



# BANKING LEGISLATION & POLICY

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## Recent Developments

### Federal Regulators Preempt Several State Laws

The Office of the Comptroller of the Currency (OCC) released an interpretive letter February 27 ruling that a Michigan national bank's mortgage subsidiary can charge Michigan interest rates for out-of-state loans because it has the rights of its parent bank. Currently, through its mortgage subsidiary, the national bank makes mortgage loans to residents in all states, except Hawaii. The bank wants to develop uniform pricing policies for its lending programs in all states based on the interest rates and fees allowed in its home state of Michigan. Because it is a national bank, under 12 U.S.C. Section 85, it is allowed to charge interest to borrowers in any state based on the laws of the state in which it is located. The mortgage unit, as an operating subsidiary of its parent bank, is subject to the same federal law that governs its parent bank. Therefore, the OCC concluded that the mortgage subsidiary is allowed to charge interest to customers in any state based on Michigan's maximum interest rate. For more information, see OCC Interpretive Letter #954 at the OCC's web site, [www.occ.treas.gov](http://www.occ.treas.gov).

In a January 30 letter, the Office of Thrift Supervision (OTS) determined that sections of the New York Predatory Lending Law (NY law) do not apply to federal savings associations. The NY law imposes several specific restrictions on high-cost home loans, defined as mortgage loans with a principal

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of \$300,000 or less that exceed certain interest rate and fee thresholds. For high-cost home loans, the law would ban balloon payments and mandate a series of disclosures and

counseling measures for borrowers.

The OTS argued that under its regulation 560.2, federal savings associations may extend credit as authorized under federal law

without regard to state laws that would regulate their credit activities. Citing the Home Owners' Loan Act, the OTS concluded that Congress intended the federal scheme of regulation, with the Federal Home Loan Bank Board (and now the OTS) as regulator, to be uniform and exclusive, leaving no room for state regulation. For more information, see the OTS legal opinion (P-2003-2) at [www.ots.treas.gov](http://www.ots.treas.gov).

On January 21, the OTS cited the same regulation, 560.2, in its decision that various provisions of the Georgia Fair Lending Act (GFLA) are preempted by federal law from applying to federal savings associations. This law would place certain restrictions on mortgage lending. It would limit late fees and prepayment penalties and prohibit the financing of credit or debt cancellation insurance.

GFLA also places limitations on the number of times certain loans may be refinanced and the circumstances in which a refinancing may occur. Finally, high-cost home loans are subject to all of these restrictions and others, including disclosure requirements, mandatory loan counseling for borrowers, and prohibitions against prepayment penalties, balloon payments, and negative amortization. For more information see the OTS legal opinion (P-2003-1) at [www.ots.treas.gov](http://www.ots.treas.gov).

A national bank requested that the OCC also issue a preemption determination that the Georgia Fair Lending Act (GFLA) is preempted by federal laws and regulations. The OCC published National City Bank and National City Bank of Indiana's request on February 26 in the *Federal Register*, pp. 8959-64, and comments were due March 26. The bank's request also prompted the OCC to publish two advisory letters warning banks about abusive lending practices.

The February 21 letters explain the terms and consequences of predatory lending, as well as steps banks can take to ensure that they are not participating in the practice. Beyond reinforcing that abusive lending practices submit banks to negative reputations and safety and soundness risks, the OCC also reminded banks of several regulations that forbid the practice. The OCC gave examples of some common abusive lending practices that include loan flipping,

or frequent refinancing in order to collect more fees, refinancing that results in the borrower's losing beneficial loan terms, hiding fees in the amount financed, negative amortization schedules, and balloon payments.

The OCC explained that these practices subject banks to regulatory scrutiny under the Federal Trade Commission (FTC) Act, the Home Ownership Equity and Protection Act (HOEPA), and in Community Reinvestment Act (CRA) evaluations. The OCC recommended that banks should take steps to determine that loans are being made based on a borrower's ability to repay. In addition, banks should develop policies to address under what circumstances loans will be made that will feature terms generally associated with abusive lending practices. And finally, banks should occasionally assess their transactions to be sure that they comply with their policies and with legal standards. (For more information, see OCC Advisory Letter AL-2003-2.)

In its other advisory letter (AL-2003-3), the OCC addressed predatory lending practices in purchased loans and loans made through mortgage brokers. The OCC stressed the importance of national banks' having the appropriate controls to avoid the legal and credit risks associated with abusive lending practices. The OCC suggested that banks develop policies for brokered loans that address terms such as frequent and consecutive refinancings, negative amortization, single-premium credit life insurance, balloon payments in short-term transactions, prepayment penalties, and interest rate increases upon default. Further, banks need to practice due diligence to ensure that, in purchasing loans, they are adhering to their own policies. For more information, see [www.occ.treas.gov](http://www.occ.treas.gov).

### **Enforcement Actions**

On January 21, the Office of the Comptroller of the Currency (OCC) ordered First National Bank in Brookings, SD, to terminate its payday lending business, pay restitution to credit card customers harmed by its marketing practices, and end merchant processing activities with a third-party vendor within 90 days. The OCC found that the bank's payday lending business,

conducted in its name by Cash America International Inc., was unsafe and unsound. In addition, in its partnership, the bank violated the Truth in Lending Act (TILA), failed to adequately underwrite or document payday loans, and failed to adequately review or audit its payday loan vendors.

In consenting to the OCC's enforcement action, First National agreed to create a \$6 million fund to reimburse customers who were deceived by the bank's various credit card marketing practices. These practices included charging very high application fees and requiring security deposits or account holds ranging from \$250 to \$500 on credit card accounts. Customers believed the credit cards would have a usable amount of available credit, but after the fees, many applicants received cards with less than \$50 of available credit, and in some cases, no available credit.

Finally, the bank was ordered to terminate its merchant processing activities conducted through First American Payment Systems by March 31 because the OCC found that the bank had an unsafe volume of merchant processing activities and that bank insiders with financial interests in the company participated in bank decisions that affected their personal financial interest.

In another enforcement order this quarter, the OCC ordered Advance America, Cash Advance Centers Inc. and Peoples National Bank of Paris, TX, to terminate their payday lending arrangement. In consenting to the January 31 order, the bank agreed to pay \$175,000 in civil penalties, and Advance America agreed not to become either an agent or a bank service provider for a national bank without first applying to the OCC. Advance America agreed to end its Peoples payday lending business conducted in North Carolina by February 28 and in Pennsylvania by March 31.

