BANKING LEGISLATION & Policy

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Recent Developments

Modernization Bills Clear House and Senate Respectively

On July 1, the House of Representatives passed H.R. 10, the Financial Services Act of 1999. This action brought the House up to speed with the Senate, which had already passed its own modernization bill (S. 900) in May. Although the passage of the respective bills puts modernization legislation further ahead than it was during the last Congress, there still remain several issues to be addressed during the Joint Conference Session if the legislation is to be enacted into law.

Privacy concerns became a late sticking point in the House. While both bills criminalize obtaining customer information from a financial institution under false pretenses, the House bill would also restrict information sharing among affiliates and prohibit the disclosure of certain account information to unaffiliated third parties for marketing purposes. It would also prohibit the disclosure of medical information by insurance companies or their affiliates. The Community Reinvestment Act (CRA) provisions of the two bills are a further point of contention. The House bill would require subsidiary depository institutions of a qualifying financial holding company (FHC) to maintain at least a satisfactory CRA rating. The Senate bill would eliminate CRA requirements for small rural banks and would, in general, require regulators to presume that a bank is in compliance with CRA if the bank has a three-year history of satisfactory ratings.

Finally, the proper placement of nonbanking activities within an FHC remains a source of disagreement. The House bill would allow FHCs to provide merchant banking services and other financial services through operating subsidiaries of the bank, but the FHC could engage in insurance underwriting and real estate development only through separate subsidiaries of the holding company. The Senate's legislation would mandate holding company subsidiaries for all nonbanking activities. However, national banks with under $1 billion in assets would be exempt from the restriction.

President Clinton has threatened a veto of the Senate bill owing to the CRA and operating subsidiary provisions. Many of the other interested parties have taken strong stances on their positions. These issues will need to be worked out when the House and Senate meet in conference to finalize a compromise modernization bill, which is predicted to take place in September.

SUMMARY OF FEDERAL LEGISLATION

New Legislation

1. Consumer Credit Card Protection Amendments of 1999 (S. 787). Introduced by Senator Schumer (D-NY) on April 13, 1999.

Status: Referred to the Committee on Banking.

This bill would amend the Truth in Lending Act (TILA) to require open-end credit lenders to disclose, at the outset of the arrangement, the method used to determine the minimum payment along with applicable penalties resulting from failure to pay the minimum. Account statements would need to state the minimum payment required, both as a dollar figure and percentage of balance; the number of months needed to settle the debt if just the minimum payment was made; the total cost to the debtor of paying off the account if only minimum payments were made; and a notice stating that total repayment costs may be higher if the current rate is an introductory rate. Credit card solicitations on the Internet would be held to the same disclosure requirements to which direct mail and other solicitation methods must adhere.

Solicitations with introductory rates would be required to disclose the date on which the introductory rate will cease along with the rate that will apply when the introductory rate ceases as well as any actions by the debtor that would invalidate the introductory offer. Creditors would be barred from assessing inactivity fees on debtors with an outstanding balance. They would also be prohibited from issuing cards to consumers under the age of 21 without either a parent's or guardian's signature indicating joint liability for debts, or else evidence that the consumer has an independent ability to repay future debts.

Creditors wishing to increase interest rates would be required to notify debtors at least 15 days prior to the next billing cycle. A consumer who decides to cancel his or her account would be permitted to make payments according to the terms in effect before the notice to increase. Creditors providing consumers with third-party checks must also disclose the transaction fee and interest rate associated with the checks. Finally, the bill would extend the ban on issuance of unsolicited credit cards to include stored-valued cards, debit cards, check cards, check guarantee cards, or purchase-price discount cards connected with an open-end credit plan.

2. Money Laundering Prevention Act of 1999 (H.R. 1426). Introduced by Representative Waters (D-CA) on April 14, 1999. Related Bills: H.R.1471

Status: Referred to the Committee on Banking and Financial Services.

