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Recent Developments

Bankruptcy Reform Stuck in Pre-Conference Limbo

After moving relatively swiftly through both chambers of Congress, bankruptcy reform legislation has stalled as congressional leaders deliberate the makeup of the joint House and Senate committee that will decide on the final language of the legislation. The House and Senate passed their respective versions of bankruptcy reform legislation on March 1 and March 19.

As with most major legislation, Senate and House representatives meet in a conference committee to hammer out a uniform bill that is then presented to the individual chambers for a vote. In most cases, each chamber's committee representation reflects the makeup of that chamber. Since the Senate is split 50-50, Democrat and Republican, the Senate leadership is attempting to work out an agreement as to the makeup of their committee delegation.

Assuming this pre-conference sticking point is resolved, the committee still faces the challenging task of forming a consensus. Several discrepancies between the House and Senate bill will need to be addressed. For example, the Senate bill (S. 420) imposes a hard cap of \$125,000 on the homestead exemption—the amount of home equity a debtor is legally permitted to shield from creditors. The House bill (H.R. 333) does not have a limitation on the homestead exemption. Another potential point of contention is the Senate bill's provision that would

make nondischargeable any civil fines assessed to a debtor as a result of the debtor's interfering with the procurement or availability of a legal good or service. This language is directed at anti-abortion activists who have threatened to use bankruptcy protections to discharge civil judgments. The House bill contains no such provision, and several representatives have indicated they would challenge this section of the Senate's bill.

Philadelphia Enacts Anti-Predatory Lending Statute

On April 19, Philadelphia enacted the Prohibition Against Predatory Lending Act. The statute, which targets nonbank lenders, defines a high-cost loan as a residential mortgage loan with an interest rate more than 6.5 percentage points

above the yield on comparable maturity Treasury securities and total points and financed fees greater than 4 percent of the total loan amount. The resolution defines a predatory loan as a high-cost loan that employs any of several practices commonly attributed to predatory lenders. Examples of these practices include the imposition of a payment schedule that results in negative amortization, mandatory arbitration provisions in the loan contract, lending without home loan counseling or regard to a borrower's ability to repay, balloon payments, or prepayment penalties. The statute imposes a penalty of up to \$300 per day for each predatory loan made by a lender and prohibits the city from engaging in business with such lenders.

The city council unanimously approved the resolution on April 5. The

Philadelphia municipal code requires the mayor to sign the passed bill or veto it within a set time. Although Philadelphia Mayor John Street conveyed his concerns about the long-term effects of the ordinance—both on the city government and residents—he decided against vetoing the measure.

Consumer and housing advocates hailed the new law and called on other cities to follow Philadelphia's lead. Lenders that do business in the city have cautioned that the terms of the new law are too restrictive and some subprime consumers may not be able to access the equity in their homes. Opponents of the measure have indicated that they will try to offer a replacement measure before the end of the 90-day period after which the bill will take effect.

SUMMARY OF FEDERAL LEGISLATION

New Legislation

1. Faith-Based Lending Protection Act (H.R. 164). Introduced by Representative Royce (R-CA) on January 3, 2001.

Status: Referred to the Committee on Financial Services. Related Bill: H.R. 760.

This bill would amend the Federal Credit Union Act (FCUA) to exclude loans made to nonprofit religious organizations from the statutory definition of *member business loan*. The FCUA prevents credit unions from making a member business loan if it would result in total member business loans exceeding a threshold set by the FCUA.

2. College Student Credit Card Protection Act (H.R. 184). Introduced by Representative Slaughter (D-NY) on January 3, 2001.

Status: Referred to the Committee on Financial Services.

This bill would prohibit credit card issuers from extending credit to full-time, traditional-aged college students in an amount greater than the larger of either \$500 times the number of full years that have elapsed since the account was opened—up to \$2000, or 20 percent of the annual gross income of the student in the most recent calendar year. In the case of a student without an annual income, a card issuer would be barred from supplying such a student with a second credit card regardless of the identity of the original issuer.

A student whose parents or guardians assume joint liability for debts incurred would be exempt from these limitations. For such joint liability

accounts, a credit limit increase would have to be authorized by the parent or guardian.

3. Financial Information Privacy Protection Act of 2001 (S. 30). Introduced by Senator Sarbanes (D-MD) on January 22, 2001.

Status: Referred to the Committee on Financial Services. Related Bill: S. 450.

This bill would expand on privacy provisions enacted in the Gramm-Leach-Bliley Act. A financial institution would be prohibited from disclosing nonpublic personal information—including Social Security numbers—to either affiliated or unaffiliated third parties unless the financial institution has informed the consumer of the categories of information

that may be disclosed and has given the consumer an opportunity to opt out. Current federal privacy statutes do not give the consumer the right to opt out of information-sharing agreements between their financial institution and its affiliates. In addition, this bill would explicitly grant consumers the right to review and dispute information held on them by their financial institution.

A financial institution that collects information on the spending or payment tendencies of its customers would be prohibited from distributing this information unless the consumer opts in to the sharing of that information. A third party that receives nonpublic personal information from a financial institution would face the same customer notification and permission requirements applicable to the financial institution. Service companies would be exempted from these restrictions so long as the transfer of information is necessary to perform the contracted service.

The legislation would also prohibit a financial institution from obtaining, through an affiliate or unaffiliated party, individually identifiable health information about the consumer unless he or she has affirmatively consented to the transfer of information. Furthermore, the same information would need to be required from all consumers as a condition for receiving the financial product or service.

Financial institutions are currently required to disclose their privacy policy to consumers at the establishment of a customer relationship and at least annually thereafter. In addition, this bill would require disclosure to an individual upon request and as part of an application for a financial product or service.

Finally, financial institutions would be barred from disclosing customer account numbers to affiliates for marketing purposes. Coupled with the current statutory prohibition on the marketing-related transfer of account numbers to unaffiliated parties, the legislation would bar all marketing-related transfers of account numbers.

4. Meeting America's Investment Needs in Small Towns Act of 2001 (S. 128). Introduced by Senator Johnson (D-SD) on January 22, 2001.

Status: Referred to the Committee on Financial Services. Related Bill: H.R. 746.