The OCC found that Peoples failed to ensure that Advance America complied with federal consumer protection laws and regulations, including disclosure requirements under TILA and the disclosure and record-keeping requirements of the Equal Credit Opportunity Act. The OCC also found that the partnership was unsafe and unsound and the bank did not have adequate controls over the lender.

*New Legislation*

**1. Social Security Number Misuse Prevention Act (S.228).** Introduced by Sen. Feinstein (D-CA.) on January 28, 2003.

Status: Placed on the Senate Legislative Calendar under General Orders.  
Related Bill: H.R.637

This bill would amend title 18 of the U.S. Code to establish criminal penalties for Social Security number misuse. To display, sell, or purchase a Social Security number, an entity must explain how and by whom the number will be used, and it must obtain expressed written or electronically mailed consent from the individual to whom the Social Security number is assigned. The bill contains exceptions for health care, national security, law enforcement, and reasonable business purposes, or when providing the Social Security number is required by federal law. Violations of this law could result in civil penalties of up to \$5000 per violation. In addition, violations could result in actions to recover actual monetary losses or \$500 per violation, whichever is greater.

**2. Identity Theft Prevention Act (S.223).** Introduced by Sen. Feinstein (D-CA) on January 28, 2003.

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

First, the bill amends the Truth in Lending Act (15 U.S.C. 1642) to require credit card issuers to notify cardholders if they receive a change-of-address notification and a request for an additional card within the same 30-day period. The issuer is required to notify the consumer at both the old and new addresses within five days of sending the additional card. In this notification, the card issuer must outline steps the cardholder can take to report incorrect changes to his or her account information.

Next, the Fair Credit Reporting Act (15 U.S.C. 1681c) would be amended so that a consumer may alert a credit reporting agency if he or she suspects his or her identity may have been used, without consent, to fraudulently obtain goods or services. Also,

a person can designate that credit should not be issued or extended under his or her name unless an issuer obtains authorization at a specific telephone number chosen by the consumer or by another means of communication. A consumer reporting agency would have to include this fraud alert in a person's file and notify entities wishing to obtain that person's credit information about the alert. Check services companies and demand deposit account information services companies are exempt from the fraud alert requirement.

The bill would also prohibit firms from printing more than the last five digits of a credit card account number on electronically printed receipts. Finally, consumer reporting agencies would be required to give a person a free copy of his or her credit report once in every 12-month period if he or she requests it.

**3. Deposit Insurance Reform Act of 2003 (H.R. 522).** Introduced by Rep. Bachus (R-AL) on February 4, 2003.

Status: Passed the House; Referred to the Senate Committee on Banking, Housing, and Urban Affairs  
Related Bills: S.229.

This bill would reform the Federal Deposit Insurance System by merging the bank and thrift funds, giving the Federal Deposit Insurance Corporation (FDIC) more flexibility to charge premiums on all institutions, and raising coverage for certain investments in individual retirement accounts. First, the bill would combine the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) into a new Deposit Insurance Fund (DIF). All subsequent insurance assessments would be paid into the DIF.

The bill would increase from \$100,000 to \$130,000 the amount of deposit insurance coverage per account offered by the FDIC. Every five years, the coverage limit would be adjusted to reflect changes in the Consumer Price Index. Municipal deposits would be insured for the lesser of \$2 million or \$130,000 plus 80 percent of the deposits in excess of that amount. The bill would also double

deposit insurance coverage for certain retirement accounts to twice the amount of the maximum deposit insurance amount. All of these changes would also apply to the Credit Union Share Insurance Fund administered by the National Credit Union Association.

This measure would also replace the current fixed designated reserve ratio (DRR) with a reserve range for the DIF of between 1.15 and 1.4 percent of estimated insured deposits. In determining the reserve ratio, the FDIC Board of Directors would take into consideration the DIF's risk of losses, the economic conditions affecting the insured depository institutions, measures to prevent sharp swings in the assessment rates, and other appropriate factors. If the DIF's reserve ratio exceeds 1.4 percent, the bill provides that dividends will be paid to insured institutions. Likewise, if there is a shortage of funds, the bill stipulates a plan for restoring the fund.

**4. Community Choice in Real Estate (H.R.111).** Introduced by Rep. Calvert (R-CA) on January 7, 2003.

Status: Referred to the House Subcommittee on Financial Institutions and Consumer Credit.  
Related Bills: S.98, H.J.RES.2

Amending the Bank Holding Act of 1956, this bill would effectively ban financial holding companies and their national banks from entering into the real estate brokerage or management businesses. The Treasury Department and Federal Reserve Board recently proposed to permit banks into the real estate business, as it is "financial in nature" and thus permissible under the Gramm-Leach-Bliley Act. However, this bill would prohibit federal regulators from making a determination that real estate brokerage or management activities are financial in nature. There is a grandfather clause for institutions that engaged in these activities on or before December 6, 2001. The measure defines real estate brokerage activities to include acting as a buyer or seller of a property, advertising and listing the real estate property for lease or sale, and providing

advice during the sale, lease, or rental of a property. The bill defines real estate management activities to include procuring a tenant for a property, negotiating leases of property, and maintaining security deposits on behalf of tenants or lessors.

**5. Business Checking Freedom Act of 2003 (H.R.859).** Introduced by Rep. Toomey (R-PA) on February 13, 2003.

Status: Referred to the House Committee on Financial Services.

This bill would remove restrictions contained in the Federal Reserve Act (12 U.S.C. 371a), the Home Owners' Loan Act (21 U.S.C. 1464(b)(1)(B)), and the Federal Deposit Insurance Act (12 U.S.C. 1828(g)), which prevent banks from offering interest-bearing checking accounts to their business customers.

**6. Business Checking Freedom Act of 2003 (H.R.758).** Introduced by Rep. Kelly (R-NY) on February 13, 2003.

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

If this bill is enacted, Federal Reserve Banks would pay member banks interest on reserve balances. Interest would be paid at least once each quarter at a rate consistent with short-term interest rates. The bill permits the Board of Governors of the Federal Reserve System to determine the best plan for deciding and distributing payments and for delegating responsibilities for doing so.

