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Recent Developments

NY Attorney General Challenges OCC Preemption Rule

The Office of the Comptroller of the Currency (OCC) is facing criticism after issuing a final rule in January that clarifies the extent to which OCC regulations preempt state laws concerning bank activities (see *Summary of Federal Regulations* section). The House Financial Services Committee included in its budget resolution a nonbinding stipulation that the OCC may have to use funds desig-

nated for other purposes to support the regulation's consumer protection goal, a provision that New York attorney general Eliot Spitzer supports.

Spitzer is challenging the OCC by suing a national bank subsidiary that he says illegally threatened to foreclose on the home of a New York resident. The OCC's preemption protects national banks from this type of state enforcement of consumer protection laws. The case stems

from a 1974 mortgage loan that, during its lifetime, was assigned to different creditors several times and is currently held by First Horizon Loan Corporation, a Texas-based subsidiary of First Tennessee Bank, a national bank. The consumer made all of the required payments due under the loan by an automatic debit from his checking account. The final payment was due October 15, 1999, but the consumer mistakenly believed the loan to be a 30-year mortgage, so he continued to allow the payments to be debited. In May of 2003 First Horizon notified the consumer that his original mortgage lender made a mistake and he should have been paying \$16 more a month. First Horizon planned to extend the mortgage's maturity date until March 2010, the additional payments totaling over \$25,000. The consumer, already having paid \$9,000 more than what was required under his mortgage, stopped the automatic debits. First Horizon warned the consumer that if he did not pay the difference between his overpayment and the amount they claimed he still owed (more than \$12,000) in 30 days, the bank would foreclose on his home.

Before filing the lawsuit, the attorney general attempted to resolve the matter with First Horizon, but bank officials said they could not discuss it because the OCC di-

rected them not to talk to state attorneys general. Spitzer is seeking to halt First Horizon's collection and foreclosure efforts and require it to make restitution to the consumer. He is also seeking civil penalties against the bank for illegal and deceptive practices.

OFHEO Orders Freddie Mac to Hold Additional Capital

On January 28, the Office of Federal Housing Enterprise Oversight (OFHEO) wrote a letter to Freddie Mac directing the government-sponsored enterprise to maintain a mandatory target capital surplus of 30 percent more than its minimum capital requirement. Each week Freddie Mac will be required to submit to the OFHEO an analysis and calculation of its mandatory target capital surplus and its current capital position. The first weekly report was due February 6 for the week ending January 30. These reports are in addition to Freddie Mac's monthly minimum-capital reports that must be completed within 30 days of the end of the month. The OFHEO took this and other steps to ensure that Freddie Mac continues to maintain an adequate surplus until its operational risk is reduced and timely, certified financial statements are produced. (For more information, see *Summary of Federal Regulations* section.)

SUMMARY OF FEDERAL LEGISLATION

New Legislation

1. Zero Downpayment Act of 2004 (H.R. 3755). Introduced by Rep. Tiberi (R-OH) on February 3, 2004.

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

This bill amends the National Housing Act to allow the secretary of Housing and Urban Development to insure zero-down-payment mortgages on single-family residences for first-time homebuyers. The bill permits the secretary to establish additional requirements, including rules regarding mortgagor and property eligibility.

2. Promoting Community Investment Act of 2004 (H.R. 3952). Introduced by Rep. Hensarling (R-TX) on March 11, 2004.

Status: Referred to the House Committee on Financial Services.

This bill would amend the Community Reinvestment Act of 1977 (CRA) to allow depository institutions with assets of less than \$1 billion to be reviewed under a streamlined CRA examination process. Currently, depository institutions with assets of less than \$250 million are examined under the streamlined process. The bill would also require the \$1 billion limit to be adjusted for inflation each

year, starting January 31, 2006. The adjusted limit would be rounded to the nearest \$50 million.

Pending Legislation

1. Financial Services Regulatory Relief Act of 2003 (H.R. 1375). Introduced by Rep. Capito (R-WV) on March 30, 2003.

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

This bill would update many laws that govern the financial services industry with the objective of reducing the regulatory burden for depository institutions. Some important provisions would: 1) permit banks to cross state lines by opening new branches; 2) allow regulators to adjust exam cycles of healthy institutions for greater efficiency; 3) modernize recordkeeping requirements for regulators; 4) prevent criminals from participating in the affairs of any depository institution; 5) give flexibility to banks in the payment of dividends; and 6) increase the ability of savings associations to invest in small-business investment companies and remove limits for thrifts on small-business and auto loans. (For more information, see *Banking Legislation and Policy*, January-March 2003.)

Before passing the bill, the House of Representatives approved two amendments. The first amendment would limit *de novo* branching for industrial loan companies

whose business is 85 percent financial in nature or those who had federal deposit insurance before October 1, 2003. The second amendment would permit banks to pay interest on business checking accounts and would allow the Federal Reserve Banks to pay member banks interest on reserve accounts.