This bill would amend the Federal Deposit Insurance Protection Act to allow for the periodic adjustment of the level of deposit insurance coverage. Coverage levels would be established every three years and would reflect changes in the cost of living as determined by the percentage by which the Consumer Price Index (CPI) exceeds the CPI for calendar year 1980.

5. Consumer Credit Fair Dispute Resolution Act of 2001 (S. 192). Introduced by Senator Feingold (D-WI) on January 25, 2001.

Status: Referred to the Committee on the Judiciary.

This bill would negate clauses in consumer credit contracts that mandate arbitration as the means for settling a controversy stemming from the contract. Agreements by affected parties to enter into arbitration after the controversy arises would be unaffected by the legislation.

6. Credit Card Consumer Protection Act (H.R. 296). Introduced by Representative Pascrell (D-NJ) on January 30, 2001.

Status: Referred to the Committee on Financial Services.

This bill would require credit card issuers to mail monthly statements at least 30 days prior to the next payment due date. The statement must prominently disclose the payment due date along with applicable fees as a result of a late payment. Card issuers would also be required to keep track of the statement mailing date as well as the payment received date. These records must be

made available upon the request of the consumer.

7. Bankruptcy Reform Act of 2001 (S. 420). Introduced by Senator Grassley (R-IA) on March 1, 2001.

Status: Passed in the Senate on March 19, 2001. The House passed its version (H.R. 333) on March 1, 2001. The conference committee has not yet been appointed. Related Bills: H.R. 333, H.R. 11.

This bill would overhaul the United States Bankruptcy Code (11 U.S.C.). It is intended to end perceived abuses of the current bankruptcy system. The major provisions that apply to the banking industry are summarized below.

Consumer Bankruptcies. The bill would make it easier to convert a bankruptcy case from Chapter 7 (liquidation) to a Chapter 13 (debt adjustment). Interested parties would be permitted to petition the court for a conversion by showing that a debtor is abusing bankruptcy laws. A rebuttable presumption of abuse would be established if the debtor has applied for Chapter 7 relief but has a five-year income, less allowable expenses and payments on secured debts, greater than the lesser of: 1) \$10,000 or 2) the larger amount of \$6,000 or 25 percent of the unsecured claims against the debtor. The bill also contains safe-harbor provisions for debtors whose income falls below the state median income level. No party in a proceeding involving such a debtor would be permitted to petition to convert a case from Chapter 7 to Chapter 13.

The bill would also limit the homestead exemption to \$125,000. This is the amount of home equity that can be shielded from creditors when the debtor's financial resources are being assessed. To claim a state's homestead exemption, the debtor must establish residency in that state at least two years prior to filing for bankruptcy protection, as opposed to the current six-month residency requirement.

When deciding whether the debtor

has abused the right to file under Chapter 7, the bankruptcy trustee would be permitted to take into account whether the debtor has extraordinary expenses, such as health care for a chronically ill immediate family member or up to \$1500 in school tuition for each dependent child. The trustee would then make a recommendation to the bankruptcy court, which would make the final judgment as to whether the case should be converted or dismissed. Dismissal of a case along with the findings of improper actions by the debtor's attorney could result in civil damages to be paid by the attorney.

The bankruptcy court would be able to terminate the automatic stay on actions against the debtor's property if the court determines that the debtor has been abusing the protection. The bill would also make certain consumer debts nondischargeable. An example of this would be credit card cash advances obtained from a single creditor that total more than \$750 and were obtained within 70 days prior to the bankruptcy filing.

A debtor would be ineligible for bankruptcy relief under Chapter 7 or Chapter 13 if he or she has received a discharge within eight or two years, respectively. Furthermore, a debtor would be ineligible for bankruptcy relief unless he or she received a briefing from an approved nonprofit credit-counseling agency in the six months prior to filing for bankruptcy. A judge would be prohibited from approving a bankruptcy plan that does not address the payment of outstanding domestic support obligations. These obligations would be assigned top priority on the list of unsecured claims against the debtor.

Consumer Protections. A creditor would be required to make a debtor aware of his or her right to a reaffirmation hearing before permitting the debtor to reaffirm a debt. A reaffirmation is a legally binding agreement between a creditor and debtor to repay all or part of a discharged obligation; it cannot be discharged by a

bankruptcy court. This requirement would be waived if the debtor had legal representation during the reaffirmation negotiation. At the hearing, a bankruptcy judge would rule on whether the reaffirmation is in the best interest of the debtor.

The bill would also mandate enhanced disclosures by creditors to consumers of open-ended credit plans or credit extensions secured by a home. Creditors would be required to disclose the amount of time it would take for consumers to pay off balances if they make only minimum payments. Credit issuers would also be required to provide enhanced disclosure regarding introductory rates and late payment penalties. Credit issuers would also be prohibited from early termination of credit plans simply because finance charges have not been incurred.

This bill would require a debt relief agency (DRA) to supply consumers with certain information before entering into an agreement with the consumer. A DRA is a for-profit person or entity that provides bankruptcy assistance to a debtor. These agencies would be required to supply the following information to the consumer: 1) his or her options regarding legal representation; 2) the costs and types of services provided by the agency; 3) information on the different types of bankruptcy; and 4) fees and documents needed to proceed with a case. Furthermore, they would be required to explain to the debtor how to properly value assets and income in addition to explaining the importance of supplying accurate information to the court. An agency that does not make the required disclosures, does not follow the federal rules of bankruptcy procedure, or was responsible for the conversion of a case because of improper filing of papers could be held liable to the debtor for civil damages.

Finally, a debtor could have his or her obligation to a creditor reduced by 20 percent if the debtor can show the bankruptcy court that the creditor

unreasonably refused to negotiate an alternative payment schedule put forth by an approved credit counseling agency in the 60 days prior to a filing for bankruptcy protection.

International Bankruptcies. This bill would create Chapter 15 of Title 11 to manage cross-border bankruptcies. This chapter would expand the scope of bankruptcy laws to incorporate the model law on cross-border insolvency. It would establish a statutory mechanism to address cross-border insolvency and to facilitate cooperation between the trustees and debtors in the United States and their foreign counterparts.

Financial Contracts. The bill would amend the bankruptcy code and the Federal Deposit Insurance Act to clarify the treatment of various derivative contracts when a counterparty becomes insolvent. For the most part, such agreements are exempted from the automatic stay and remain apart from the property of an estate.