This bill would also allow all businesses to make up to 24 transfers each month from interest-bearing accounts to their other transaction accounts at the same institution. Additionally, the bill would allow the Federal Reserve Board to set lower reserve requirements on a bank-by-bank basis.

**7. Access to Money Act of 2003 (H.R.774).** Introduced by Rep. Andrews (D-NJ) on February 13, 2003.

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

This bill would amend the Electronic Fund Transfer Act (15 U.S.C. 1693) to prohibit automated teller machine (ATM) operators from charging customers fees for using their

machines if any paid advertising appears on them. Exceptions to this bill include public service announcements and advertisements related to the operators' own products and services.

**8. Identity Theft Consumer Notification Act (H.R.818).** Introduced by Rep. Kleczka (D-WI) on February 27, 2003.

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

This bill would require a financial institution to take steps to notify and assist a customer if it realizes that the customer's identity has been compromised or stolen, through the fault of the bank. The institution would be required to notify the customer of the compromise and of any misuse of their information. The financial institution would be required to assist the consumer in remedying any problems arising from the security breach and would update the customer's credit report information. The financial institution would then be required to reimburse the customer for any financial losses suffered because of the compromised security, including fees for obtaining, investigating, and correcting consumer reporting agency information. The institution may withhold disclosure for a limited period of time at the request of law enforcement.

**9. Bankruptcy Abuse and Consumer Protection Act of 2003 (H.R.975).** Introduced by Rep. Sensenbrenner (R-WI) on February 27, 2003.

Status: Passed the House; Placed on the Senate Legislative Calendar under General Orders.

This bill would revamp the bankruptcy system to require debtors with relatively high incomes to repay some portion of their debt under a court-approved bankruptcy plan. Specifically, debtors who earned more than their state's median family income and who, over five years, could afford to repay at least 25 percent of their debt or \$6000, whichever is higher, would be forced to file bankruptcy under Chapter 13 repayment plans instead of discharging their debt under Chapter 7. This bill is almost identical to the bankruptcy reform bill that stalled in the House last year, except that it excludes a provision that would have prohibited people with court-ordered fines for violent

protest from filing for bankruptcy to avoid paying the fine. For more information, see *Banking Legislation and Policy*, January-March 2001.

**10. Responsible Lending Act (H.R.833).** Introduced by Rep. Ney (R-OH) on February 13, 2003.

Status: Referred to the House Subcommittee on Housing and Community Opportunity.

With some exceptions, the bill would ban balloon payments, negative amortization schedules, and mandatory arbitration clauses on high-cost mortgage loans. It would also prohibit refinancing high-cost mortgages with new high-cost mortgages within the first year of the loan, and the refinancing of government-subsidized loans with high-cost mortgages within the first 10 years of the loan. Additionally, the bill prohibits single premium credit life insurance, call provisions, and fees imposed automatically when the mortgage terms are modified or when loan payments are deferred. It also reduces from five years to four the period during which prepayment fees can be charged. This bill would also increase reporting requirements, restrictions on the resale of foreclosed properties, and restrictions on home improvement contracts.

The bill defines a "high-cost mortgage" as being any of the following: a first mortgage that has an annual percentage rate (APR) at least eight points higher than the yield on U.S. Treasury securities of comparable maturity; a second mortgage with an APR of at least 10 points higher than the yield on U.S. Treasury securities of comparable maturity; a loan of over \$30,000 with points and fees of 6 percent of the loan amount; or a loan of \$30,000 or less where total points and fees exceed 7 percent of the loan total.

The bill would also establish the Consumer Mortgage Protection Board (CMPB) as an agency of the Department of Housing and Urban Development (HUD). The CMPB would have 15 members representing the following groups: consumers, lenders, real estate agents, real estate appraisers, title insurance providers, mortgage insurers, settlement service management companies, electronic mortgage servicers, real estate attorneys, and mortgage brokers. The board's primary responsibility would be to establish, monitor, and coordinate credit counseling programs for HUD. The counseling would be done by private organizations, but the CMPB would

set standards and provide financial assistance. The CMPB's secondary responsibilities would be to certify software for comparing consumer mortgage options, develop and distribute informational booklets, and create and maintain a national database of mortgage brokers that would include a listing of each licensed broker and any complaints and disciplinary or enforcement actions taken against them.

Within three years of this bill's enactment, states would be required to enact licensing and education requirements for mortgage brokers. HUD would be responsible for setting minimum standards for the state laws, but states could enact tougher standards.

**11. Check Clearing for the 21st Century Act (H.R.1474).** Introduced by Rep. Hart (R-PA) on March 27, 2003.

Status: Referred to the House Committee on Financial Services.

Without mandating the receipt of checks in electronic form, this act would permit a substitute check to be used instead of an original check as long as the substitute accurately represents all of the information on the front and back of the original check and explicitly states that it is a copy of the original. Currently, banks exchange paper checks by physically presenting them for payment. Under this alternative method, they could electronically transmit copies of the checks and, in doing so, reduce handling times and lower costs. The act makes warranties that a bank can be required to honor a substitute check only once and that a substitute check must meet the requirements for legal equivalence.

If in using a substitute check, a bank makes an erroneous charge or breaches one of the warranties, consumers may make claims for expedited recredit. Consumers must make claims for expedited recredit within 30 days of receiving an account statement or after receiving the substitute check. In making a claim, a person must explain why his or her account was wrongly debited and include any warranty claim, a statement of loss, and sufficient information to identify the check for investigative purposes. If the claim is valid, the bank must recredit the customer within 10 days. If the bank cannot determine if the claim is valid by the end of the 10th business day after it was filed, it must recredit the customer's account for either the amount of the substitute check or \$2500, whichever is less.

Some exceptions to this policy include recredits to accounts less than 30 days old and accounts frequently overdrawn.

A bank may make a claim for expedited recredit against an indemnifying bank within 120 days of the date of the transaction that gave rise to the claim. Similar to a consumer's claim, a bank's claim must include an explanation of why a check cannot be properly charged to an account, an explanation of losses suffered, and enough information about the check to help the indemnifying bank investigate the claim. The indemnifying bank then has 10 business days after the claim is filed to either recredit the claimant or explain why it is not receding the claimant. Receding the claimant will not, however, absolve the indemnifying bank from liability for claims brought under any other law or from additional damages with respect to the substitute check. Delaying recredit beyond these time frames is excused only if the delay is caused by interruption of communication or computer facilities, suspension of payments by another bank, war, emergency conditions, failure of equipment, or other circumstances beyond the bank's control.