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

Status: Added as an amendment to Senate measure S. 1920.

SUMMARY OF FEDERAL REGULATIONS

Office of the Comptroller of the Currency

Preemption Powers (1/13)

The Office of the Comptroller of the Currency (OCC) issued a final rule to clarify the applicability of state laws to national banks. The rule lists the types of state law restrictions that are (and are not) preempted by federal regulations. The lists are not meant to be exhaustive, and the OCC reserves the right to determine whether a state's restrictions should be preempted on a case-by-case basis. The final rule asserts that state laws do not apply to national banks if they obstruct, impair, or condition a national bank's ability to exercise its federally authorized real estate lending powers, unless a federal law makes the state law applicable. Examples of these types of laws are those that pertain to licensing requirements for lenders, the use of credit reports, loan-to-value ratios, and restrictions on credit insurance.

Generally, state laws are not preempted and do apply to national banks if they accommodate the banks' authority to engage in real estate lending and their effect on real estate lending operations is only incidental. Such laws generally pertain to contracts, acquisition and transfer of property, taxation, zoning, crimes, torts, homestead rights, and national banks' right to collect debt.

The final rule also specifically states that national banks have the authority to engage in deposit-taking activities under the OCC's regulation, and the final rule warns that state laws that obstruct, impair, or condition a national bank's ability to engage in these activities are not applicable and will be preempted. Types of state laws that would be preempted because of their effect on deposit-taking activities include state requirements concerning abandoned and dormant accounts, checking accounts, disclosure requirements, and funds availability.

The final rule prohibits national banks from making a consumer loan (a loan for personal, family, or household purposes) based predominantly on the liquidation or foreclosure value of the borrower's collateral. Banks may consider the borrower's ability to repay the loan by us-

The House of Representatives passed Senate measure S. 1920, a bill that authorizes a six-month extension of Chapter 12 of the bankruptcy code, which offers farmers relief from bankruptcy. Before its passage, the House attached the Bankruptcy Abuse and Consumer Protection Act of 2003 (H.R. 975) to the Senate bill. The Bankruptcy Abuse and Consumer Protection Act would revamp the bankruptcy system, requiring debtors with relatively high incomes to repay some portion of their debt under a court-approved plan (see *Banking Legislation and Policy*, January-March 2003).

ing any reasonable method, including assessments of the borrower's current income, cash flow, net worth, financial obligations, employment status, and credit history. The final rule also includes a statement that warns banks against engaging in unfair or deceptive practices, as defined by the Federal Trade Commission Act.

This final rule became effective February 12. For more information, see 69 *Federal Register*, pp.1904-17.

CRA Evaluations (2/6)

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 a rule to amend the Community Reinvestment Act (CRA) regulations in two areas. First, the agencies propose to amend the definition of a "small institution" for purposes of the streamlined examination test. Next, the agencies propose that a bank's CRA performance will be negatively affected if a bank or a bank's affiliate engages in discriminatory, illegal, or abusive lending.

Currently, a small institution is defined as one that, at the end of either of the past two years, has less than \$250 million in assets and was either independent or affiliated with a holding company with total bank and thrift assets of less than \$1 billion. Being classified as a small institution allows the bank to participate in a streamlined examination that focuses mostly on lending. Conversely, large institutions, with a few exceptions, are evaluated under a three-part exam of lending, investment, and service. Large institutions must collect and report data on small-business loans, small-farm loans, and community development loans, and may volunteer to collect data on consumer loans. The agencies believe the gap between the smallest and largest institutions has grown since the classifications were introduced in 1995, and currently too few institutions are being classified as small. The agencies are proposing to redefine small institutions as those with less than \$500 million in assets and to allow them to qualify regardless of holding company assets.

The agencies also propose to clarify that instances of predatory lending by a bank or a bank's affiliate will adversely affect the bank's CRA performance. Examples of violations that would negatively affect CRA evaluations include discrimination against loan applicants, evidence of illegal referral practices, and evidence of unfair or deceptive credit practices. The agencies will look for these predatory practices in connection with home mortgage, small-business, small-farm, consumer, and community development loans. One example is equity stripping — the practice of extending home mortgage or consumer loans based predominantly on the foreclosure value of the collateral, where the borrower cannot be expected to make the scheduled payments. Evidence of equity stripping will result in a lower CRA rating.

The rule also proposed some less significant changes to CRA evaluations. First, the agencies propose to distinguish loan purchases from loan originations in the data presented in an institution's public evaluation. Loan purchases and originations would continue to be weighted equally when assessing an institution's lending. Also, data on small-business and small-farm lending would be required to be disclosed as the number and amount of loans extended in each census tract.

Comments on this proposed rule were due April 6. For more information, see 69 *Federal Register*, pp. 5729-47.