The bill recognizes master agreements between counterparties as contracts exempted from the automatic stay. Such agreements govern netting arrangements across a number of contracts between counterparties.

The bill also clarifies conditions in which walkaway clauses in financial contracts with depository institutions in default could not be exercised. A walkaway clause is a provision that eliminates the payment obligation of one party as a result of the default of another party.

8. Municipal Deposit Insurance Protection Act of 2001 (S. 227). Introduced by Senator Torricelli (D-NJ) on January 31, 2001.

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

This bill would amend the Federal Deposit Insurance Act to provide FDIC

insurance on the total amount of deposits belonging to a municipality. The deposits would need to be with a depository institution located in or having a branch within the same state as the municipality.

9. Interest on Business Checking Act of 2001 (S. 229). Introduced by Senator Hagel (R-NE) on January 31, 2001.

Status: Referred to the Committee on Banking, Housing, and Urban Affairs. Related Bills: S. 601, H.R. 974, H.R. 1048, and H.R. 1009.

This bill would legalize the payment of interest on commercial demand accounts by repealing the sections of the Federal Reserve Act, Home Owners Loan Act, and Federal Deposit Insurance Act that currently prohibit the practice. The legislation would also permit the Federal Reserve System to pay interest on reserves maintained at the Reserve Banks by depository institutions.

10. Unlawful Internet Gambling Funding Prohibition Act (H.R. 556). Introduced by Representative Leach (R-IA) on February 12, 2001.

Status: Referred to the Committee on Financial Services.

This bill would prohibit the acceptance of credit cards, electronic fund transfers, checks, or other negotiable instruments payable through a financial institution for the purpose of unlawful Internet gambling that violates a state or federal statute.

The bill would create a safe harbor for a financial institution as long as the institution is not knowingly engaged in the business of gambling or acts as an agent of a gambling enterprise.

11. Deposit Insurance Fairness and Economic Opportunity Act (H.R. 557). Introduced by Representative Lucas (R-OK) on February 12, 2001.

Status: Referred to the Committee on Financial Services.

This bill would amend the Federal Deposit Insurance Act and the Federal Home Loan Bank Act to require the Federal Deposit Insurance Corporation (FDIC) to transfer from the deposit insurance funds any amounts in excess of 1.40 percent of insured deposits to the Federal Housing Finance Board's Finance Corporation (FICO) beginning in 2002. These transferred funds would be used to pay interest obligations on FICO bonds that were issued to finance the thrift industry cleanup of the 1980s.

The bill would also permit the FDIC to disburse the excess funds as rebates to insured depository institutions starting in 2017 if the amount transferred exceeds the costs of FICO obligations.

12. Truth in Lending Act Amendment (H.R. 605). Introduced by Representative Weiner (D-NY) on February 13, 2001.

Status: Referred to the Committee on Financial Services.

This bill would require any store in which a consumer may open a credit or charge account to display a sign that conspicuously communicates the disclosures currently required by the Truth in Lending Act.

The legislation would supersede state disclosure laws but allow for the creation of state-level legislation to enforce the provision.

13. Social Security Number Privacy Act of 2001 (S. 324). Introduced by Senator Shelby (R-AL) on February 14, 2001.

Status: Referred to the Committee on Financial Services. Related Bills: H.R. 91, H.R. 220, and S. 451.

This bill would require federal banking agencies to promulgate rules implementing a general prohibition on

the sale or purchase of Social Security numbers by financial institutions.

14. Community Reinvestment Modernization Act of 2001 (H.R. 865). Introduced by Representative Barrett (D-WI) on March 6, 2001.

Status: Referred to Committee on Financial Services.

Banks, Bank Holding Companies, and Financial Holding Companies. The bill would extend the Community Reinvestment Act (CRA) to certain nonbank subsidiaries of a bank holding company (BHC) or a financial holding company (FHC). Additionally, banks would receive separate CRA ratings for each state and metropolitan statistical area in which they maintain an office, and any community in which the bank makes more than 0.5 percent of its total loans. Regulators would be required to consider these ratings when evaluating merger applications from banks, BHCs, and FHCs. The legislation would require that at least one public meeting be held regarding an application for a merger or acquisition by a bank, BHC, or FHC. Furthermore, an FHC could lose its authority to engage in new activities if its mortgage bank, insurance company, or securities firm subsidiary receives a poor CRA rating.

The bill would expand the number of CRA ratings from four to five by deleting the satisfactory rating and introducing high satisfactory and low satisfactory ratings. Regulators would also be required to take into account the racial characteristics of a neighborhood as well as the neighborhood's income level when evaluating a bank's CRA performance. In addition, regulators would be required to treat predatory lending practices—defined as any practice by a bank, BHC, or FHC that has a negative impact on a community—as negative factors when evaluating the institution's CRA performance.

Banks and their affiliates would be required to report their small business and agricultural lending in a manner similar to loans subject to current Home Mortgage Disclosure Act (HMDA) reporting requirements. That is, for each loan application received, the bank would report the race and gender of the applicant; the revenue of the farm or small business; the census tract where the small business is located; and whether the application was approved. Finally, the bill would amend HMDA to require covered financial institutions to disclose the number and dollar value of prime and subprime mortgage loans. Additional HMDA reporting fields would include interest rate, origination fee, and balloon payment. The Secretary of Housing and Urban Development would define a subprime loan for reporting purposes.

Insurance Companies. This bill would extend CRA coverage to insurance companies, with the Department of Housing and Urban Development (HUD) as the evaluator. HUD would be required to evaluate insurance firms on the number and distribution of customers throughout a community along with the dollar amounts of policies belonging to these customers. The evaluation would grade the following: 1) the extent to which the company has adopted innovative and flexible marketing methods; 2) the company's record of community development investments; 3) the company's record of opening and closing offices; and 4) the extent to which the company has provided educational and financial counseling classes in low- and moderate-income areas.

Underwriting practices that have a negative impact on the community could reduce the company's rating. HUD would notify the insurance regulator of each state about any firm within its jurisdiction that received an unsatisfactory rating. In addition, insurance firms that receive unsatisfactory ratings would be required to execute a remediation agreement with

HUD. Insurance companies with unsatisfactory ratings could face restrictions on the purchases of their mortgages by the Federal Home Mortgage Corporation (Freddie Mac) or the Federal National Mortgage Association (Fannie Mae).