Finally, this bill authorizes the Federal Reserve Board (the Board) to issue regulations that clarify, modify, or implement provisions of this act to reduce risk, accommodate technological or other advances, and alleviate compliance burdens. Within one year of this law's enactment, the Board would be required to issue draft model language for a statement that banks can send their customers informing them about substitute checks.

**12. Mortgage Servicing Clarification Act (H.R.314).** Introduced by Rep. Royce (R-CA) on January 8, 2003.

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

This bill would exempt mortgage servicers from certain requirements of the Fair Debt Collection Practices Act (FDCPA), with respect to federally related first mortgage loans, which are residential property loans made or assisted by a federal government agency. The FDCPA protects debtors from abusive practices, such as harassing phone calls, by third-party debt collectors. Normally, original creditors are exempt from FDCPA. In addition, people who buy or service home mortgage loans are also exempt,

as long as the loan is not in default when it is transferred. If a loan is delinquent or in default when it is transferred, it is covered under FDCPA. This bill would provide an additional exemption for mortgage servicers who acquire federally related first mortgages, even if the loans are in default at the time they were acquired.

**13. Economic Opportunity Protection Act of 2003 (S.660).** Introduced by Sen. Johnson (D-SD) on March 19, 2003.

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

The Fair Credit Reporting Act (FCRA) regulates the consumer credit reporting industry. It contains a provision that prevents states from enforcing new laws that are more restrictive than the FCRA, and that provision will expire on January 1, 2004. This bill would indefinitely extend the federal preemption of new state legislation.

**14. Financial Services Regulatory Relief Act of 2003 (H.R.1375).** Introduced by Rep. Capito (R-WV) on March 20, 2003.

Status: Referred to the House Committee on Financial Services.

This bill would reduce regulatory burdens on financial institutions by removing certain restrictions preventing national and state banks from expanding via new interstate branching, allowing regulators to adjust the exam cycle of healthy institutions for greater efficiency, modernizing record-keeping requirements for regulators, giving flexibility to banks in payment of dividends, increasing the ability of savings associations to invest in small business investment companies, removing limits for thrifts on small business and auto loans, and streamlining depository institutions' merger application requirements.

First, this bill would permit interstate mergers and branching on an unlimited basis. Currently, states can opt out of the federal laws that permit interstate mergers and branching. Additionally, nondepository trust companies would be subject to the same regulations as banks for purposes of interstate banking and branching. This bill would permit federally chartered thrifts to merge with affiliated nondepository institutions. It would also repeal the requirement that out-of-state thrifts pass the "qualified thrift lender test" for each state in which

they operate. Credit unions would not have to pre-notify the Federal Trade Commission before merging, and multiple common-bond credit unions would be permitted to merge. Also, this bill would shorten the post-approval Department of Justice review of merger applications from 15 to 5 days.

Addressing credit unions, this bill would permit privately insured credit unions to become members of the Federal Home Loan Bank System, as long as their state regulators certify that the credit unions meet the eligibility requirements for federal deposit insurance. Federal credit unions would be permitted to invest in securities other than stocks for their own accounts. The securities would have to be investment grade, and the credit union's investment would be limited to 10 percent of its net worth for any single entity or 10 percent of total assets for all securities. Common-bond credit unions, which serve the employees of one company, would be permitted to convert to community credit unions, which can draw their members from a defined geographic area.

The bill would also increase the maximum term on credit union loans from 12 to 15 years. Another provision would allow credit union boards of directors to expel members and limit the number of terms directors can serve. Finally, the bill would make credit unions and thrifts subject to the same terms as banks under the Securities Exchange Act (SEA) and the Investment Advisors Act (IAA).

Other provisions addressing thrifts would remove the 10 percent of assets limit on thrift auto loans and eliminate the lending limit on small business and other commercial loans. Thrifts would be permitted to invest in nonfinancial businesses in low- and moderate-income neighborhoods subject to a limit of aggregate investments not exceeding 10 percent of a thrift's capital and unimpaired surplus.

Other provisions would permit national banks to be organized as entities other than corporations, such as limited partnerships. Also, banking regulators would be permitted to skip examinations of well-managed banks. Branches of foreign banks would be

accorded the same treatment as domestic banks for purposes of branch capital requirements.

#### *Enacted Legislation*

**1. An Act to Improve the Federal Subsidy Rate with Respect to Certain Small Business Loans (S.141).** Introduced by Sen. Snowe (R-ME) on January 10, 2003.

Status: Signed into law by President George W. Bush on February 25 and became Public Law No. 108-8.

This bill allows the Office of Management and Budget (OMB) to use a newly approved econometric model to substantially increase the subsidy rate for Small Business Administration (SBA) Section 7(a) small business lending (for more information, see *Banking Legislation and Policy*, October-December 2002). Under the new model, the SBA can increase 7(a) lending for fiscal year 2003 from \$4.8 billion to \$8.2 billion.

## **SUMMARY OF FEDERAL REGULATIONS**

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### **Federal Financial Institutions Examination Council**

#### *Subprime Lending (1/7/03)*

Federal regulators terminated a three-year effort to require banks and thrifts to report information about their subprime loans in call reports. The agencies declared that they will not mandate stricter call report disclosures about lending to subprime borrowers with poor credit histories; instead, they will rely upon existing reporting requirements. In making their decision, the agencies noted that the banking industry does not have standard definitions for several key terms, including "subprime." In lieu of the reporting requirements, the agencies will monitor subprime consumer lending activity through the examination process. For more information about what would have been required, see 67 *Federal Register*, pp. 46250-4 or *Banking Legislation and Policy*, July-September 2002.

#### *Credit Card Lending (1/8/03)*

The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of

Thrift Supervision (collectively, "the Agencies"), through the Federal Financial Institutions Examination Council, issued guidance governing account management and loss allowance practices for credit card lending for all banks and thrifts. In this guidance, the Agencies outlined their expectations for prudent risk management, income recognition, and loss allowance practices. Except for several clarifications, described below, the guidance is very similar to the draft guidance issued in July 2002.