Third Party Debt Rating (2/23)

National banks must meet certain conditions if they wish to acquire or establish a financial subsidiary that engages, as principal, in activities that are financial in nature and not otherwise permissible for a national bank. If the bank is one of the 50 largest FDIC-insured banks, it must have at least one issue of outstanding eligible debt that is currently rated within the three highest investment-grade categories by a nationally recognizable statistical-rating organization.

The Office of the Comptroller of the Currency (OCC) recently released a letter written to one of the 50 largest FDIC-insured banks that allows the bank to satisfy the debt-rating requirement with a Standard and Poor's (S&P) rating on the uninsured portion of the bank's long-term certificates of deposit (CDs). The bank did not have any issues of nondeposit debt outstanding, but it did have outstanding long-term CDs that were rated "A-," or strong, by S&P. An "A" rating is the third-highest S&P investment-grade rating (an addition of a plus or minus does not change the rating category), which satisfies the rating requirement. To further qualify as eligible, a debt must be unsecured (meaning that it is not supported by any credit enhancement and is not held by any person affiliated with the bank) and long term (having an initial maturity of 360 days or more). The bank's CDs satisfy both conditions.

The OCC's final determination hinged on whether, for purposes of the debt-rating requirement, the CDs are considered "debt" of the bank. The term "debt" is not defined in the OCC's financial subsidiary regulation. The

agency concluded, based on the ordinary meaning of the term, that CDs should be considered a debt. The OCC therefore permitted the bank to establish or acquire a financial subsidiary.

For more information, see *OCC Interpretive Letter No. 981*.

Electronic Filing (1/2)

The Office of the Comptroller of the Currency (OCC) issued a final rule that permits national banks to file applications and notices electronically. At the time of the final rule's publication in the *Federal Register*, nine applications and notices were available for electronic filing, and the OCC was working to add more. National banks do not have to file electronically and instead can continue to file paper applications.

This final rule became effective February 2. For more information, see 69 *Federal Register*, pp. 1-2.

Asset Composition (1/7)

The Office of the Comptroller of the Currency (OCC) issued a proposed rule that would require national banks to obtain the OCC's approval before fundamentally changing asset composition by either, 1) selling or disposing of assets, or 2) after having sold or disposed of assets, subsequently purchasing or acquiring assets. Currently, banks do not have to obtain the OCC's approval before "stripping down," or disposing of assets. Nor do dormant banks have to gain approval before increasing assets to engage again in banking business.

Before selling or disposing of all or substantially all of its assets, a bank must obtain the OCC's approval. In assessing the bank's application, the OCC will consider the reasons for the proposed decrease in asset size and future plans for the bank charter (including any liquidation plans), future asset growth, future plans to market or sell the charter, and future business plans. The OCC will also assess how long the dormant charter may continue and may require the bank to submit a plan of liquidation.

A dormant bank that wishes to increase assets must also gain prior OCC approval. The OCC will consider the bank's future business plan and whether this plan involves activities that deviate significantly from the bank's original business plan. The OCC will also assess the bank's staffing plans, plans for oversight of the activity within the bank, and accountability to the board of directors, along with plans to acquire, develop, or modify internal control systems adequate to monitor the new activity. The same rules will apply for a stripped bank that has been acquired by another bank. Dormant banks could not gather deposits to fund asset acquisition without first seeking the OCC's approval.

The OCC will treat stripped banks wanting to increase assets as *de novo* banks for purposes of the application. When evaluating an application to establish a *de novo* bank, the OCC considers whether: 1) its organizers are familiar with national banking laws and regulations; 2) its

management is competent and experienced; 3) it has sufficient capital; 4) it can reasonably be expected to be profitable; 5) it will be operated in a safe and sound manner; and 6) there is risk to the federal deposit insurance fund.

Comments on this proposed rule were due March 8. For more information, see 69 *Federal Register*, pp. 892-5.

Regulatory Burden (1/21)

Together, 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 (the agencies) issued a notice of regulatory review and request for comments about lending-related consumer protection rules. The agencies, pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996, are reviewing the consumer protection rules to identify any outdated, unnecessary, or unduly burdensome requirements. The agencies are seeking suggestions of ways to reduce regulatory burdens relating to fair housing, loans in identified flood hazard areas, consumer leasing, equal credit opportunity, the Home Mortgage Disclosure Act, truth in lending, and unfair or deceptive acts or practices.

Comments on this proposed rule were due April 20. For more information, see 69 *Federal Register*, pp. 2852-5.

Operating Subsidiaries (3/25)

The Office of the Comptroller of the Currency (OCC) issued a proposed rule that would require national banks to file annual reports listing operating subsidiaries that do business directly with consumers. For each operating subsidiary, a national bank would be required to provide the subsidiary's name, location, contact information, and line of business. An operating subsidiary is thought to do business directly with consumers if it provides products or services to individuals that are used primarily for personal, family, or household purposes. National banks will be required each year to prepare the reports by March 31 and file them with the OCC by July 1. The OCC will make the information public on its web site at www.occ.treas.gov/customer.htm.