The legislation also includes the Insurance Disclosure Act, which contains language similar to that contained in HMDA. It would require HUD to design a method for annually collecting data on the following: 1) the availability and affordability of each line of noncommercial insurance coverage by the census tract, race, and gender of the policyholders; 2) the location of the principal place of business of insurance agents; and 3) the agents that have been terminated, by census tract, race, and gender. Covered insurance lines would include automobile and residential property policies. Insurance companies would also be required to report, by census tract, the total number of commercial real estate loans, commercial and industrial loans, and single-family mortgages held in their portfolios. The single-family mortgage and C&I categories would need to be further disaggregated by the race and gender of the borrower. Finally, the legislation would extend HMDA to cover mortgage insurance providers.

Securities Firms. The bill would extend CRA to securities companies, including brokers, dealers, and investment advisors, with the Securities and Exchange Commission (SEC) as the evaluator. The SEC would be required to evaluate securities firms on the following: 1) the number and distribution of customers throughout a community; 2) the dollar amount of investments made by those customers; 3) the extent to which the company has adopted innovative and flexible marketing methods so as to attract low- and moderate-income customers; 4) the company's record of community development investments; and 5) the extent to which the company has provided investment education and

financial counseling classes in low- and moderate-income areas. Investment practices that have a negative impact on the community would reduce the company's rating.

Mortgage Banks. The bill would extend both CRA and HMDA to cover mortgage banks with HUD as the enforcing agency. HUD would be authorized to limit or prohibit the purchase of loans by Freddie Mac or Fannie Mae from any company deemed to be noncompliant with CRA.

15. Freedom From Behavioral Profiling Act of 2001 (S. 536). Introduced by Senator Shelby (R-AL) on March 14, 2001.

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

This bill would prohibit a financial institution from disclosing any information about a consumer for the purpose of marketing a nonfinancial product. A financial institution would also be prohibited from disclosing the identity of someone its customer has sent payment to or received payment from unless the consumer has opted in to the disclosure of all such information.

16. Access to Money (ATM) Act of 2001 (H.R. 1047). Introduced by Representative Andrews (D-NJ) on March 15, 2001.

Status: Referred to the Committee on Financial Services.

This bill would prohibit the operator of an automated teller machine (ATM) from charging a fee to a consumer for an electronic fund transfer if the ATM screen displays an advertisement for which the operator receives compensation.

17. Predatory Lending Consumer Protection Act of 2001 (H.R. 1051). Introduced by Representative LaFalce (D-NY) on March 15, 2001.

Status: Referred to the Committee on

Financial Services. Related Bill: H.R. 1053.

This bill would amend several statutes to enhance consumer protections with regard to high-cost mortgages. A high-cost mortgage is defined as any first or subordinate mortgage secured by the consumer's principal home with an annual percentage rate that exceeds the yield on a U.S. Treasury security with a comparable maturity by 6 percentage points for a first mortgage or 8 percentage points for a subordinate mortgage. The term would also apply to a mortgage where the total points and fees on the transaction exceed the larger of \$1000 or 5 percent of the total loan amount.

The bill would also expand the definition of a high-cost lender to include a person who acts as a broker on at least six high-cost mortgages during the preceding 12-month period. In addition, the definition would apply to directors, employees, or controlling stockholders of the company. Furthermore, any consultant, shareholder, or person who participates in or controls the lending practices of the high-cost lender would be considered a high-cost lender for the purposes of the Truth in Lending Act and therefore be subject to the requirements and penalties of the act.

A high-cost mortgage lender would be required to provide additional disclosures alerting consumers that they may be able to secure a loan with a lower rate. With regard to a refinancing loan, the lender must disclose that the consumer may end up paying a higher total amount relative to the original loan. Lenders would also be required to inform the consumer that he or she may benefit from a home ownership or credit counseling service before agreeing to the terms of the loan.

The bill would prohibit creditors from assessing prepayment penalties after a two-year period. For a loan in which creditor-financed points and fees exceed 3 percent of the total loan amount, the prohibition on prepayment penalties would be in effect for the life of the

mortgage. The legislation would prohibit balloon payments and call provisions triggered at the discretion of the lender. Creditors would be required to determine the consumer's ability to make the scheduled payments before making a high-cost loan. The financing of fees or points in excess of the greater of \$600 or 3 percent of the total loan amount would be prohibited. Furthermore, prepayment fees or refinancing fees applicable to high-cost mortgages would be prohibited if the same lender refinances the original mortgage.

The legislation would prohibit the inclusion of mandatory arbitration provisions for high-cost mortgages. Damage awards for violations of the Truth in Lending Act related to mortgage loans would be substantially increased. Finally, high-cost lenders would be bound to report each borrower's complete payment history to a credit bureau.

18. Consumer Credit Card Protection Amendments of 2001 (H.R. 1052). Introduced by Representative LaFalce (D-NY) on March 15, 2001.

Status: Referred to the Committee on Financial Services. Related Bills: H.R. 1054, S. 539.

This bill would 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 a consumer's failure to pay the minimum. Account statements would need to state: 1) the minimum payment required; 2) the number of months needed to settle the debt if just the minimum payment was made; 3) the total cost to the debtor of paying off the account if only minimum payments were made; and 4) 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 need to adhere to the same disclosure requirements applicable to direct mail and other customer solicitation methods.

A solicitation with an introductory rate would need to disclose when the introductory rate will expire along with the new applicable rate, as well as any actions by the debtor that would invalidate the introductory offer. Creditors would be barred from assessing inactivity fees on debtors who carry a balance. They would also be prohibited from issuing cards to consumers under the age of 21 without either a parent or guardian's signature indicating joint liability for debts, or evidence that the consumer has an independent ability to repay future debts.

A creditor wishing to increase the annual percentage rate on an account would be required to notify consumers 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 checks tied to his or her credit line must also disclose transaction fees and the interest rate associated with the checks. Finally, the bill would extend the ban on issuance of unsolicited credit cards to include stored-value cards, debit cards, check cards, check guarantee cards, or purchase-price discount cards connected with an open-end credit plan.

19. Federal Payday Loan Consumer Protections Amendments of 2001 (H.R. 1055). Introduced by Representative LaFalce (D-NY) on March 15, 2001.