The Agencies clarified that an institution should document the criteria used in assigning credit lines and significantly increasing credit lines. Documentation should specifically include an analysis of decision factors such as repayment history, risk scores, and behavior scores. The Agencies clarified that over-limit authorization on open-end accounts should be restricted and subject to appropriate policies and controls. The Agencies also require that minimum payments amortize the current balance over a reasonable period of time and should not induce negative amortization, where the minimum balance does not cover finance charges and fees and the balance continues to rise. Finally, the Agencies increased the

repayment period from four to five years for workout agreements, when the credit line is closed and the balance owed is fixed. For more information on the guidance, see *Banking Legislation and Policy*, July-September 2002.

### **Board of Governors Of the Federal Reserve System**

#### *Foreign Bank Underwriting (1/9/03)*

Foreign banks wishing to engage in underwriting of securities within the United States must either be a financial holding company or have authority to engage in underwriting activity under section 4(c)(8) of the Bank Holding Company Act (BHC Act), the Federal Reserve Board (the Board) said in its interpretation of Regulation K. The Board clarified that by conducting underwriting activities through an office of a subsidiary in the United States, foreign banks are engaging in underwriting business and activities, which makes foreign banks subject to the BHC Act.

This rule became effective February 19. For more information, see 68 *Federal Register*, pp. 7898-9.

### *Reporting and Disclosure Requirements (1/31/03)*

State member banks that have a class of securities registered under the Securities Exchange Act of 1934 must comply with any reporting, disclosure, and corporate governance rules adopted by the Securities and Exchange Commission under designated sections of the Sarbanes-Oxley Act, the Federal Reserve Board announced in its final rule, Regulation H. This final rule is identical to the September 2002 interim rule.

This final rule was effective April 1. For more information, see 68 *Federal Register*, pp. 4092-6.

### *Fair Lending (2/7/03)*

Nonmortgage credit lenders will be allowed, but not required, to collect information about borrowers' race, sex, and other personal characteristics to evaluate lenders' compliance with the Equal Credit Opportunity Act (ECOA), the Federal Reserve Board (the Board) announced in the final rule, Regulation B. This information is already required for mortgages and home improvement loans under the Home Mortgage Disclosure Act. ECOA prohibits discrimination on the basis of a credit applicant's national origin, marital status, religion, color, sex, race, age, and other factors.

The Board hopes that by allowing lenders to collect such information, they can better assess their lending practices and measure their adherence to the anti-discriminatory policies. A lender's self-testing results are not subject to discovery in litigation. However, certain information, such as the methodology and scope of the tests, is not privileged and may have to be provided. If the litigation involves a discrimination claim, the lender may use the test results to defend itself, but it is not required.

If creditors use pre-selection and pre-approval techniques to solicit borrowers through direct marketing, they are required to maintain the records documenting the prescreening characteristics for 25 months. For instance, a creditor would need to keep the criteria used to pre-select credit candidates, and they would also need to supply a copy of the solicitation material they used in case they are needed to investigate possible discrimination. In addition, this rule requires that other records currently held for 12 months would now need to be maintained for at least 25 months. This rule became effective April 15, and

lenders must be in compliance by April 15, 2004. For more information, see 68 *Federal Register*, pp. 13143-98.

### *Commodity Contracts (3/14/03)*

The Board of Governors of the Federal Reserve System (the Board) proposed to amend Regulation Y to allow bank holding companies (BHCs) to enter into derivative contracts that result in taking or making delivery of title to commodities on an instantaneous, pass-through basis, as long as the BHCs do not take physical possession of the commodity. Currently, BHCs are permitted to trade in commodity contracts only if: (1) the commodity underlying the contract is eligible for investment by a state member bank; or (2) the contract requires cash settlement; or (3) the contract allows for assignment, termination, or offset prior to delivery or expiration, and the BHC has made every effort to avoid taking or making delivery of the underlying commodity. The Board developed the restrictions to help ensure that BHCs would not become involved in and bear the risks of physical possession, transport, storage, delivery, and sale of bank-ineligible commodities.

The Board is proposing to permit BHCs to take or make delivery of title to, but not physical possession of, commodities on an instantaneous, pass-through basis, saying that it will not subject the BHCs to the risks associated with commodity ownership. The Board said that such transactions involve the routine BHC operations such as passing notices, documents, and payments.

The Board also proposed to allow BHCs to enter into commodity contracts that do not require cash settlement or specifically provide for assignment, termination, or offset prior to delivery, as long as the contracts involve commodities for which futures contracts have been approved for trading on a U.S. futures exchange.

Comments on this proposed rule were due April 14, 2003. For more information, see 68 *Federal Register*, pp. 12316-8.

### *Truth in Lending (3/28/03)*

The Federal Reserve Board (the Board) issued a final rule to revise the staff commentary to Regulation Z, which implements the Truth in Lending Act (TILA). Very similar to the Board's November 2002 proposed revisions, this rule clarifies and classifies certain credit card and mortgage fee disclosures and allows substitute and replacement credit cards to be issued on the same account. In one notable contrast to its earlier proposal, the Board will

not require credit card companies to disclose expedited payment charges as "other charges." Expedited payment charges are applied when a customer requests that his or her payment be processed more quickly, either by electronic transfer or some other means. Previously, the Board had proposed requiring credit card companies to make such disclosures. For more information on the proposal, see *Banking Legislation and Policy*, October-December 2002.

This final rule became effective April 1. For more information, see 67 *Federal Register*, pp. 72618-22.

## **Office of the Comptroller of the Currency**

### *Audit Services (1/8/03)*

Jointly, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (together, "the Agencies"), proposed more encompassing guidelines for debaring or suspending accountants who perform required audit services for insured depository institutions with total assets exceeding \$500 million.

The proposal defines good cause for removing accountants and accounting firms if they are not qualified to perform audit services, violate applicable professional standards, give misleading or false information to the Agencies, or violate any federal banking or securities laws. This definition is based on existing practice rules and the Securities and Exchange Commission's (SEC) practice rules.