The Treasury Department would be required to identify and designate countries where money laundering activities are concentrated as high-intensity money laundering areas. Banks operating in these areas would be required to maintain account information so that account activity could be associated with a particular account holder. Banks must be prepared to provide this information to law enforcement authorities.

The Board of Governors of the Federal Reserve System (Board), when reviewing a bank acquisition or merger application, would be required to take into account the applicant's effectiveness in combating money laundering. The Board would not be allowed to consider applications from banks with pending federal prosecutions or investigations centering on possible money laundering activities.

3. Small Business Banking Regulatory Relief Act of 1999 (H.R. 1435). Introduced by Representative Metcalf (R-WA) on April 15, 1999.

Status: Referred to the Committee on Banking and Financial Services.

This bill would allow depository institutions to offer businesses interest-bearing checking accounts. In addition, balances maintained by depository institutions at a Federal Reserve Bank would earn interest at a rate determined by the Federal Reserve System.

4. Payday Borrower Protection Act of 1999 (H.R. 1684). Introduced by Representative Bush (D-IL) on May 5, 1999.

Status: Referred to the Committee on Banking and Financial Services.

This bill would amend the Consumer Credit Protection Act to prohibit payday loans in any state that does not specifically have laws authorizing and regulating such transactions. Under a payday loan, the borrower authorizes the lender to debit his or her account for the amount of the loan at some predetermined date, for example, the borrower's payday. In addition to setting requirements for appropriate state regulation of payday lending, the bill also imposes a maximum APR on payday loans of 36 percent.

5. Consumer Fairness Act of 1999 (H.R. 2258). Introduced by Representative Guiterrez (D-IL) on June 17, 1999.

Status: Referred to the Committee on Banking and Financial Services.

This bill would amend the Consumer Credit Protection Act to make it illegal for a consumer contract to contain a provision requiring binding arbitration of disputes. In particular, this prohibition would apply to credit card contracts. Arbitration would be permissible if the parties involved agree to this form of resolution after the dispute arises.

6. Unsolicited Loan Check Consumer Protection Act of 1999 (H.R. 2351). Introduced by Representative LaFalce (D-NY) on June 24, 1999.

Status: Referred to the Committee on Banking and Financial Services.

This bill would amend the Consumer Credit Protection Act to prohibit creditors from sending unsolicited loan checks or other negotiable instruments to consumers in an attempt to extend credit. Consumers who received an unsolicited loan check could not be held liable to repay if they cash the check, and no information concerning alleged consumer liabilities incurred by cashing such a check could be sent to a credit bureau.

Pending Legislation

1. Financial Services Act of 1999 (H.R. 10). Introduced by Representative Leach (R-IA) on January 6, 1999. Related Bills: H.R 665, H.R. 823, S. 576, S. 900. [See Recent Developments and *Banking Legislation and Policy*, First Quarter 1999, for a summary of H.R. 10 as introduced.]

Status: Passed the House of Representatives on July 1, 1999.

2. Year 2000 Readiness and Responsibility Act (H.R. 775). Introduced by Representative Davis (R-VA) on February 23, 1999.

Status: House and Senate agreed to Conference Report on July 1, 1999. Cleared for White House review.

This bill would set limits on lawsuits arising out of Year 2000 (Y2K) failures. Defendants in Y2K civil cases, who fall out of compliance with federally mandated requirements because of a Y2K failure, would be able to invoke a 'Y2K upset' defense against charges brought by the federal government. This defense would not be permitted for banks or broker-dealers nor would it be permitted for defendants who have not reasonably addressed prevention measures.

Before initiating a Y2K lawsuit, the plaintiff must give the defendant notice of the planned suit. The defendant would have 30 days to propose remedies to the problem or to select arbitration. The plaintiff must then give the defendant an additional 60 days to complete the remedy before proceeding with the suit. Defendants in Y2K cases that have judgments entered against them would be liable only in proportion to their level of culpability in damaging the plaintiff.