Status: Referred to the Committee on Financial Services. Related Bill: H.R. 1319.

This bill would prohibit federally insured depository institutions from originating or providing funds for the making of payday loans. A payday loan is defined as a short-term cash advance made to a consumer in exchange for a consumer's post-dated check or authorization to debit his or her transaction account on a future agreed-upon date.

The prohibition would apply to

payday loans made by the depository institution or loans provided to another party for the purpose of making a payday loan. The legislation would also prohibit payday lenders from accepting a check drawn on an insured depository institution or an electronic transfer authorization on an account maintained by an insured depository institution.

20. Consumer Automobile Lease Advertising Improvement Act of 2001 (H.R. 1056). Introduced by Representative LaFalce (D-NY) on March 15, 2001.

Status: Referred to the Committee on Financial Services.

This bill would amend the Consumer Credit Protection Act (CCPA) by modifying its lease disclosure requirements. The bill would increase from \$25,000 to \$75,000 the maximum consumer obligation threshold for a contract to be considered a lease and thus be subject to the protections afforded by CCPA. This \$75,000 ceiling would also be indexed to annual changes in the Consumer Price Index.

Television lease advertisements would be required to communicate, both aurally and visually, that a lease contract is being advertised. The bill would also extend current rules on lease advertising to encompass all media, including Internet web pages and e-mail. Advertisements would need to state the number of available vehicles to which the advertised payment applies. The automobile dealer would also be required to disclose customer incentives available for each vehicle model.

To simplify lease comparisons, the bill would set forth a model formula (to be promulgated by the Board of Governors) for determining lease payment amounts. The formula would be based on the total capitalized cost of the vehicle advertised, a lease term of 24 months, and a mileage allowance of 12,000 miles.

21. Truth in Savings Enhancement Act of 2001 (H.R. 1057). Introduced by Representative LaFalce (D-NY) on March 15, 2001.

Status: Referred to the Committee on Financial Services.

The Truth in Savings Act (TISA) makes depository institutions financially responsible to account holders for harm resulting from noncompliance with the statute. The bill would extend the liability provisions, which would otherwise expire in September 2001.

In addition, the bill increases the maximum damages that can be awarded in individual and class actions against a depository institution. The bill would also allow a state to bring action against suspected violators in the appropriate federal court. Finally, the bill would prohibit mandatory arbitration provisions in contracts governing deposit accounts if those provisions would prohibit a consumer from exercising his or her rights under TISA.

22. Unsolicited Loan Check Consumer Protection Act of 2001 (H.R. 1058). Introduced by Representative LaFalce (D-NY) on March 15, 2001.

Status: Referred to the Committee on Financial Services.

This bill would amend the Consumer Credit Protection Act to prohibit creditors from sending unsolicited checks or other negotiable instruments to consumers in an attempt to extend credit. The prohibition would not apply to consumers who have submitted an application to the creditor prior to the receipt of the check.

A consumer who receives an unsolicited check could not be held liable for repayment if he or she cashes the check. Furthermore, information concerning consumer liabilities incurred by cashing such a check could not be sent to a credit bureau.

23. Consumer Affordable Transaction Account Act of 2001 (H.R. 1059). Introduced by Representative LaFalce (D-NY) on March 15, 2001.

Status: Referred to the Committee on Financial Services.

This bill would require all insured depository institutions to make available to consumers an affordable transaction account. The banking agencies would define the requirements for these accounts through regulations that would address initial deposit amounts, minimum balance levels, and monthly service charges applicable to these accounts. Furthermore, the regulations must permit a consumer to make eight withdrawal transactions per cycle at no additional cost.

Depository institutions would be permitted to require state residency and direct deposit of regular payments to a consumer's account as conditions for opening an affordable transaction account.

24. Credit Card Predatory Practices Prevention Act of 2001 (H.R. 1060). Introduced by Representative LaFalce (D-NY) on March 15, 2001.

Status: Referred to the Committee on Financial Services.

This bill would prohibit credit card issuers from engaging in a list of unfair or deceptive trade practices. While the Board would be required to define "unfair or deceptive trade practices," the legislation explicitly provides several examples of what would constitute an unfair or deceptive trade practice. Examples include: 1) requiring the payment of an application or processing fee; 2) requiring the consumer to purchase a membership, product, or service as a condition for receiving credit; 3) implying that a consumer is pre-approved when in fact, no firm offer of credit has been made; or 4) issuing a

credit card account to a direct mail respondent with terms and conditions less favorable to the consumer than those terms and conditions included in the solicitation.

The bill would also require the Board to promulgate regulations requiring credit card issuers to provide notice to a consumer regarding the reason for his or her failure to qualify for a particular credit plan. The issuer would also be required to inform the consumer of the terms of an account the consumer is qualified to receive and the procedures required for the consumer to apply for or receive such an account.

25. Fair Credit Reporting Act Amendments of 2001 (H.R. 1176). Introduced by Representative Ford (D-TN) on March 22, 2001.

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

This bill would amend the Fair Credit Reporting Act to require credit-reporting agencies to supply, upon the consumer's request, a free credit report. The reporting agency would be required to report all information contained in the consumer's

file, including the consumer's credit score. Finally, the legislation would require credit rating agencies to expunge from their credit reports a charged-off account or account placed in collection if the loss on the account did not exceed \$100 and the loss predates the report by more than three years. For the debt to be expunged, the consumer must complete a credit and financial management class during the three-year period.

26. Deposit Insurance Stabilization Act (H.R. 1293). Introduced by Representative Ney (R-OH) on March 29, 2001.

Status: Referred to the Committee on Financial Services.

This bill would merge the Bank Insurance Fund and the Savings Association Insurance Fund into the Deposit Insurance Fund (DIF). The bill would also require payment of additional fees by a depository institution with an increase in new insured deposits in excess of the increase determined appropriate by the Federal Deposit Insurance Corporation during the semiannual assessment period. The

legislation is designed to ensure that depository institutions with large increases in their level of insured deposits do not cause a decrease in the ratio of DIF reserves to insured deposits.

27. Wire Transfer Fairness and Disclosure Act of 2001 (H.R. 1306). Introduced by Representative Guitierrez (D-IL) on March 29, 2001.