If the Agencies find good cause, they may decide to take action against a firm by assessing, among other things, the gravity and scope of the incident, the extent to which management was involved, and the measures taken to ensure it doesn't happen again. If the Agencies decide that an entire firm should not be held accountable, they may still take action against particular offices within the firm.

If an agency takes action, it will hold hearings governed by the Agencies' uniform rules of practice and procedure. These rules provide the opportunity for a hearing before an administrative law judge who would recommend a decision to the agency that would then give a final decision. The agency can also decide whether to extend the suspension, removal, or debarment to all depository institutions that it regulates or to a limited number of them. The proposal would also allow the Agencies to

immediately suspend any accountant or accounting firm believed to be engaged in practices that would constitute grounds for removal, suspension, or debarment. Additionally, the proposal establishes an expedited review system.

Finally, any accountant or accounting firm that is subject to a final order of removal, suspension, or debarment by one agency or by the SEC or the Public Company Accounting Oversight Board would be automatically precluded from performing audit services for insured depository institutions regulated by the other Agencies. The individual or firm would be able to request reinstatement one year after the effective date of the order and at any time at least one year after its last request.

Comments on this proposed rule were due March 10. For more information, see 68 *Federal Register*, pp. 1116-30.

#### *Community Development (1/10/03)*

The Office of the Comptroller of the Currency (OCC) proposed a regulation to simplify the process by which national banks invest in community development projects. First, the OCC proposes to replace the term "Community Development Corporation" (CDC) with "Community and Economic Development Entity" (CDE) to better reflect the range of investment vehicles that can be used for making investments. A CDE refers to any type of organization whose activities primarily benefit low- and moderate-income individuals or areas.

The proposal also clarifies that a bank should use generally accepted accounting principles to calculate its aggregate amount of public welfare investments, which may not exceed 10 percent of its capital and surplus. After-the-fact notices would be given to the OCC within 10 days after a bank's making a public welfare investment. The notices would be shortened and simplified to include only (1) a description of the bank's investment, (2) the amount of the investment, (3) the percentage of the bank's capital and surplus represented by the investment and the bank's aggregate outstanding public welfare investments, and (4) a certification that the investment benefits low- and moderate-income individuals and doesn't exceed the investment limits. Finally, banks would no longer need to show community support for a public welfare investment.

Comments on this proposed rule were due March 11. For more information, see 68 *Federal Register*, pp. 1394-9.

#### *Corporate Powers (2/7/03)*

The Office of the Comptroller of the Currency (OCC) proposed a rule to clarify procedures for mergers between national banks and nonbank affiliates and for organizing de novo limited-purpose national banks. The proposal also expands the list of activities permissible for national banks and changes the method for valuation of mutual fund assets. Further, the proposal would clarify the extent to which access to national banks' financial records is exclusive to the OCC. Finally, the rule would permit national banks to lengthen and stagger their directors' terms and have larger boards of directors.

The proposal would allow a national bank to become a subsidiary of a bank holding company as long as the OCC does not object to the combination. Current regulations require the express approval of the OCC. Next, the proposal clarifies that national banks can, with OCC approval, merge with affiliated nonbanking companies. The nonbank would be handled like a state bank for purposes of the application, but the current provision allowing for public comments and requests for hearings on the application would not apply.

Next, the proposal would allow limited-purpose national banks to be established for purposes other than fiduciary activities. It would also permit national banks to reinsure credit and provide tax advice and planning services. Further, the proposal would change the way national banks value their mutual funds. Currently, these funds are revalued quarterly, unless the fund is primarily invested in real estate or other assets that are not readily marketable. Under the proposal, readily marketable assets would be revalued every quarter while all other assets would be revalued annually, regardless of the fund's composition.

Another part of the proposal states that the only exception to the OCC's exclusive authority for visitation of national banks is the "vested in the courts of justice" exception. That is, courts may compel a national bank to furnish its records in connection with private litigation. The rule further asserts that state executive, legislative, or administrative authorities cannot bring lawsuits for the purpose of gaining access to national bank records.

Finally, the rule would expand a national bank director's maximum term from one to three years. It would also permit banks to stagger the terms of their directors, and it would allow, with prior approval, national banks to have more than 25 directors.

Comments on this proposed rule were due April 8. For more information, see 68 *Federal Register*, pp. 6363-76.

#### *Refund Anticipation Loans (2/13/03)*

In a letter to an unnamed bank, the Office of the Comptroller of the Currency (OCC) determined that the appropriate risk weight for tax refund anticipation loans (RAL) is 100 percent. RALs are bank loans made to individual taxpayers in anticipation of tax refund payments. With a 100 percent risk weighting, banks will have to set aside one dollar for every dollar lent in an RAL to protect against losses. A bank argued that the consumer loans should carry only a 20 percent risk weighting, since they are guaranteed by the Internal Revenue Service (IRS). But the OCC decided that, because the IRS can reduce or reject a tax filing, the anticipated refund may not always be accurate. If the IRS check does not come or is not for the expected amount, the payment of the RAL depends on the individual's creditworthiness, making it more high-risk. For more information, see OCC Interpretive Letter #959, available on the regulator's web site at [www.occ.treas.gov](http://www.occ.treas.gov).

### **Office of Thrift Supervision**

#### *Financial Reports (1/23/03)*

The Office of Thrift Supervision (OTS) proposed changes to savings institutions' quarterly financial reports to enhance their usefulness and to make them more consistent and comparable with other banking institutions' requirements. Beyond clarifying some terms and categorizing some disclosures to be more explicit, the OTS proposes to shorten the thrift financial report (TFR) filing period from 30 to 20 days after the end of the quarter. Further, holding company (HC) and consolidated maturity rate (CMR) schedules would be due not 45 days, but 30 days after the end of the quarter.

Comments on this proposed rule were due March 24. For more information, see 68 *Federal Register*, pp. 3318-24.

### **Department of Housing and Urban Development**

#### *FHA appraisals (1/13/03)*

The Department of Housing and Urban Development (HUD) proposed a rule holding lenders responsible for the quality of appraisals on Federal Housing Administration (FHA) insured mortgages. The current process to obtain FHA mortgage

insurance begins with lenders selecting an appraiser from an FHA roster of qualified appraisers. The appraiser submits a report on the property to the lender, who, through an underwriter, reviews and certifies the report to ensure that it satisfies HUD's FHA requirements.

