



# BANKING LEGISLATION & POLICY

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## HIGHLIGHTS

### *Recent Developments*

Basel II .....	1
Federal Regulators Divided over Eligibility for Streamlined Exams .....	2

### *Summary of Federal Legislation*

Identity Theft Penalty Enhancement Act.....	2
Appropriations Bill.....	3

### *Summary of Federal Regulations*

Affiliate Marketing.....	3
Asset-Backed Commercial Paper .....	3
Bank Holding Companies.....	4
Substitute Checks .....	5

### *Summary of Judicial Developments*

Alternative Mortgages .....	6
Second Circuit Allows Class Claims That Markups Violate RESPA.....	6

### *Summary of Third District Developments*

NJ – Law to Restrict Abusive Lending Practices.....	7
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## Recent Developments

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### **Basel II**

In June, the Basel Committee on Banking Supervision released the final version of the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, otherwise known as Basel II. Basel II updates minimum capital standards set forth in Basel I in 1988. The new framework is organized into three regulatory pillars. The new approach outlines principles banks must use to assess the adequacy of their capital (Pillar 1) and for super-

visors to review banks' assessments to ensure they have adequate capital to support their risks (Pillar 2). It also seeks to strengthen market discipline by enhancing transparency in banks' financial reporting (Pillar 3). In August 2003, U.S. regulators issued an advance notice of proposed rulemaking to implement the New Basel Capital Accord (see *Banking Legislation and Policy*, July-September 2003).

Basel II provides three approaches, ranging in levels of sophistication, for determining risk-based capital re-

quirements. U.S. regulators have indicated that a number of large U.S. banking organizations will use the most sophisticated approach, the advanced internal ratings-based (A-IRB) approach. Under this approach, banks will rely significantly on their own measures of a borrower's credit risk to determine their capital requirements, subject to strict data, validation, and operational requirements. These banks will also incur an explicit capital charge for exposures to the risk of losses caused by failures of systems, processes, or staff when such failures are caused by external events, such as natural disasters.

The final version of the Basel II proposals includes some significant modifications. Previously, under the A-IRB approach for assessing credit risk, the rules called for banks to hold enough capital to absorb expected and unexpected credit losses. The final version requires separate treatment of unexpected and expected losses, and the regulators' capital requirement will depend solely on the unexpected loss portion of IRB calculations. Where provisions for loan losses exceed expected losses, the excess provision amounts may be applied to Tier Two capital. On the other hand, if expected losses exceed provisions for loan losses, the shortfall is deducted evenly from Tier One and Tier Two capital.

Another change allows banks to use an internal assessment approach (IAA) to derive the risk weights on eligible unrated exposures to asset-backed commercial paper conduits by mapping their internal risk assessments to external credit ratings. The new rules also provide a simplified "supervisory formula" to be used for determining capital for unrated securitization exposures that are not eligible for the IAA treatment. Basel II also allows rated securitization exposures held by both originating and investing banks to be evaluated using the ratings-based approaches.

Basel II also revises the treatment of qualifying revolving retail exposures (QRRE). The asset correlation for QRRE will be fixed at 4 percent. Before, the correlation varied based on the probability of default. In one other change, Basel II develops a scaling factor – which could be greater than or less than one – that could be applied to the results of the new framework if desired capital levels are not achieved through the framework formulas.

The Basel Committee on Banking Supervision expects that the less sophisticated approaches will be implemented starting year-end 2006, and advanced approaches will be

implemented starting year-end 2007. For more information on Basel II, see <http://www.bis.org/publ/bcbs107.htm>.

### **Federal Regulators Divided over Eligibility for Streamlined CRA Exams**

In February the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Board of Governors of the Federal Reserve System (the Board), and the Federal Deposit Insurance Corporation (FDIC) (together, the agencies) issued a proposed rule to increase the number of banking institutions eligible to participate in streamlined Community Reinvestment Act (CRA) examinations. The agencies proposed to double the asset limit (from \$250 million to \$500 million) for banks that are considered "small banks" and eligible for streamlined CRA exams (see *Banking Legislation and Policy*, January – March 2004).