Comments on this proposed rule were due April 26. For more information, see 69 *Federal Register*, pp. 15260-2.

Federal Deposit Insurance Corporation

Living Trust Insurance (1/21)

The Federal Deposit Insurance Corporation (FDIC) issued a final rule to clarify deposit insurance coverage rules for living trust accounts. A living trust is a formal revocable trust over which the owner (grantor) retains ownership during his or her lifetime. Upon the owner's death, the trust becomes irrevocable. In the FDIC's final rule, living trust accounts would be insured for up to \$100,000 per qualifying beneficiary in the event of an insured depository institution's failure. Qualified beneficiaries include

spouses, children, grandchildren, parents, and siblings. The \$100,000 per beneficiary insurance is irrespective of any defeating contingencies that may be contained in the trust document. Defeating contingencies are clauses that create the possibility that a beneficiary may never receive funds after the trust owner's death. For instance, a trust may stipulate that a beneficiary is entitled to funds only if he or she graduates from college. Previously, the FDIC would not insure trust documents that contained defeating contingencies.

Nonqualifying beneficiaries' interests will be included in another group of funds called the owner's single-ownership (or individual) funds. All of an individual's single-ownership funds at the same institution will be added together and insured for a total of \$100,000. For instance, if a living trust account provides \$100,000 each for the grantor's wife and daughter (qualifying beneficiaries), and \$50,000 each for his niece, nephew, and cousin (non-qualifying beneficiaries), and assuming the grantor has no other single-ownership funds at the same depository institution, the trust account would be insured for a total of \$300,000. The wife's and daughter's interests would both be insured for \$100,000, for a total of \$200,000. The interests of the nonqualifying beneficiaries when added together equal \$150,000, but as single-ownership funds they can only be insured for up to \$100,000. Therefore, the account is insured for a total of \$300,000.

The final rule does not require depository institutions to keep records of the names of living trust beneficiaries in order for the accounts to be insured. Depository institutions will be required to record only that an account is a living trust account. In the event that a depository institution fails, FDIC claims agents would review the trust agreements to identify beneficiaries and determine their interests.

This final rule became effective April 1. For more information, see 69 *Federal Register*, pp. 2825-9.

Affiliate Transactions (3/17)

The Federal Deposit Insurance Corporation (FDIC) issued a proposed rule to clarify that insured state nonmember banks are subject to the same rules governing transactions between them and their affiliates as are member banks (sections 23A and 23B of the Federal Reserve Act). The FDIC's proposed rule is similar to Regulation W, which the Board of Governors of the Federal Reserve System (the Board) finalized in December 2002 to implement sections 23A and 23B. The rules aim to protect state banks from losses arising from transactions with affiliates. The FDIC's proposal cross-references Regulation W because the Federal Deposit Insurance Act mandates that state nonmember banks be subject to sections 23A and 23B just as if they were state member banks.

The FDIC is proposing an exemption for subsidiary relationships established before the proposal was published in the *Federal Register*. In other words, if the FDIC did not consider a subsidiary relationship to be subject to

sections 23A and 23B before this proposal, but it is considered an affiliate under Regulation W, the subsidiary will not be treated as an affiliate under this proposed rule. This means that these relationships will not have to be brought into compliance with Regulation W's restrictions, and in the future, a bank's dealings with that subsidiary company will not be governed by Regulation W.

The exemption applies only as long as the subsidiary does not change its line of business. The FDIC may also make case-by-case exceptions to these rules as long as the exception is in the public interest and consistent with the purposes of the Federal Reserve Act. Nonmember banks must file a written request for exemption with the FDIC, rather than with the Board, as was the practice in the past. The proposal outlines the filing procedures and the information that must be submitted, including a description of the parties' relationship and specific restrictions from which the bank is seeking exemption.

The proposal also clarifies that the FDIC, as supervisor of insured state nonmember banks, has the authority to interpret and enforce sections 23A and 23B as they apply to state nonmember banks. Section 23A stipulates that a person or company is entitled to a hearing before being considered to have control over another company, thus making it an affiliate. This proposed rule clarifies that the FDIC, not the Board, is the regulatory agency that grants and presides over the hearing and makes the final determination when insured state nonmember banks are involved.

Comments on this proposed rule were due May 3. For more information, see *69 Federal Register*, pp. 12571-80.

MERIT exams (2/4)

The Federal Deposit Insurance Corporation is broadening the use of its streamlined examination process called "MERIT" (for Maximum Efficiency Risk-Focused, Institution-Targeted) examinations to include banks that meet certain eligibility requirements. In conducting MERIT examinations, examiners will focus on determining the adequacy of an institution's internal control systems and reviewing internal and external audit programs. Examiners will also assess an institution's risk-management processes. Lower risk activities will be reviewed primarily through discussions with management. Banks will be eligible for the streamlined process if they have less than \$1 billion in total assets and are well capitalized, are well rated in component and composite ratings, and have stable management and effective loan-grading systems. The program was previously limited to banks with less than \$250 million in total assets.