Status: Referred to the Committee on Financial Services.

This bill would amend the Electronic Fund Transfer Act (EFTA) to require that all businesses that perform international money transfers disclose both the exchange rate used in the transaction and the exchange rate in the pertinent foreign country as of the close of business on the preceding day. The financial institution would also have to disclose all commissions and fees charged for the transaction along with the exchange rate used in the transaction. Such information would have to be posted on the premises, on all forms and receipts, and in any print, broadcast, or electronic advertisements.

SUMMARY OF FEDERAL REGULATIONS

Board of Governors of the Federal Reserve System

FHC Applications (1/3/2001)

The Federal Reserve Board, together with the Department of the Treasury, has adopted an interim rule, with request for comment, setting the procedure for determining whether a proposed activity is financial in nature according to the Gramm-Leach-Bliley Act.

An FHC or financial subsidiary can request that the appropriate regulator

determine whether an activity is financial in nature. The request must define the activity and explain how it falls within the realm of 1) lending, exchanging, or investing for others; 2) providing a medium for transferring money or other financial assets; or 3) arranging or facilitating financial transactions for the account of third parties. The request must also explain

how and through what entity the activity would be conducted, in addition to providing any other information required by the Board or Treasury.

Upon receipt of the request, the Board or Treasury must consider changes in the marketplace in which financial holding companies and banks compete and whether the activity is necessary or appropriate so as to allow financial

holding companies and their subsidiaries to effectively compete with any company seeking to provide financial services in the United States. This interim rule became effective January 2, 2001. Comments were due February 2, 2001. For further information, see 66 *Federal Register*, pp. 257-61. (Regulation Y).

FHC Activities (1/3/2001)

The FRB, together with the Department of the Treasury, proposed a rule that would permit financial holding companies (FHCs) and financial subsidiaries to provide both real estate brokerage and real estate management services. Real estate management services would include the procurement of tenants, the negotiation of leases, and other management-related activities.

The proposal would forbid an FHC and a financial subsidiary from becoming financially involved in the underlying real estate transaction while acting as a broker, making investments in or developing real estate, or taking title of or holding ownership interest in any real estate that is the subject of the company's brokerage services. Comments were due May 5, 2001. For further information, see 66 *Federal Register* pp. 307-14. (Regulation Y).

Financial Holding Company Conversions (1/3/2001)

The FRB made final a rule describing the procedures a bank holding company (BHC) must follow and the requirements that it must meet to qualify as a financial holding company (FHC). The final rule also lists the activities that the Gramm-Leach-Bliley Act defines as financial in nature and therefore permissible for an FHC. Finally, the rule sets up a procedure for FHCs to follow if they wish to have the Board determine an activity to be financial in nature.

The rule defines an FHC as a bank holding company that applies to become an FHC and whose controlled depository institutions are well managed, well

capitalized, and have a CRA rating of satisfactory or better. A bank is deemed well capitalized if it meets or exceeds the capital ratios established by its respective federal banking agency. A bank is assumed to be well managed if it receives a satisfactory composite rating and at least a satisfactory management rating (if applicable) in its most recent examination by the appropriate federal or state regulator.

FHCs that fail to keep their subsidiary depository institutions well capitalized and well managed would be required to execute a corrective action agreement within 45 days of receiving a notice of deficiency from the Board. Within 180 days of the deficiency notice, an FHC whose subsidiary depository institutions remain noncompliant would be required to divest ownership of its depository institutions or cease engaging in activities impermissible for a bank holding company (BHC). FHCs with a subsidiary depository institution that receives a less than satisfactory CRA rating would be prohibited from commencing any additional activities not permissible for BHCs. The rule permits the Board to not count against the holding company the CRA grade of an institution that has been acquired in the 12 months prior to the FHC filing. To receive this waiver, the holding company must submit to the appropriate regulator a plan that details how the holding company intends to bring the depository institution back into CRA compliance.

An FHC may engage in any activity that is financial in nature or incidental to a financial activity without obtaining prior approval from the Board. An FHC may also commence such activities by acquiring a company that is exclusively engaged in such activities. In either instance, the FHC must notify the Board within 30 days of beginning the activity. Subsequent notice is required if an FHC acquires more than 5 percent of a company and the cost of the acquisition exceeds either \$200 million or 5 percent of the FHC's Tier 1 capital.

An FHC may also purchase more than 5 percent of the shares of a firm not exclusively engaged in financial activities if at least 85 percent of the firm's assets and revenues are attributable to activities that are financial in nature, incidental to a financial activity, or otherwise permissible under section 4(c) of the BHC Act. The Board requires notice within 30 days of the acquisition if the FHC assumes a controlling interest in the company. Furthermore, the FHC has two years to divest the company or cease all activities that are impermissible for the FHC.

The Board requires prior notice and approval of the FHC's purchase of more than 5 percent of the shares of a savings association. The Board also reserves the right to require an FHC to provide prior notice and seek Board approval to engage in new activities. Prior Board approval is required before an FHC may commence an activity that is complementary to a financial activity.

Interested parties wishing to have an activity determined as either financial in nature or incidental to a financial activity must make a written request to the Board. The request must define the activity and explain how it falls within the realm of 1) lending, exchanging, or investing for others; 2) providing a medium for transferring money or other financial assets; or 3) arranging or facilitating financial transactions for the account of third parties. The request must also explain how and through what entity the activity would be conducted, in addition to providing any other information required by the Board. The Board would then provide the Secretary of the Treasury with a copy of the request. The Board would decide within 60 days of completing its consultation with the Treasury.

The rule also details the regulatory mechanism applicable to foreign banks wishing to be treated as FHCs. Generally, the Board would apply capital and management standards to foreign banks comparable to standards applied to U.S.

banks owned by an FHC. This rule became effective February 2, 2001. For further information, see 66 *Federal Register*, pp. 399-422. (Regulation Y).

Merchant Banking (1/31/2001)

The FRB, together with the Department of the Treasury, issued a final rule governing the merchant banking investments of financial holding companies (FHCs). Merchant banking refers to the holding of an equity interest in a nonfinancial firm for the purpose of resale or other disposition of assets and not for the purpose of engaging in nonfinancial activities.