The bill would require that in suits where the defendant is not the manufacturer, seller, or distributor of a product suffering a Y2K failure, a plaintiff must prove that the defendant knew or recklessly disregarded the risk of failure occurring. Also, the fact that a defendant was in possession of a product that suffered a Y2K failure causing damages could not be the sole basis for damages being charged to the defendant. Punitive damages against a small business or an individual with a net worth below $500,000 would be capped unless it could be proven that the business's or individual's intention was to hurt the plaintiff or commit fraud. Government entities would be exempt from punitive damages.

Homeowners would be offered some protection against defaults due to the faulty crediting of mortgage payments as a result of a Y2K failure. Foreclosure efforts would not be permitted until the end of January 2000 or four weeks after the consumer provides notice to the mortgage servicer of the Y2K problem. This grace period would not extend past the end of May 2000.

3. Bankruptcy Reform Act of 1999 (H.R. 833). Introduced by Representative Gekas (R-PA) on February 24, 1999. Related bills: S. 625.

Status: Passed the House of Representatives on May 5, 1999. Placed on the Senate Legislative Calendar on May 12, 1999. [See *Banking Legislation and Policy*, First Quarter 1999, for a summary of H.R. 833 as introduced.]

4. Financial Services Modernization Act of 1999 (S. 900). Introduced by Senator Gramm (R-TX) on April 28, 1999. Related bills: H.R. 10, H.R. 665, H.R. 823, S. 753.

Status: Passed the Senate on May 6, 1999. [See Recent Developments and *Banking Legislation and Policy*, First Quarter 1999, for a summary of S. 900 as introduced.]

Board of Governors of the Federal Reserve System

Risk-Based Capital Standards (4/19/99)
Together with the Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation, issued a final rule addressing capital standards for market risk for banks and bank holding companies with significant trading activities. Under the final rule, which leaves intact the treatment of market risk, a bank that measures the specific risk of its trading positions using an internal model does not have to use the capital charge calculated under the standardized approach as a benchmark. Previously, banks had to hold at least 50 percent of the capital charge for specific risk calculated under the standardized approach. Specific risk refers to price variations in an institution's trading portfolio due to circumstances unique to the security issuer, for example, the credit risk of individual counterparties.

The agencies will review the institution's internal model to ensure that the models properly account for specific risk. Models found to be inadequate may be subject to specific risk add-ons. This rule became final on July 1, 1999. For further information, see 64 *Federal Register*, pp. 19034-9. (Regulations H and Y)

Automated Clearing House (ACH) Operations (5/21/99)
Issued a notice requesting comments on modifications to the Federal Reserve Banks' ACH operations. Specifically, the Board is looking for commentary on revising the pricing schedule and deposit deadlines applicable to private sector ACH operators (PSOs). The Federal Reserve Banks (FRBs) account for roughly 80 percent of ACH transactions. The remaining transactions are handled collectively by PSOs - Visa, New York Automated Clearing House, and American Clearing House. Current legislation and regulations specify that the FRBs are allowed to recognize only depository institutions as customers. This restriction results in a 'double charging' of depository institutions that use the PSOs as their ACH whenever the FRB ACH system must be used to complete a transaction. In addition, the FRBs use uniform deposit deadlines and delivery schedules for their customers, PSOs, and third party processors – companies that perform backroom operations for banks. So in order to meet the FRBs' deposit deadlines, PSOs must impose an earlier deadline on their customers, putting them at a competitive disadvantage relative to the FRBs.

The Board is requesting comments on changes to current regulations regarding pricing and deposit deadlines. Specifically, the Board requests comments on whether fee schedules or deposit deadlines should be changed for transactions partially handled by PSOs and if similar modifications should be enacted for third party processors. Comments are due by August 6, 1999. For further information, see 64 *Federal Register*, pp. 27793-6.

