multiple-bond credit unions to by-pass the membership limit by permitting credit unions to not count family members and retirees among the membership totals and the "reasonable proximity" definition for a community credit union. The court, however, affirmed the district court's decision that "each of the challenged provisions reflects a reasonable interpretation of the FCUA" and thereby ruled in favor of the NCUA. Moreover, the court noted that neither party, in its briefs, could define "an electronic facility of a credit union that was not an ATM."

On December 21, the U.S. District Court of Minnesota ruled against a motion brought by Fleet Mortgage Corporation (FMC) and supported by the Office of the Comptroller of the Currency (OCC). The ruling and motion come from a case in which Minnesota's attorney general is suing FMC for deceptive telemarketing practices (*Minnesota v. Fleet Mortgage Corp.*, D. Minn., No. 01-48 ADM / AJB, 12/21/01). Fleet had argued that the court did not have the power to hear the suit and it should be dismissed.

The motion hinged on whether FMC is considered a "bank" under Section 133 of the Gramm-Leach-Bliley Act (GLBA). Section 133 allows state attorneys general to sue nonbank subsidiaries of national banks for telemarketing fraud under the Federal Trade Commission's Telemarketing Sales Rule. The OCC argued that FMC is a national bank operating subsidiary and considered a bank under its standards. The court disagreed and ruled that the Federal Deposit Insurance Act (which is incorporated into Section 133) specifically defines what a bank is, and operating subsidiaries are not listed. Because operating subsidiaries are not included in this definition, the court ruled that they are not banks and therefore are subject to suit under the FTC's Telemarketing Sales Rule. This is the first time a federal court has made a ruling that interpreted Section 133 of (GLBA) and it may lead to further suits against nonbank subsidiaries.

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