Board of Governors of the Federal Reserve System

FACTA Effective Dates (2/11)

The Board of Governors of the Federal Reserve System and the Federal Trade Commission (the agencies) released joint final rules to establish effective dates for portions of

the recently enacted Fair and Accurate Credit Transactions Act (FACTA) for which effective dates were not already established. FACTA amends the Fair Credit Reporting Act (FCRA) to establish uniform national credit reporting standards, combat identity theft, increase the accuracy of consumer reports, and give consumers greater control over the marketing solicitations they receive (see *Banking Legislation and Policy*, October-December 2003).

The rules were initially proposed in December 2003 (see *Banking Legislation and Policy*, October-December 2003). For portions of FACTA that govern the relationship between the FCRA and state laws, the agencies set effective date December 31, 2003, as the Provisions of the FCRA were set to expire at the end of 2003, and without the December 31 effective date, there would have been a period in which some state laws relating to credit disclosures would not have been preempted by federal law. The agencies also established December 31, 2003, as the effective date for provisions of the act that require federal regulatory agencies to issue regulations or take other actions to implement sections of FACTA. The agencies proposed to establish March 31, 2004, as the effective date for provisions of FACTA that are self-effectuating but do not contain specific effective dates. An example of a self-effectuating provision is the FACTA provision that permits an employee's credit report to be given to an employer for purposes of investigating the employee's misconduct at work or in cooperation with federal, state, or local laws. The agencies proposed December 1, 2004, as the effective date for provisions of the act that require changes in systems, disclosure forms, or practices. In all cases, the agencies determined that these were the appropriate effective dates and re-established them in the final rule.

The final rule became effective on March 12. For more information, see *69 Federal Register*, pp. 6526-31.

Anti-Tying (2/2)

In a letter dated February 2, the Board of Governors of the Federal Reserve System (the Board) permitted Merrill Lynch Bank and Merrill Lynch Private Finance (MLPF) to offer loans collateralized by securities, subject to the securities being kept in collateral accounts with the lenders' broker-dealer affiliate, Merrill Lynch, Pierce, Fenner & Smith (MLPF&S). The bank and MLPF have lending arrangements with customers in which the customers are required to hold a minimum level of collateral in an account with MLPF&S, and they are never expected to exceed the minimum level. There is no fee for the customer to set up or maintain the account, and customers are not required to purchase any other services or products from the bank, MLPF, or MLPF&S. Borrowers must obtain approval from the bank or MLPF before withdrawing assets from collateral accounts. The bank's and MLPF's policy generally is to approve withdrawals as long as the collateral requirement is still met. If a collateral account falls below the minimum level, the bank or MLPF will instruct the customer either to place additional securities in the account or to pay down

the outstanding loan balance.

The Board determined that this lending program is not a violation of the Bank Holding Company Act's anti-tying restrictions. The Board believes that by requiring the accounts to be held with MLPF&S, an affiliated broker-dealer, the bank and MLPF can "obtain detailed and timely information regarding the value of the collateral, ensure the collateral is safeguarded and managed appropriately, and ensure that instructions with respect to the collateral will be executed promptly and consistently." In addition, the Board notes that customers are not required to hold excess securities in the collateral accounts and are not required to pay a fee to establish the accounts. Further, customers are not required to purchase any other products or services to obtain credit.

For more information, see the Board's legal interpretation at its web site, www.federalreserve.gov.

Truth in Lending (3/31)

The Board of Governors of the Federal Reserve System (the Board) published a final rule to revise Regulation Z, which implements the Truth in Lending Act (TILA). The rule clarifies that the word "amount," as it is used in Regulation Z, refers to a numerical amount. The final rule also revises the staff commentary to Regulation Z by providing additional guidance about consumers' right to rescind home-secured loans. A consumer may rescind a home-secured loan within a specified period by notifying his or her creditor. The creditor is required to provide the consumer with a form and an address that the consumer can use to notify the creditor (or an agent of the creditor) that he or she wishes to rescind the loan. In cases when a creditor does not provide the notification form and address, the consumer may notify the person to whom he sends payments. Under TILA, this notification will be considered to have been given to the creditor.

In December 2003, the Board proposed changing the definition of "clear and conspicuous" in Regulation Z to make a uniform "clear and conspicuous" standard for several different regulations (see *Banking Legislation and Policy*, October-December 2003). The Board did not adopt this new definition in the final rule because of concerns that it would be too burdensome.

This final rule became effective April 1, and compliance is mandatory beginning October 1. For more information, see *69 Federal Register*, pp. 16769-75.