Extension of Credit by Federal Reserve Banks (5/27/99)
Gave notice of proposed rulemaking to establish a lending program to address liquidity concerns centering on the century date change period. The proposal calls for making credit under a new special liquidity facility (SLF) available from November 1, 1999, until April 7, 2000. The interest rate applicable would be 1.5 percentage points above the federal funds rate. The SLF would be available only to those financial institutions in sound financial condition. A foreign bank branch or agency would be eligible to borrow from the SLF if the branch or agency is subject to Regulation D's reserve requirement. Each Federal Reserve Bank would have final discretion as to whether to extend credit, but unlike regular discount window loans, borrowing banks would not be expected to exhaust all alternate sources of funds before applying for a loan under the SLF. Comments were due on July 2, 1999. For further information, see 64 *Federal Register*, pp. 28768-70. (Regulation A)

Federal Deposit Insurance Corporation

Deposit Insurance Regulations (4/1/99)
Issued a final rule that would amend current deposit insurance regulations to ensure equal treatment of all depositors, whether their savings are held in individual or joint accounts. In the case of a joint account owned by two persons, for instance, the maximum coverage would increase from $100,000 to $200,000. The maximum coverage that any one person can obtain regardless of the sum of all of his or her interests in all joint accounts would be $100,000.

The amendment would also add siblings and parents to the list of qualifying beneficiaries for payable-on-death (POD) accounts. Currently, spouses and children are the only eligible beneficiaries. The insurance coverage of POD accounts depends on the number of qualified beneficiaries rather than the number of owners of the account. For example, an account with four qualified beneficiaries would be insured up to $400,000. This rule became effective on April 1, 1999. For further information, see 64 *Federal Register*, pp. 15653-7.

Asset and Liability Backup Program (6/9/99)
Issued an interim final rule to require certain institutions to set up asset and liability backup programs (ALBPs). In general, FDIC-insured depository institutions with a Y2K rating below satisfactory as of July 31, 1999, would have to maintain backup files of loan and

deposit account information. Such information would be useful in the event that the institution experienced Y2K-related computer problems. The type of information required to be kept includes account numbers, tax ID numbers, customer identification data, account balances, loan types, and other pertinent data. The interim rule became effective July 9, 1999. Comments were due July 9, 1999. For further information, see 64 *Federal Register*, pp. 30869-80.

Office of the Comptroller of the Currency

Availability and Release of Information (6/1/99)
Issued a final rule clarifying the right of the OCC to make nonpublic information available to any party that the Comptroller deems necessary, without the request of a third party. The rule also stresses that such information still remains the property of the OCC and cannot be given out to another party except with prior permission from the Comptroller. This rule became final June 1, 1999. For further information, see 64 *Federal Register*, pp. 29214-7.

Public Welfare Investments (6/10/99)
Gave notice of proposed rulemaking that relaxes national banks' certification requirements for investments designed primarily to promote the public welfare, for example, investments in community development corporations. The proposed rule would remove the requirement that national banks demonstrate the extent to which the investment benefits communities otherwise served by the bank.

Currently, banks seeking to make public welfare investments must also demonstrate nonbank community support for the investment, usually through the participation of community representatives in decision making. The OCC is seeking comment as to whether this community support requirement is appropriate and what alternative criteria could be used as evidence of community support. The proposed rule would allow eligible community banks—national banks with less than $250 million in assets—to self-certify all public welfare investments.

Finally, self-certification would no longer be restricted to those projects in which 25 percent of the investment is local. Comments are due by August 9, 1999. For further information, see 64 *Federal Register*, pp. 31160-4.

Investment Securities (6/14/99)
Gave notice of proposed rulemaking that would update and codify a number of previous interpretive rulings. These include the ruling that automated loan machines, deposit production offices, loan production offices, or any combination of these are not considered branches. Comments are due by August 13, 1999. For further information, see 64 *Federal Register*, pp. 31749-56.

Bank for International Settlements

Capital Adequacy Guidelines (6/99)
Gave notice of proposed rulemaking that would modify the international capital measurements and adequacy standards adopted by the Basle Committee on Banking Supervision in July 1988. The new revisions would address minimum capital requirements, supervisory review, and market discipline.