Under the proposal, lenders and their underwriters will be held accountable for misleading or fraudulent appraisals. Appraisers, sponsor lenders (who underwrite loans), and loan correspondent lenders (who originate loans on behalf of their sponsors), would be held equally responsible for the quality of appraisals on properties that secure FHA-insured mortgage loans. It clarifies that lenders must ensure that an appraisal meets FHA standards before submitting it. The proposal does not outline specific steps lenders should take to assess the quality of the appraisal, but it does mention several tools they can use including, but not limited to, reviewing appraisal documents, performing quality assurance checks, using technology such as the Automated Value Model to determine whether the value derived by an appraiser is within reason, and working with appraisers who carry errors and omissions insurance. Comments on this proposed rule were due March 14. For more information, see 68 *Federal Register*, pp.1766-9.

#### *Real Estate Settlement Procedures (2/7/03)*

The Department of Housing and Urban Development (HUD) postponed a rule implementing changes to the Real Estate Settlement Procedures Act (RESPA) until this spring or thereafter. The proposal addresses the unexpected charges borrowers sometimes encounter during mortgage settlements and requires lenders to disclose fees paid to mortgage brokers that are not included in closing costs. However, in response to criticism of the current proposal, HUD is considering issuing a revised proposal. For more information about the current proposal, see *Banking Legislation and Policy*, July-September 2002.

#### **Financial Accounting Standards Board**

##### *Variable Interest Entities (1/17/03)*

The Financial Accounting Standards Board (FASB) issued Interpretation No. 46, Consolidation of Variable Interest Entities, for consolidation of another entity's assets and liabilities in a firm's financial statements. A variable interest entity (VIE) can be a corporation, partnership, trust, or any other

legal structure used for business purposes that either does not have equity investors with voting rights or has equity investors that do not provide sufficient financial resources for the entity to support itself.

The current practice is for a firm to consolidate an entity it controls through voting interests. This interpretation addresses rules for consolidating entities that are controlled through other means. According to this interpretation, if a company is subject to a majority of the risk of loss from a VIE's activities, or if it is entitled to receive a majority of the entity's residual returns, then that company is the primary beneficiary of the entity and should consolidate it. When consolidating, the primary beneficiary must also disclose a description of the variable interests, why and how it has such interests, information on the size and activities of the interests, and the maximum exposure of potential loss from that involvement. Companies that have a significant variable interest in a VIE should also disclose information about it even if they are not the primary beneficiary. The relative size of a variable interest is determined by comparing the expected future losses of that interest.

The interpretation applies immediately to VIEs created after January 31 and to all VIEs in which an enterprise obtains an interest after that date. Further, it applies in the first fiscal year or interim period beginning after June 15 to VIEs in which an enterprise holds a variable interest that it acquired before February 1.

#### **Federal Deposit Insurance Corporation**

##### *Payday Lending (1/29/03)*

The Federal Deposit Insurance Corporation (FDIC) released draft proposed guidelines for financial institutions that participate in the payday lending business. The January 29 proposal warned of the risks posed to banks and thrifts when they make these short-term, small-dollar, unsecured loans to borrowers who promise to repay them with their next paycheck. The FDIC advised that this guidance does not apply to banks that make occasional short-term loans to customers. Payday loans are usually priced at a fixed dollar-rate that represents the finance charge of the loan. Because the loan terms are of relatively short maturity, the finance charges, expressed as an annual percentage rate, can range from 300 to more than 1000 percent.

The FDIC's proposed guidelines

examine the risks involved with payday lending and suggest safety and soundness compliance considerations for examining and supervising the programs. The FDIC argues that the combination of the typical borrower's limited financial capacity, the unsecured nature of the credit, and the limited underwriting analysis of the borrower's ability to repay poses substantial risk for banks and thrifts. Many insured depository institutions do not directly originate payday loans, but rather they may enter into arrangements with third-party lenders whereby the third party originates the loan and the financial institution funds it. In these instances, the FDIC argued, financial institutions are subject to greater risks, including credit, legal, and reputation risks.

In its 2001 Subprime Guidance and the Subprime Lending Examination Procedures, the FDIC recommended that institutions hold one-and-a-half to three times greater capital against subprime assets than what is recommended for non-subprime assets. For payday loans, however, the FDIC now recommends significantly higher levels of capital, including dollar-for-dollar matching for payday loans outstanding. The FDIC instructed examiners to assess depository institutions' payday lending relationships with third parties, ensuring that they are guided by written contract and approved by the institution's board. Additionally, the FDIC recommended that banks employ an oversight policy to monitor the third party's financial condition, its controls, and the quality of its service and support. These measures will help to indemnify the financial institution for potential liability.

The FDIC also recommended that banks limit the frequency of payday lending to the same customers, including limiting extensions, deferrals, and renewals. Further, the FDIC recommended that lenders establish a waiting period between the time a payday loan is repaid and another application is made.

Comments on this proposed guideline were due March 14. For more information, see the draft at the FDIC's web site, [www.fdic.gov/regulations/laws/PublicComments/Payday1.html](http://www.fdic.gov/regulations/laws/PublicComments/Payday1.html).

##### *Deposit Insurance (2/13/03)*

The Federal Deposit Insurance Corporation (FDIC) issued a final rule allowing banks that are organized as limited-liability companies (LLC) to be eligible for federal

deposit insurance. Previously, banks had to be incorporated to be eligible. The FDIC decided that as long as an LLC possessed four characteristics, it is indistinguishable from a corporation for purposes of the Federal Deposit Insurance Act. These four characteristics are: (1) perpetual succession,

that is, the entity must continue to exist independent of its owners; (2) centralized management, meaning that authority to manage the entity is exclusive to a group of individuals appointed or elected by the owners; (3) limited liability, meaning that the owner(s) are not responsible for the debts

of the entity; and (4) free transferability of interests, which means that an owner can sell his or her interest in the entity without the consent of the other owners.

This rule became effective March 17. For more information, see 68 *Federal Register*, pp. 7301-9.