Office of Thrift Supervision

Assessments and Fees (2/10)

The Office of Thrift Supervision (OTS) proposed a rule that would replace examination fees for savings and loan holding companies (SLHCs) with semi-annual assessments on top-tier SLHCs. Top-tier SLHCs are defined as the highest level of ownership by a registered holding company in the holding company structure. The OTS is authorized by the Home Owners Loan Act to assess

fees against savings associations and holding companies to pay for the OTS's cost of doing business and performing examinations.

Currently, the OTS determines savings associations' semi-annual assessments by considering three factors: the association's asset-size, condition, and complexity. The OTS provides a lower, alternative asset size component for certain small, qualifying savings associations, but the OTS is proposing to abandon this alternative. The OTS believes nonqualifying associations carry an extra, unfair burden because of the alternative.

The OTS is proposing to charge a base assessment amount of \$3,000. Next, the OTS will assess the SLHC's level of complexity and risk by considering its financial condition, financial and operational independence, reputational risk, and management experience. The OTS will then assign an SLHC to one of two categories: Category I for noncomplex and relatively low-risk holding company structures, or Category II for structures that are complex and high risk. The OTS plans to charge Category I SLHCs a lower assessment amount. The proposed rule contains an assessment schedule for Category I and Category II SLHCs under the risk and complexity component. As an SLHC's total consolidated assets increase, the OTS will charge a higher assessment amount for both Category I and Category II companies. The risk and complexity assessment charge will be added to the base assessment amount.

The OTS is proposing to calculate the organizational form component by adding the base amount to the risk and complexity amount and multiplying it by a positive or negative factor that will be established for a particular organizational type. Currently, the OTS is considering applying this component only to section 10(l) holding companies, which are holding companies that have state subsidiary depository institutions. The OTS experiences higher costs associated with examining section 10(l) holding companies because more time and effort are required to learn about the state subsidiaries, which the OTS does not regulate. The OTS is considering establishing an organizational form component multiplier of 50 percent for section 10(l) holding companies.

Finally, the OTS will assess a condition component if the most recent top-tier SLHC examination rating was "unsatisfactory." Unsatisfactory ratings are given to companies that have a detrimental or burdensome effect on the thrift. Under the proposed rule, the condition component would be equal to 100 percent of the total of the base assessment, the risk and complexity component, and the organizational component. In other words, an SLHC rated unsatisfactory would be charged twice as much as a similar SLHC rated satisfactory.

The OTS will bill SLHCs semi-annually using the same procedures used to bill assessments from savings associations. Payments would be due January 31 and July 31 of each year. The OTS expects to begin the assessments with the July 2004 semi-annual assessment.

Comments on this proposed rule were due March 26. For more information, see 69 *Federal Register*, pp. 6201-14.

Federal Trade Commission

Free Credit Disclosure (3/19)

The Federal Trade Commission (FTC) issued a proposed rule to establish a centralized source from which consumers can request a free credit file disclosure each year, as required by the Fair and Accurate Credit Transactions Act of 2003 (see *Banking Legislation and Policy*, October – December, 2003). The FTC is proposing to require nationwide consumer reporting agencies (NCRAs) to jointly design, fund, implement, maintain, and operate the centralized source. An NCRA is defined as a consumer reporting agency that compiles and maintains files on consumers on a nationwide basis. Consumers will be able to make a single request to the centralized source and receive free credit disclosures from each of the NCRAs. If an NCRA does not own information on a particular consumer, the NCRA will be required to go through a third party to receive the information. NCRAs will be required to give free credit file disclosures only to consumers who submit requests through the centralized source. The NCRAs will be required to establish a toll-free telephone number, an Internet web site, and a mail process for consumers to make requests for annual file disclosures.

The centralized source must have adequate capacity to handle a reasonable amount of requests. During periods of extraordinary request volume, NCRAs will not be held liable for not being able to process all of the requests within 15 days of receiving them. NCRAs will be permitted to ask some of the consumers to submit their requests at a later time or accept the requests in a queue and process them at a later time. Extraordinary request volume is defined as any 24-hour volume that is greater than twice the daily rolling 90-day average request volume.

The FTC is proposing a regional roll-out of the centralized source, starting in the West and moving eastward across the country. Residents in California and 12 other western states will have access to the centralized source on December 1, 2004. On March 1, 2005, consumers in the 12 midwestern states will also become eligible to request their annual file disclosures from the centralized source. On June 1, 2005, consumers in 11 southern states

will have access to the centralized source. Finally, on September 1, 2005, all remaining consumers will have access to the centralized source.

Comments on this proposed rule were due April 16. For more information, see 69 *Federal Register*, pp. 13192-210.

Department of Housing and Urban Development

RESPA (3/22)

The U.S. Department of Housing and Urban Development (HUD) announced that it withdrew its proposed rule to reform the Real Estate Settlement Procedures Act (RESPA). RESPA is a consumer protection law that governs mortgage closings and settlement costs. HUD cited concerns from members of Congress, consumer groups, and the business community as reasons for withdrawing the rule. HUD has been trying to revise the regulation for almost two years.