The proposed modifications would introduce new risk-weighting systems to differentiate high-risk assets from low-risk assets in a more discriminating way. The new system would incorporate independent agency ratings and a weighting scale between 0 and 150 percent. The risk weights for off-balance-sheet items would also be affected by the new proposal. Loan commitments under one year would be subject to an increased risk weight of 20 percent. The proposal would also eliminate the current 50 percent ceiling on risk weights for OTC transactions.

The proposal would also move to increase market discipline by imposing disclosure requirements. One such proposed revision would necessitate that a country subscribe to the IMF's Special Data Dissemination Standards in order for the country's sovereign debt to become eligible for a risk weighting below 100 percent. The proposal also says that regulators should be able to impose higher minimum capital requirements at their discretion as well as the power to effectively intervene before a bank's capital is impaired.

The BIS also seeks comments on a number of issues for which it has no concrete proposals. Among these are: 1) how banks' internal loan risk classifications should be used in setting capital requirements; 2) how risk reduction techniques like hedging and guarantees can be incorporated; and 3) how interest rate risk and operational risk can be incorporated. For further information, see *http://www.bis.org/publ/index.htm*, Basle Committee on Banking Supervision, Publication no. 50. Comments are due by March 31, 2000.

On April 5, 1999, the U.S. Court of Appeals for the Eleventh Circuit found that the Office of the Comptroller of the Currency (OCC) was mistaken in allowing a bank to issue an insurance-like product called the retirement certificate of deposit. The appeals court in this case (*Blackfeet National Bank v. Nelson 11th Cir., No. 96-3021, 4/5/99*) found that a bank issuing a retirement CD would, in effect, be acting as an insurance underwriter — an activity prohibited by the National Bank Act (NBA).

The case originated in 1994 when Blackfeet National Bank sued the Florida insurance commissioner in federal district court to stop Florida's efforts to regulate the retirement CD as an insurance product. Blackfeet, along with the OCC, maintained that the CD was an investment product rather than an insurance product and therefore outside the reach of state insurance regulators.

The retirement CD has qualities of both a traditional certificate of deposit and an annuity. An initial deposit is made, during which time the interest is fixed and a penalty for early withdrawal is assessed. At "maturity" a partial withdrawal can be made, with the remaining amount paid out in equal installments over the course of the customer's life, even if the balance reaches zero.

The Appeals Court found that the bank's assumption of risk, in the event that the bank continued to make payments beyond the current balance, and its use of actuarial tables in pricing this risk meant that the bank was engaged in insurance underwriting. The court ruled that, as an underwriting activity, the retirement CD is prohibited by the Banking Act and therefore, beyond the OCC's authority to regulate. In addition, since the retirement CD is an insurance product, it does come under the authority of state insurance regulators.

On April 7, 1999, the United States District Court of Connecticut issued a narrow ruling clarifying the Office of the Comptroller of the Currency's (OCC) role as sole regulator of national banks. This ruling (*Fleet Bank N.A. v. The Honorable John P. Burke, et al* (*3:98CV2186"JBA"*) should serve as an obstacle to attempts by Connecticut banking regulators to enjoin national banks from imposing ATM surcharges. The court's ruling did not address the standing of Connecticut's ban on surcharging. Instead, the ruling made clear that the OCC, as regulator of national banks, has exclusive authority to enforce all bans or orders applicable to national banks.

Although this ruling has eliminated one point of contention, the dispute over ATM surcharging in Connecticut still remains. The statute against ATM surcharging in Connecticut remains on the books. And although the OCC has given no formal indication of whether it would enforce the ban, the Attorney General's office, on April 19, announced that it had filed a lawsuit in Hartford Superior Court requesting a temporary injunction on the surcharging of noncustomers. So far, the national banks doing business in Connecticut have not resumed surcharging at their ATMs.

On April 9, 1999, the United States Court of Federal Claims awarded Glendale Federal Bank, FSB (Glendale) $910 million in its regulatory goodwill case against the United States. The ruling (*Glendale Federal Bank, FSB v. The United States, No. 9090-772C*) is likely to affect many of the 120 remaining regulatory goodwill cases that are currently winding their way through the court system.