To engage in merchant banking an FHC must control a securities affiliate or an insurance underwriting affiliate and an investment advisor affiliate. An FHC may not acquire or control a merchant banking investment through a depository institution or a subsidiary of a depository institution.

When an FHC owns an equity interest in a nonfinancial company, that company is called a portfolio company. An FHC may also indirectly own an interest in a portfolio company through its ownership or control of a private equity fund (PEF). The rule defines a PEF to be a limited partnership or other investment vehicle used by institutional investors and sophisticated individual investors to pool their capital for investment purposes.

The rule requires prior approval of merchant banking investments whenever the carrying value of an FHC's existing merchant banking investments exceeds 30 percent of its Tier 1 capital, or when the carrying value of its merchant banking investments, less its investments in PEFs, exceeds 20 percent of its Tier 1 capital. These provisions will remain in effect until a final rule on the regulatory capital treatment of merchant banking and other equity investments is in place.

The distinction between merchant banking and engaging in nonfinancial activities is maintained by prohibiting FHCs from routinely managing portfolio

companies. FHCs are permitted to engage in routine management of a portfolio company only when it is necessary to ensure a reasonable return on the sale or disposition of the FHC's investment. The FHC must keep records of its role in managing the portfolio company and notify the Board when its management role continues for more than nine months. The FHC must cease its routine management of a portfolio company once it has taken the actions necessary to obtain a reasonable return on the sale or disposition of its investment.

FHCs are permitted to invest in private equity funds that routinely manage a portfolio company so long as the FHC does not directly routinely manage the portfolio company and the FHC does not control or routinely manage the PEF. The rule specifies conditions under which an FHC would be presumed to control or manage a PEF.

Another way in which the distinction between merchant banking and engaging in nonfinancial activities will be maintained is through limits on the duration of FHCs' ownership of equity interests in nonfinancial firms. FHCs may not retain an equity interest in a portfolio company for more than 10 years without obtaining prior permission from the Board. An FHC may indirectly hold equity interests in portfolio companies through a qualifying PEF for up to 15 years without obtaining prior approval from the Board. This longer term applies only when the PEF has a fixed duration of 15 years or less and the FHC does not own more than 25 percent of the total equity in the fund. If the Board allows an FHC to hold a merchant banking investment for an extended period, the FHC must take an additional capital charge that is at least equal to 25 percent of the carrying value of the investment on its balance sheet.

The rule prohibits a depository institution controlled by an FHC from cross marketing its products or services to the customers of the portfolio company. Similarly, the rule prohibits a portfolio company from marketing its

products or services to the customers of the FHC's depository institutions. There are a number of exceptions to this prohibition. The prohibition does not apply to the cross marketing of products or services offered by a nondepository affiliate of the FHC. The cross-marketing restriction does not apply if the FHC owns less than 5 percent of the voting shares or ownership interest of a company. In addition, the restriction does not apply to portfolio companies owned through a PEF unless the FHC controls the PEF.

Finally, the Board requires that FHCs adopt rules and policies designed to manage the risks associated with making merchant banking investments. Such procedures and systems must: 1) monitor and assess the carrying value, market value, and performance of each merchant banking investment in addition to the company's aggregate portfolio; 2) identify and manage the market, credit, concentration, and other risks associated with merchant banking investments; 3) identify and monitor risks associated with the company's relationship with a portfolio company; and 4) ensure the maintenance of corporate separateness between the FHC and its portfolio companies. This rule became effective February 15, 2001. For further information, see 66 *Federal Register*, pp. 8465-93. (Regulation Y).

Financial Subsidiaries (2/2/2001)

The FRB, together with the Department of the Treasury, issued a final rule specifying requirements for certain large banks wishing to own or control a financial subsidiary. The 50 largest of these institutions—as measured by consolidated total assets—are required to have at least one issue of outstanding debt rated in one of the three highest rating categories by a rating organization, for example, Moody's or Standard and Poor's. The Gramm-Leach-Bliley Act requires the 50 to 100 largest banks to meet this requirement or an alternate criterion as determined by the Board and the Treasury.

The final rule allows depository institutions belonging to this second tier to meet the rating requirement by maintaining a long-term issuer credit rating in one of the three highest investment grade rating categories of a national rating organization. An issuer credit rating assesses a bank's overall capacity and willingness to pay its unsecured financial obligations on a timely basis. It differs from a debt rating in that it does not assess the bank's ability to make payments on a specific issue or class of debt. This rule became effective March 5, 2001. For further information, see 66 *Federal Register*, pp. 8748-50. (Regulation H).

Merchant Banking Capital Guidelines (2/14/2001)

The FRB, together with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, proposed a rule establishing regulatory capital requirements for equity investments made in nonfinancial companies. The rule would apply to financial holding companies, bank holding companies, and banking organizations.

The proposal lays out a set of charges against Tier 1 capital based on the total adjusted carrying value of covered equity investments in nonfinancial companies. There would be a capital charge of 8 percent for investments that account for less than 15 percent of an institution's Tier 1 capital. A capital charge of 12 percent would apply to all investments in excess of 15 percent, but less than 25 percent, of the institution's Tier 1 capital. A capital charge of 25 percent would apply to all investments exceeding 25 percent of the institution's Tier 1 capital. The agencies would reserve the right to closely monitor and levy additional capital charges on institutions whose merchant banking investments exceed 50 percent of their Tier 1 capital.

These capital charges would not apply to a bank's equity investments in firms engaged in financial activities already permitted at the bank or bank holding company level. Nor would they apply to securities held in the trading account for

underwriting, market making, and dealing activities. The charges would not be assessed against equity investments in nonfinancial firms by state nonmember banks grandfathered under section 24(f) of the Federal Deposit Insurance Act. No additional capital charge would apply to equity investments in nonfinancial corporations made through a Small Business Investment Company (SBIC) as long as the adjusted carrying value of those investments is less than 15 percent of the bank's Tier 1 capital. However, these SBIC investments would be used to calculate total covered equity investments for the purpose of applying the marginal capital charges described above. Comments were due April 16, 2001. For further information, see 66 *Federal Register*, pp. 10212-26. (Regulations H and Y).

Electronic Fund Transfers (3/6/2001)

The FRB made final a rule that implements a provision of the Gramm-Leach-Bliley Act that deals with automated teller machine (ATM) disclosure notifications. In general, the rule requires a depository institution to disclose situations in which the consumer might be assessed a fee for using an ATM operated by another party.