Office of Federal Housing Enterprise Oversight

Freddie Mac (1/28)

In addition to requiring Freddie Mac to keep a 30 percent higher capital surplus (see *Recent Developments* section), the Office of Housing Enterprise Oversight (OFHEO) is requiring the government-sponsored enterprise to seek OFHEO approval for certain corporate transactions, such as making any payments to repurchase, redeem, retire, or otherwise acquire any of its shares, including share repurchases; calling any issuance of preferred stock or paying preferred stock dividends above stated contractual rates; and taking any other action likely to prevent Freddie Mac from meeting the target capital surplus. After declaring common stock dividends, Freddie Mac must also submit a written report to the OFHEO before paying them. Freddie Mac should disclose the amount of the dividend, the reason for paying it, and the impact it will have on the capital surplus.

The requirements became effective immediately and will remain in effect until the OFHEO determines otherwise. In making a determination to ease the requirements, the OFHEO will take into consideration Freddie Mac's timely submission of capital reports, as well as an audit of Freddie Mac's financial reports for the most recent year by an outside accountant.

SUMMARY OF JUDICIAL DEVELOPMENTS

Creditors Must Reasonably Investigate Credit Disputes under FCRA

On February 11 the U.S. Court of Appeals for the Fourth Circuit affirmed a district court's decision that creditors must make a reasonable investigation to verify credit information disputed by customers, pursuant to the Fair Credit Reporting Act (FCRA) (*Johnson v. MBNA America*

Bank NA, No. 03-1235). Linda Johnson contends that when her husband, Edward Slater, applied for an MBNA MasterCard, she was listed as an authorized user. However, MBNA claims that Johnson was a co-applicant and equally responsible for paying the account's balance. When Slater filed for bankruptcy in 2000, MBNA removed his name from the account and informed Johnson that she owed

the \$17,000 balance. Johnson disputed the information with the three major credit reporting agencies, Experian, Equifax, and Trans Union. When the agencies then alerted MBNA, the creditor was required by the FCRA to investigate and verify the disputed information. MBNA checked the account information on its computer system and verified that the disputed information was correct.

Johnson sued MBNA, claiming it had violated the FCRA by not conducting a proper investigation. The court ruled that the FCRA intends that creditors carefully investigate disputed information. MBNA employees admitted that they merely confirmed the name and address listed on the account and observed that the computer system had coded Johnson as the only responsible party on the account. MBNA did not check the account application because it no longer possessed it (applications are required to be held only for five years). The court ruled that in that case, MBNA should have notified the consumer reporting agencies that the information could not be verified, at which time the agencies would have deleted the information from Johnson's file or modified it based on the reinvestigation. The appeals court found no reversible errors in the district court's judgment and therefore affirmed the opinion.

Second Circuit Court Overturns RICO Award

On February 17, the U.S. Court of Appeals for the Second Circuit reversed a district court judgment that would have awarded over \$100 million in compensatory damages to Bank of China because the district court improperly instructed the jury (*Bank of China v. NBM LLC*, No. 02-9267). The appellants in this case, NBM LLC, defrauded Bank of China out of millions of dollars by borrowing huge amounts of money from the bank using false and misleading representations and forged documents. At least one of the bank's employees at the time, Patrick Young, handled the appellant's business at the bank and was knowledgeable about the scheme, accepting bribes from NBM to help facilitate the fraudulent activity. It is unclear whether other bank employees were aware of the fraud, but testimony indicated that it is entirely possible, as officers and managers frequently socialized and even occasionally took trips with the appellants.

The district court awarded damages of over \$100 million under the Racketeer Influenced and Corrupt Organizations Act (RICO) after the jury, applying the judge's instructions, decided that the institution had been defrauded even though its employees participated in the fraudulent activities. The court of appeals reversed this judgment, finding that the district court gave erroneous instructions to the jury, basing them mostly on criminal law, when the case was a matter of civil law. Civil law requires the victim (Bank of China) to establish that it reasonably relied on NBM's misrepresentations when making the loans. However, the district court's interpretation of the law relieved the bank from having to prove that it relied upon the misrepresentations and, in doing so, did not give NBM a chance to present a defense.

The court of appeals ruled that there is a fundamental difference between criminal and civil law, and the district court's instructions to the jury based on criminal law were erroneous and caused harm to NBM. Therefore, the court reversed the district court's judgment and called for a new trial.