In 1981, Glendale undertook a supervisory merger with First Federal Savings and Loan Association of Broward County (Broward). Broward was an ailing thrift whose net assets had a market value of negative $734 million. As part of the supervisory merger contract, Glendale was permitted to treat this negative value as goodwill capital for purposes of meeting regulatory capital requirements. Eight years later, the U.S. government passed the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), which prohibited Glendale and other thrifts with similar agreements from counting the goodwill as capital beginning in 1990.

By 1992, Glendale failed to meet its risk-based capital requirement. In January 1993, the OTS issued a prompt corrective action directive (PCA) to Glendale requiring the thrift to increase its capital to regain compliance. Glendale eventually returned to compliance after a major recapitalization drive, which involved the selling off of University Savings and Glendale's offices in Florida.

Glendale sued the government for tort damages, citing breach of contract. These damages included lost profits, increased costs of funds, increased deposit premiums, and the miscellaneous costs attributable to the alleged breach. The government countered that Glendale actually benefited from this new legislation, because the thrift was compelled to sell unprofitable investments to meet the new capital requirements. Also, since Glendale never actually paid money for Broward, the government asserted that Glendale's costs associated with acquiring the troubled thrift were minimal.

The court, in rejecting the government's claims, ruled that Glendale was entitled to roughly $528.2 million in restitution for the net benefits transferred to the government as a result of the contract. Also, the thrift was awarded $380.8 million in reliance damages. The court also used the ruling to send a message to the litigants in the remaining cases. Chief Judge Loren A. Smith urged the remaining parties to craft private agreements without relying on the courts to settle the dispute.

In an eight to one ruling, the Supreme Court placed limits on the new-value exception to the absolute priority rule with its May 3 ruling on *Bank of America Nat. Trust and Sav. Assn. v. 203 North LaSalle Street Partnership, 97-1418*. The Court overturned a bankruptcy court's and a circuit court's earlier rulings by finding that the owners in a bankrupt real estate project should not have been allowed to retain equity in the project over the objections of unpaid creditors. Specifically, the Supreme Court found that creditors had the right to block a plan incorporating the new-value exception if the debtor is the only party allowed to offer a reorganization plan.

Traditionally, bankruptcy courts have enforced the absolute priority rule, which says that junior claimants, for example, the firm's owners, are not allowed to receive payments as long as senior creditors remain unpaid. However, bankruptcy courts have made exceptions to this rule by invoking the new-value exception. This exception allows equity holders to maintain ownership if they invest new money in the project, even while some creditors are not fully reimbursed.
Bank of America (BofA) originally took this case to court when a bankruptcy judge approved a reorganization plan that allowed the 203 North LaSalle Street Partnership (LaSalle), which had borrowed $93 million from BofA – with the building as collateral – to repay the bank a total of $58.5 million within seven to 10 years. Under the plan, LaSalle was required to invest new money in the project and would have been able to retain ownership. BofA countered that the building should be sold and challenged the bankruptcy court's decision to override its objection. Two lower courts sided with LaSalle before the case made it to the Supreme Court.

The Court's decision did not address the standing of the new-value exception. Instead, the Court ruled on the narrow grounds that the lower courts were wrong in giving the debtor an exclusive right to propose a reorganization plan. Whether competing bids to provide new value would be upheld remains an open question.

SUMMARY OF THIRD DISTRICT DEVELOPMENTS

Delaware
On April 15, 1999, Representative Obele (R) introduced H.B. 152. The bill would prohibit any bank regulated by the Delaware State bank commissioner from charging a fee at an automated teller machine (ATM). The bill is currently in the Economic Development and the Banking and Insurance committees of the Delaware House of Representatives.

On May 18, 1999, Governor Carper signed into law H.B. 156. The new law provides the mechanism for foreign banks without an existing domestic headquarters to elect Delaware as their home state under the International Banking Act of 1978.