## **SUMMARY OF JUDICIAL DEVELOPMENTS**

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### **Massachusetts Preemption Suit Dismissed**

On February 13 the U.S. Court of Appeals for the First Circuit dismissed a case challenging the Office of the Comptroller of the Currency's (OCC) authority to preempt portions of a Massachusetts consumer protection statute (*Bowler v. Hawke*, No. 02-1738). Massachusetts Commissioners of Insurance and Banks petitioned the court to negate an OCC informal opinion letter asserting that the 1999 Gramm-Leach-Bliley Act (GLBA) preempts three provisions of the Massachusetts statute: "An Act Providing Consumer Protection Relative to the Sale of Insurance by Banks" (the act).

GLBA establishes that individual states may regulate insurance sales, solicitation, and cross-marketing activities of depository institutions and their affiliates only as long as the rules are mostly the same and no more burdensome or restrictive than GLBA provisions. The act in question would prohibit nonlicensed bank personnel from referring bank customers to a licensed insurance agent or broker except upon an inquiry initiated by the customer. The act also prohibits nonlicensed bank personnel from receiving additional compensation for insurance referrals regardless of whether the compensation was conditioned upon the sale of insurance. Finally, the act prohibits banks from making an insurance solicitation in connection with an application for an extension of credit until after the application has been approved and, in the case of an extension of credit secured by a mortgage on real estate, until after the customer has accepted the bank's written commitment to extend credit.

On March 18, 2002, the OCC issued a letter asserting that GLBA preempts the Massachusetts law. Massachusetts filed suit citing "regulatory conflict" as its grievance. However, the court found that the opinion letter did not create a regulatory conflict as

the letter did not impose a legal or practical constraint on Massachusetts. Further, the court opined that the letter would not impair Massachusetts' ability to enforce its laws, and therefore, it does not create a controversy or regulatory conflict.

The court realized the potential effects this decision might have on future preemption cases and narrowed the scope of the opinion. The court argued that future cases would be better decided on a case-by-case basis, based on their specific facts, rather than by any precedent established in this decision.

### **RESPA Kickback Suits Are Not Eligible For Class Certification**

The U.S. Court of Appeals for the Fifth Circuit ruled on February 7 that a lower district court erred in assigning class status to a group of plaintiffs who alleged that a mortgage broker violated provisions of the Real Estate Settlement Procedures Act (RESPA) by accepting kickbacks (*O'Sullivan v. Countrywide Home Loans Inc.*, No. 01-21028).

Countrywide Home Loans, a mortgage brokerage firm, used its employees and its computer system to create original loan documents and then selected law firms to review them. The law firms then charged the plaintiffs a fee for preparing the documents. In federally required HUD-1 settlement statements, Countrywide disclosed various settlement costs, including the attorney's fees, as "document preparation fees." The HUD-1 disclosures seemed to indicate that the fees the plaintiffs paid went directly to the law firm; however, the law offices and the defendant split the fees to compensate Countrywide for its work in preparing the mortgage documents. The HUD-1 did not reflect this fee-splitting, and the plaintiffs contended that it was a kickback or a referral fee, a RESPA violation.

A lower court granted class certification

to the plaintiffs, saying that the practice itself permitted class action. The Court of Appeals reversed, however, acknowledging that each case requires an individual judgment to determine whether the fee-splitting was reasonable for the amount of work Countrywide did for each loan. Referring to 1999 and 2001 Department of Housing and Urban Development (HUD) policy statements, the court determined that kickback claims require a comparison of the compensation received with the actual services provided on a transaction-by-transaction basis, making a class action impossible.

### **Card Companies Can Change Their "Annual" Interest Rates**

The North Carolina Supreme Court determined that a bank may change its annual interest rate, refusing to hear a customer's appeal that doing so violated his cardholder agreement (*Gaynoe v. First Union Corp.*, No. 620P02). In 1993, the plaintiff chose an agreement from the First Union credit options, accepting their highest annual fee in exchange for their lowest annual interest rate. Then, in 1997, First Union increased the annual interest rate mid-period while keeping the annual fee the same. The plaintiff charged that by changing the rate during the annual period, the bank breached the cardholder contract because the annual interest rate and fee should apply for the whole year. The plaintiff argued that by paying the annual fee, he was entitled to the pre-set and agreed-upon annual percentage rate for the entire year. However, a North Carolina appeals court found for the bank in 2002, reasoning that the annual fee did not purchase the annual interest rate, but instead was a fee for the line of credit. The North Carolina Supreme Court, by not hearing the appeal, let the decision stand.

**New Jersey**

The New Jersey Senate passed anti-predatory lending legislation February 27. If enacted, the bill could become the next in a string of state anti-predatory lending measures preempted by federal regulators (see the "Recent Developments" section of this *Banking Legislation and Policy*).

Introduced May 9, 2002, the New Jersey Home Ownership Security Act (A.75) would prohibit abusive lending practices, such as financing points and fees, loan flipping (frequent refinancing), charging pre-payment fees, and accelerating indebtedness. The bill also limits late-payment penalties to no more than 5 percent of the amount past due for more than 15 days.

"High-cost home loans" are subject to further restrictions, including prohibitions against increasing interest rates after default, negative amortization, and scheduled payments that are more than twice the

amount of earlier scheduled payments. Lenders must evaluate the borrower's ability to repay the loan and submit to the borrower a statement explaining that he or she may be able to obtain a mortgage at a lower cost through another lender. The statement would warn the borrower that his or her home may be seized if payments are not made, and it would advise him or her to consult an attorney and financial advisor about the risks of accepting the mortgage loan. If the borrower wishes to finance points and fees, the lender must receive confirmation from an approved third party that the borrower sought counseling from an accredited counselor before the high-cost home loan transaction can be made.

**Pennsylvania**

Introduced February 24 and referred to the Committee on Commerce, the Pennsylvania ATM Fee Regulatory Act (H.B.376, P.N.440)

places restrictions on automated teller machine (ATM) transaction fees. First, financial institutions will be required to display the fee for each transaction on the ATM screen and give the customer the chance to cancel. Next, financial institutions will need to provide a written notice to their customers advising them that they may charge a fee for using other financial institutions' ATMs. If a financial institution does not make these notices, customers are not required to pay the fees. Further, a customer may not be charged more than one fee per ATM transaction, regardless of how many financial institutions are involved in the transaction. Also, a financial institution may not charge an ATM transaction fee if it does not dispense cash at all of its branches. And finally, customers may not be charged fees for electronic transfers initiated via telephone.

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