On August 18, however, the OTS issued a final rule that quadruples the original small institution asset limit to \$1 billion, regardless of the assets of an institution's holding company, effective October 10 (see *69 Federal Register*, pp. 51155-61). Two days later, the FDIC issued a proposed rule that would also increase the asset limit for banks it supervises to \$1 billion. However, unlike the OTS, the FDIC added an additional "community development" criterion for institutions with total assets between \$250 million and \$1 billion that wish to be eligible for the streamlined evaluation. Under the proposal, community development activities would include investing in community services or affordable housing for low- or moderate-income individuals or for individuals in rural areas. For institutions with assets between \$250 million and \$1 billion the FDIC will assess the institution's community development performance, including the number and amount of community development loans the bank has made and its responsiveness to community development needs (see *69 Federal Register*, pp. 51611-6).

Meanwhile, both the OCC and the Board have elected to withdraw their February proposals to raise the asset limit to \$500 million, preferring instead to retain the \$250 million threshold for small institutions. News releases issued July 16 from each agency cite the struggle between small institutions that wish to have the asset limit raised to reduce burden and community groups that fear a raised limit would be detrimental to rural communities

## **SUMMARY OF FEDERAL LEGISLATION**

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### *Enacted Legislation*

#### **1. Identity Theft Penalty Enhancement Act (H.R. 1731).** Introduced by Rep. Carter (R-TX) on April 10, 2003.

Status: Signed into law by President George W. Bush on July 15 and became Public Law No. 108-275.

Related Bills: H.R. 858, S. 153

The Identity Theft Penalty Enhancement Act mandates longer imprisonment terms for criminals who commit felonies or acts of terrorism by knowingly and illegally transferring, possessing, or using another person's identity. A person who uses a stolen identity to commit certain felonies will receive a prison sentence extended two years beyond the typical sentence for the crime. The list of felo-

nies includes theft of public money, property, or rewards; theft or embezzlement by a bank employee; theft from employee benefit plans, mail, bank, and wire fraud; and obtaining customer information by false pretenses. A person who uses a stolen identity to commit acts of terrorism will receive the standard prison sentence for the crime he or she committed, plus an additional five years for using a stolen identity.

#### *New Legislation*

**1. Appropriations Bill (H.R. 5025).** Introduced by Rep. Istook (R-OK) on September 8, 2004.  
Status: Passed the House on Sept. 22. Related Bill: S. 2086

## SUMMARY OF FEDERAL REGULATIONS

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### Office of the Comptroller of the Currency

#### *Affiliate Marketing (7/15)*

The Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the National Credit Union Administration (together, the agencies) issued a proposed rule to allow consumers to opt out of having their information shared with a company's affiliates for marketing purposes. The rule implements sections of the Fair and Accurate Credit Transactions Act of 2003 (FACTA) that govern the use of consumer information shared by affiliates (see *Banking Legislation and Policy*, October-December 2003).

The proposed rule would require companies to notify consumers that their information may be shared with affiliates and may be used for marketing solicitations by the affiliates. The notice must be clear and conspicuous and provide the consumer with an easy way to opt out of having their information used for marketing solicitations. Once a consumer elects to opt out, affiliates may not use shared information for marketing solicitations for five years. After the five-year period expires, the consumer must be given a chance, again, to opt out indefinitely.

The rule includes a number of exceptions to these requirements, including cases in which an affiliate: 1) has a preexisting business relationship with the customer; 2) makes communications about an individual's employee benefit services; 3) performs services for another affiliate, unless the consumer has opted out of receiving solicitations from the other affiliate; 4) is responding to a communication initiated by the consumer; 5) has been authorized by the consumer to make solicitations; or 6) must make the solicitations to comply with state insurance laws.

The proposed rule applies only to solicitations that are directed toward a particular consumer based on information received from an affiliate. In other words, the proposed rule does not cover mass communications intended for the general public.

The House of Representatives passed its appropriations bill for the Departments of Transportation and Treasury and independent agencies for the fiscal year ending September 30, 2005. The bill includes a provision that would prohibit the Treasury Department from using any funds to finalize, implement, or enforce a rule that would allow banks to engage in real estate brokerage activity (see 66 *Federal Register*, pp. 307-14). The prohibition would be effective for one year. The Senate's appropriations bill, however, includes a permanent ban on the Treasury Department's enforcement of this rule.