Illiterate Consumers Are Not Excused from Arbitration

On March 19, the U.S. Court of Appeals for the Fifth Circuit decided that an arbitration clause in a financial services contract is not invalid under Mississippi law simply because a customer cannot read (*Washington Mutual Finance Group LLC v. Bailey et al.*, No. 02-60794). A group of illiterate customers brought suit against Washington Mutual Finance, and Washington Mutual took action against the customers, asking that they be forced to settle their disputes through arbitration, as they signed an arbitration agreement. The customers did not allege that they were coerced into signing the agreement, that the legal language was too complex, or even that the print was inconspicuous. The customers argued that the arbitration clause was unenforceable because they are illiterate and could not read it. Further, the customers claim that the clause is unenforceable because upon the customers' notifying Washington Mutual that they were illiterate, Washington Mutual failed to tell them they were signing an arbitration agreement. Finally, one of the customers, Miriah Phinizee, asserts that although her husband signed the agreement, she did not, and therefore she should not be required to submit to arbitration.

A district court ruled in favor of the customers, determining that the arbitration agreement was unconscionable. However, the court of appeals reversed the ruling for the following reasons. First, the court held that Mississippi law stipulates that "an individual's inability to understand a contract because of his or her illiteracy is not a sufficient basis for concluding that a contract is unenforceable." The court determined that the customers had a responsibility to ask to have the contract read to them, and the customers were ultimately accountable for understanding what they were signing. Further, the court found that Washington Mutual did not deceive the customers about what they were signing. Even though Washington Mutual did not specifically explain to the customers that they were signing arbitration pacts, the customers could have cleared up any confusion by having the contract read to them.

Finally, the court rejected claims that Miriah Phinizee should not be subject to the arbitration clause because her husband signed it and she did not. Phinizee's claims are based on loans her husband obtained and the credit insurance he bought. The court ruled that Phinizee is prohibited from using part of the contract to get something she wants (the loans and credit insurance) and another part of the contract to avoid what she doesn't want (arbitration). Therefore, the court ruled that Phinizee must also arbitrate her claims.

Third Circuit Court Dismisses RICO and Antitrust Case

On March 11, the U.S. Court of Appeals for the Third Circuit dismissed racketeering and antitrust claims made against a group of banks that allegedly had fraudulently inflated the prime rate, costing consumers more in interest payments (*Lum v. Bank of America*, No. 01-4348). A group of plaintiffs argued that the defendant banks violated the Racketeer Influenced and Corrupt Organizations Act (RICO) and the Sherman Act by agreeing to misrepresent their prime rates as the lowest rates available to the most creditworthy borrowers. The plaintiffs alleged that the banks independently reported their inflated prime rates to financial publications that compile an index of the prime rates. The index is then used as a benchmark in credit agreements under which borrowers pay an interest rate equal to the prime rate benchmark plus a certain percentage. The plaintiffs alleged that the banks colluded to report higher prime rates to collect more interest from consumers, and the actual prime rate was lower than what was reported because the banks offered loans to the largest and most creditworthy customers at a rate lower than the reported prime rate.

The court affirmed a district court's dismissal of the claims, saying that the plaintiffs failed to plead the fraud with particularity. Specifically, the plaintiffs failed to show that the defendants represented the prime rate as the lowest rate that would be available to any customer. The court reasoned that the prime rate was just a base rate and discounts could be given for the most creditworthy customers. The plaintiffs also failed to show how the false information about the prime rates was sent to the financial publication, which is necessary to prove mail or wire fraud under RICO. Further, the plaintiffs failed to show what information was sent, to whom it was sent, and when it was sent. The plaintiffs also did not specify by how many points the prime rate was misrepresented, and they did not show there were consistencies among the banks

in terms of the amounts by which the prime rates were falsely reported. For these reasons, the court dismissed the claims.

Iowa Supreme Court Dismisses Loan Participation Case

On February 25, the Iowa Supreme Court dismissed a lawsuit by a class of Iowa residents against a group of out-of-state banks that took participation interest in a pool of loans, ruling that Iowa does not have jurisdiction over the nonresident banks (*Ross v. Thousand Adventures*, No. 150/02-0697). The class of consumers filed the suit after purchasing memberships from Thousand Adventures, Inc., that gave them access to a nationwide network of 58 recreational vehicle campgrounds. Consumers bought the memberships for \$10,000, payable over a period of less than five years. Thousand Adventures sold pools of the installment contracts to financial institutions and investors around the country, one of which was Western National Bank (Western), of Bedford, Texas. Western then sold fractional interests of its pool to other banks, including First Savings Bank (First Savings) of Arlington, Texas. Later, the plaintiffs sued Thousand Adventures, claiming the company failed to provide all of the membership's promised benefits. When Thousand Adventures filed for bankruptcy, the plaintiffs subsequently sued the financial institutions that had an interest in the installment contracts, one of which was First Savings.

The court ruled that First Savings needed to have a minimum number of contacts with Iowa in order to be subject to Iowa's jurisdiction. The justices concluded that because First Savings was a participant bank, it had no relationship with the borrowers and no direct, purposeful contact with Iowa in relation to the participation agreement. Therefore, the court upheld a district court's dismissal of the claims against First Savings for lack of personal jurisdiction.

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