Comments on this proposed rule were due August 16. For more information, see 69 *Federal Register*, pp. 42502-42.

#### *Asset-Backed Commercial Paper (7/28)*

The Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (together, the agencies) issued a final rule amending risk-based capital standards for asset-backed commercial paper (ABCP) programs. An ABCP program is a special purpose entity (SPE) that primarily issues externally rated commercial paper backed by the SPE's assets. Last year, the Financial Accounting Standards Board (FASB) issued Interpretation No. 46, Consolidation of Variable Interest Entities, which requires certain SPEs, including ABCP programs, to be consolidated onto the balance sheets of their sponsoring organizations (see *Banking Legislation and Policy*, January-March 2003).

This final rule permits any ABCP program assets that are consolidated because of the FASB rule, plus any related minority interest, to be excluded from banks' calculations of risk-weighted assets and Tier One capital when banks calculate their Tier One and total risk-based capital ratios. When calculating their Tier One leverage-capital ratio, banks must include these consolidated assets in the denominator, but they must exclude any related minority interests from the numerator.

The agencies are also amending their treatment of liquidity facilities that support ABCP programs. A liquidity facility is a commitment by a bank to lend to or purchase assets from an ABCP program if it is necessary to repay maturing commercial paper. Banks must include in their capital calculations 10 percent of all eligible short-term liquidity facilities (with original maturity dates of one year or less) that support ABCP programs. Previously, banks were not required to include any short-term liquidity facilities in these calculations. However, as before, 50 percent of eligible long-term liquidity facilities (with original maturity dates of longer than one year) will be included

in capital calculations. To be considered eligible, a liquidity facility must fund only assets that are no more than 90 days past due. In addition, the facility may be used only to fund assets that are externally rated investment grade at the time of funding. If the facility does not meet both of these requirements, it is considered ineligible and treated as a recourse obligation or direct credit substitute, in which case 100 percent of the facility will be included in the regulatory capital calculations.

This final rule became effective September 30, 2004, except that the portion of the rule that pertains to liquidity facilities will become effective September 30, 2005. For more information, see 69 *Federal Register*, pp. 44908-25.

#### *Asset Composition (8/16)*

The Office of the Comptroller of the Currency (OCC) issued a final rule that requires national banks to receive the OCC's approval before changing the composition of all, or substantially all, of its assets by either 1) selling or disposing of assets, or 2) after having sold or disposed of assets, subsequently purchasing or acquiring assets (including dormant banks that are restarting operations). When reviewing any application to make a change in asset composition, the OCC will consider the purpose of the transaction, its impact on the safety and soundness of the bank, and any effect on the bank's customers. Further, in applications to acquire assets or expand operations after having previously sold or disposed of all assets, the OCC will consider the applicant bank's future business plan and whether this plan involves activities that deviate significantly from the bank's original business plan.

Banks do not need to receive the OCC's approval if the change in composition of assets is in response to an OCC direction (such as an enforcement action) or if the bank is liquidating and has filed a notice of liquidation with the OCC explaining its intent to dissolve and return its charter to the OCC. Similarly, banks do not need the OCC's approval for changes in asset composition that occur as a result of the bank's standard business of originating and securitizing loans.

This final rule becomes effective January 1, 2005. For more information, see 69 *Federal Register*, pp. 50293-8.

#### *Lending Limits (8/19)*

The Office of the Comptroller of the Currency (OCC) issued a final rule to permit national banks to make larger residential real estate and small-business loans to single individuals. Specifically, the rule extends by three years its pilot lending program that allows eligible national banks to have increased lending limits for residential real estate, small-business, and agricultural loans in states that permit state-chartered banks to have lending limits higher than the federal limits. Banks authorized under the program may continue to lend at the higher limits until June 11, 2007. Banks may be eligible for the program if they meet standards proving they have sufficient capital and good managerial oversight. After being approved by the OCC,

an eligible bank may use the special lending limits to lend more to a single customer seeking residential, small-business, and agricultural loans.

Usually, national banks can lend only 15 percent of unimpaired capital and surplus to a single borrower. Under the program, however, eligible banks may lend up to the lesser of an additional 10 percent of capital and surplus or the state lending limit. But the absolute maximum lent to any single borrower may not exceed \$10 million more than the normal lending limit.

This interim final rule became effective August 19. For more information, see 69 *Federal Register*, pp. 51355-8.

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

#### *Bank Holding Companies (7/23)*

The Board of Governors of the Federal Reserve System (the Board) issued a notice of its intent to revise the bank holding company (BHC) rating system. The new system would emphasize risk management and provide a framework for assessing the potential impact of the non-depository entities of a holding company on the subsidiary depository institutions. The new rating system would be called the RFI/C(D), which stands for the following components: Risk management, Financial condition, Impact of the parent company and nondepository subsidiaries on the depository subsidiary, Composite, and Depository institution.

The risk management (R) component represents the major change from the current system, evaluating the ability of the board of directors and senior management to identify, measure, monitor, and control risk. The R component has four subcomponents: 1) competence of board of directors and senior management; 2) adequacy of policies, procedures, and limits given the BHC's risks; 3) risk monitoring and management information systems; and 4) internal controls. Each of the subcomponents is assigned a qualitative rating of "strong," "acceptable," or "weak." The overall R component is rated based on a five-point numerical scale, with one being the strongest rating and five the weakest rating.

The financial condition (F) component evaluates the consolidated organization's financial strength and focuses on the ability of the BHC's resources to support the level of risk associated with its activities. The F rating is composed of four subcomponents: capital, asset quality, earnings, and liquidity on a consolidated basis. Each subcomponent will receive a rating of one to five and will support an overall F component rating of one to five.

The impact (I) component is an assessment of the potential impact of a BHC or its nondepository entities on a subsidiary depository institution. The I component rating should take into consideration any risk management or financial issues at the parent company or nondepository subsidiaries that could potentially impact the safety and soundness of the subsidiary depository institution. This rating, too, will be based on a one to five numerical scale.

The composite (C) component rates the overall composite assessment of the BHC as reflected by consolidated risk management, consolidated financial strength, and the impact of the parent company and nonbank subsidiaries on the depository institutions. The C component is not an average of the other ratings but reflects the examiner's judgment about the overall safety and soundness of the BHC's operation. Finally, the depository institution (D) component evaluates the overall condition of the subsidiary depository institution or the combined condition of depository subsidiaries.

BHCs will face more stringent exams as their complexity increases. For example, examiners for a noncomplex one-bank holding company with assets greater than \$1 billion will rely mainly on the evaluations of the banking subsidiary's primary regulator, doing additional analysis only if the examiners are not satisfied with the primary regulator's evaluation. On the other hand, nontraditional BHCs will be required to undergo a full examination by the examination staff, regardless of their size. Nontraditional BHCs include BHCs in which most or all nondepository operations are regulated by one of the federal bank regulators and in which the subsidiary depository institution is small in relation to nondepository operations.

Comments on this notice were due September 21. For more information, see *69 Federal Register*, pp. 43996-44007.

#### *Substitute Checks (8/4)*

The Board of Governors of the Federal Reserve System (the Board) issued a final rule to add a new subpart to Regulation CC, which governs the availability of funds deposited in checking accounts and the collection and return of checks. The revisions will accommodate the Check Clearing for the 21st Century Act (see *Banking Legislation and Policy*, October-December 2003) by making the regulation applicable to substitute checks. The final rule is essentially the same as the proposed rule (see *Banking Legislation and Policy*, October-December 2003), with just a few modifications.

The first amendment to the rule clarifies that Check 21 does not require banks to use electronic check processing or to change their check collection practices. Since not every bank will be accepting electronic checks, substitute checks will be used in lieu of original checks. A substitute check is a paper reproduction of an original check that can be processed in the same manner as the original check. The substitute check must contain an image of the front and back of the original check and meet several other technical requirements. A bank that uses substitute checks will be required to qualify a substitute check for return differently than it does an original check.

The final rule also establishes endorsement and identification requirements for substitute checks, including that endorsements must be made in black ink (currently they are in purple ink) on the back of substitute checks only and must include the bank's name and location information when the endorsement is applied physically instead

of electronically. The rule also gives examples of model consumer awareness disclosures and other model notices.

This final rule became effective October 28, 2004, except that banks have until January 1, 2006, to convert from purple ink to black ink for endorsements. For more information, see *69 Federal Register*, pp. 47290-328.

#### *Electronic Checks (9/17)*

The Board of Governors of the Federal Reserve System (the Board) issued a proposed rule to clarify that electronic check conversions and employer-issued payroll cards are covered by Regulation E, which implements the Electronic Fund Transfer (EFT) Act. In an electronic check conversion transaction, a consumer provides a check to a payee and information from the check is used to initiate a one-time EFT from the consumer's account. Normally in an EFT, funds are debited from the consumer's account more quickly than through check processing. Also, the consumer's financial institution will not be able to return the original check to the consumer if the transaction was processed as an EFT. For those reasons, the Board is proposing to require merchants and other payees that make electronic check conversion services available to consumers to obtain the consumer's authorization for the EFT. Merchants may satisfy this rule by posting a notice to consumers at the point of sale. A consumer is considered to have "authorized" an EFT transaction if he or she chooses to go through with the transaction after receiving notice that it may be processed as an EFT.

Next, the proposed rule states that Regulation E governs payroll card accounts directly or indirectly established by an employer on behalf of a consumer to which EFTs of the employee's compensation are made on a recurring basis. This does not include a card used for a one-time EFT of a salary-related payment, such as a bonus, or a card used solely to disburse nonsalary-related payments, such as petty cash or a travel per diem card. If an employer wishes to issue a replacement payroll card or multiple cards to access the same payroll account, the card must be invalid at the time it is issued and validated later by the employee.

Comments on this proposed rule were due November 19. For more information, see *69 Federal Register*, pp. 55996-6011.

### **Office of Thrift Supervision**

#### *Change in Control (7/16)*

In a legal opinion issued July 16, the Office of Thrift Supervision (OTS) permitted a unitary savings and loan holding company to keep its unitary status despite holding two savings associations for 45 days as part of a multiphase merger. Unitary thrift holding companies are typically prohibited from holding more than one other savings association in order to prevent the expansion of savings and loan holding companies. At the time of the application, the applicant holding company already held one other savings association. The applicant and its subsidiary planned to

merge with another holding company and its subsidiary, and for tax reasons, the applicant planned a multiphase merger. The OTS granted the applicant permission to hold two savings associations for the specified period of time without losing its unitary holding company status because the holding company provided a commitment to merge the two entities within 45 days of the holding company merger. Furthermore, the holding company had a legitimate business reason for holding the entities for 45 days (to avoid added expenses from tax penalties).

## Department of Housing and Urban Development

### *FHA Appraisals (7/20)*

The Department of Housing and Urban Development (HUD) issued a final rule to clarify that lenders will be held accountable for the quality of appraisals on mortgages insured by the Federal Housing Administration (FHA). To

obtain FHA mortgage insurance, lenders first choose 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 final rule, lenders and their underwriters will be held responsible for misleading or fraudulent appraisals. Appraisers, sponsor lenders (who underwrite loans), and loan correspondent lenders (who originate loans on behalf of their sponsors) will be held equally accountable for the quality of appraisals on properties that secure FHA-insured mortgage loans. Lenders must verify that an appraisal meets FHA standards before submitting it. Lenders and appraisers may face sanctions if an appraisal is found to be faulty or noncompliant with FHA standards.

This final rule became effective August 19. For more information, see 69 *Federal Register*, pp. 43504-9.

## SUMMARY OF JUDICIAL DEVELOPMENTS

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### Alternative Mortgages

On July 13, the U.S. District Court for the District of Columbia Circuit upheld a rule by the Office of Thrift Supervision (OTS) that does not give equal treatment to federally chartered and state-chartered creditors that wish to charge prepayment and late payment penalties on alternative mortgage transactions (*National Home Equity Mortgage Association v. Office of Thrift Supervision*, No. 03-5204).

An alternative mortgage transaction (AMT) is a mortgage loan for which the term, interest rate, or both are adjustable rather than fixed. Congress passed the Alternative Mortgage Transaction Parity Act (AMTPA) in 1982 to allow both federally chartered and state-chartered lenders to engage in AMTs but permitted the OTS to determine which provisions of its regulations implementing the law were not appropriate for state-chartered creditors.

In 2002, the OTS determined that by allowing state-chartered lenders to charge prepayment and late payment penalties on AMTs (as federally chartered lenders were), there was a rise in predatory lending practices in the subprime mortgage market. Therefore, the OTS issued a rule that made its prepayment and late payment fee regulations inapplicable to state-chartered creditors, thereby making them subject to their charter state's laws governing prepayment penalties and late fees.

The National Home Equity Mortgage Association, representing nonfederally chartered lenders, appealed this rule, arguing that Congress intended that federally chartered and state-chartered creditors that engage in AMTs should receive equal treatment under the law. However, the court ruled that by enacting the AMTPA, Congress intended only that both federally chartered and state-chartered creditors be able to engage in AMTs and not for each of the

implementing regulations to be applied to state-chartered institutions as they are to federally chartered institutions. Congress realized that some of the regulations would be inappropriate for state-chartered institutions, and for that reason, Congress permitted the OTS to determine which portions of its regulations would not preempt state restrictions on AMTs. The court, therefore, upheld the OTS rule.

### Second Circuit Allows Class Claims That Markups Violate RESPA

On September 9, the U.S. Court of Appeals for the Second Circuit permitted a class to organize and submit a claim that a mortgage lender violated Section 8(b) of the Real Estate Settlement Procedures Act (RESPA) by charging price markups on services provided by third parties (*Kruse v. Wells Fargo Home Mortgage, Inc.*, No. 03-7665). Section 8(b) prohibits anyone from giving or accepting a portion, split, or percentage of any real estate settlement service charge, unless the portion is compensation for services actually performed. The plaintiffs in this case obtained settlement services from Wells Fargo Home Mortgage and Wells Fargo Financial Services. The plaintiffs alleged that Wells Fargo charged them unreasonable overcharges and markups on the settlement services. Overcharges occur when a lender provides a service and then charges the customer substantially more for the service than what the lender paid. Markups occur when a third party provides a service and a lender charges more than what the third party charged and keeps the excess without performing any additional service.

On the first claim that overcharges violate Section 8(b), the court ruled that RESPA "clearly and unambigu-

ously does not extend to overcharges.” However, the court found that RESPA was unclear and ambiguous about its treatment of markups. Because the law does not explicitly say how to treat markups, the court considered a Department of Housing and Urban Development (HUD) 2001 policy statement, which interpreted Section 8(b) to prohibit markups. The court ruled that HUD’s interpretation is entitled to deference because HUD is the agency desig-

nated to implement rules that foster RESPA’s intent. In addition, the court recognized that HUD possesses expertise in this field, and it issued the policy statement after careful consideration over a period of time. Therefore, the court permitted a class to form and argue its case with regard to markups, but not overcharges. The case was remanded to district court for further proceedings.

## SUMMARY OF THIRD DISTRICT DEVELOPMENTS

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### New Jersey

Governor James McGreevey signed into law P.L. 2004, c. 84, an act that restricts certain abusive lending practices and amends the New Jersey Home Ownership Security Act of 2002 (see *Banking Legislation and Policy*, April-June 2003). The law prohibits creditors making home loans from financing any credit life, credit disability, credit unemployment, or credit property insurance, or any other life or health insurance, or any payments for debt cancellation or suspension agreements. However, debt cancellation or suspension fees that are calculated and paid on a monthly basis will not be considered financed by the lender. Creditors also may not recommend or encourage default on an existing loan or debt prior to the closing of a home loan that refinances all or any portion of that existing loan or debt.

Creditors may only charge late payment fees that do not exceed 5 percent of the amount of the payment past due. Late payment fees may be applied only once for a single late payment, and a fee may be assessed only after a payment is past due for more than 15 days. Creditors must alert borrowers that a late payment fee has been assessed no more than 45 days after the payment was due. Further, home loans may not include provisions that permit a creditor to accelerate the indebtedness, except when the acceleration is in good faith because the borrower failed to comply with terms of the loan. Finally, creditors may not charge a fee for informing a consumer of the balance due to pay off a home loan.



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