This rule also requires an operator of a fee-charging ATM to post, in a prominent and conspicuous location, a notice that a fee will be imposed for the transaction. The notices must be on or at the ATM and on the screen or in paper form. This rule became effective March 9, 2001. Compliance will be mandatory as of October 1, 2001. For further information, see 66 *Federal Register*, pp. 13409-13. (Regulation E).

Electronic Disclosures (3/30/2001)

The FRB adopted an interim rule that would establish uniform guidelines on the electronic delivery of disclosures required by Regulation M, which implements the Consumer Leasing Act. The rule requires a lessor to obtain the lessee's affirmative consent prior to providing electronic disclosures. Disclosures may be sent by email or

posted on a website. Website disclosures must be available for at least 90 days so as to give the lessee adequate time to access and retain the information. The Board is adopting similar rules under Regulations B, E, Z, and DD, which implement the Equal Credit Opportunity Act, Electronic Fund Transfer Act, Truth in Lending Act, and the Truth in Savings Act, respectively. This rule became effective March 30, 2001. Compliance will become mandatory as of October 1, 2001. Comments were due June 1, 2001. For further information, see 66 *Federal Register*, pp. 17322-9. (Regulation M)

Federal Deposit Insurance Corporation

Activities and Investments of Insured State Banks (1/5/2001)

The FDIC issued a final rule implementing the provision of the Gramm-Leach-Bliley Act that permits state nonmember banks to control or hold an interest in a subsidiary that engages as principal in activities that a national bank may conduct only through a financial subsidiary. The rule requires insured state nonmember banks to submit prior notice to the FDIC before engaging in new activities. The notice must give a brief description of the activity. The bank must certify that it is well managed and all insured depository institution affiliates are well capitalized. Furthermore, the bank is required to deduct the aggregate amount of its outstanding equity investment in all financial subsidiaries from the bank's assets and tangible equity total in addition to its risk-based capital total.

State banks that own a financial subsidiary must satisfy sections 23A and 23B of the Federal Reserve Act. These sections provide rules addressing the relationship between a depository institution and its affiliates. For subsidiaries engaged in securities underwriting, the rule requires that the depository institution and the subsidiary take specific steps to ensure the physical and financial separateness of each entity's activities.

The bank and its insured depository institution affiliates must maintain at

least a satisfactory Community Reinvestment Act (CRA) rating. State nonmember banks and their depository institution affiliates that fail to maintain a satisfactory CRA rating would be prohibited from commencing new permissible activities. This rule became effective January 5, 2001. For further information, see 66 *Federal Register*, pp. 1018-31.

Office of the Comptroller of the Currency

Investment Securities and Bank Activities (1/30/01)

The OCC proposed modifying its rules to permit national banks to hold certain municipal securities other than general obligation bonds even if total bond holdings exceed regulatory limits. In general, the total amount of securities of a single issuer held by a national bank for its own account cannot exceed 10 percent of the bank's capital and surplus. Certain types of securities (such as U.S. Treasury securities) are exempt from the 10 percent limit if the bank is well capitalized. The Gramm-Leach-Bliley Act specified that holdings of certain types of municipal bonds would also be exempt from this limit.

The rule would also clarify that, unless otherwise provided in federal law or OCC regulation, state laws apply to operating subsidiaries to the same extent they apply to the parent national bank. Comments were due April 2, 2001. For further information, see 66 *Federal Register*, pp. 8178-84.

Office of Thrift Supervision

Community Reinvestment Act (1/10/2001)

The OTS, together with the Federal Reserve Board, Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, made final a rule requiring the disclosure of CRA-related agreements between a depository institution, or an affiliate, and a nongovernmental entity or person (NGEP). Disclosure is required for written agreements that involve payments in excess of \$10,000, or loans

in excess of \$50,000, in a calendar year. The NGEP need not be the recipient of these payments or loans. The disclosure requirement does not apply to individual mortgage loans or to other loans as long as they are not made at below-market rates or used to fund loans to third parties.

A depository institution can fulfill its public disclosure obligation by keeping a copy of a relevant agreement in its CRA public file for up to 12 months after the expiration of the agreement. The rule permits depository institutions to withhold certain proprietary information if it would also be protected from disclosure by its regulatory supervisor under the Freedom of Information Act. At a minimum, the depository institution must disclose the names and addresses of parties to the agreement, the amount of any payments, loans, or other consideration specified in the agreement, and the duration of the agreement.

Depository institutions are required to report any new CRA agreements to their regulatory supervisors within 60 days after the end of each quarter. The agency may request a complete copy of an agreement up to 36 months after the expiration of the agreement. A supervisory agency may also require an NGEP that is a party to the agreement to file a complete copy of the agreement with the agency.

If, in a given year, an NGEP receives or uses funds or other resources provided under a CRA agreement, it must file a report with the relevant supervisory agency within six months of the end of its fiscal year. This report must include an itemized accounting of how those funds or resources were used in the previous year. The rule specifies the minimum detail required in such an accounting. This rule became effective April 1, 2001. For further information, see 66 *Federal Register* pp. 2051-113. (Regulation G).

Basel Committee on Banking Supervision

New Basel Capital Accord (1/16/2001)

The committee released for comment a proposal to modify international capital

adequacy standards. The proposal is organized into three pillars—minimum regulatory capital requirements, supervisory review, and market discipline. Its goal is to develop a standard mechanism for determining the capital needs of banks, regardless of domicile.

The Standardized Approach for Credit Risks

The standard approach builds on the 1988 Capital Accord by establishing additional risk buckets for sovereign and corporate borrowers. Relative to the existing accord, this will increase the sensitivity of the regulatory capital/asset ratio to the risk of the bank's assets.

The bank's portfolio is broken into several categories, including sovereigns, corporate claims, claims on banks and securities firms, commercial mortgages, residential mortgages, and unrated credits. Borrowers would be assigned to a risk bucket and associated risk weight according to ratings set by qualified rating agencies. The risk weight would be based on the borrower's rating. For example, AAA-rated sovereigns would receive a 0 percent risk weight while those below investment grade would receive a 150 percent risk weight. Similarly, corporate credits would be assigned risk weights of 20 percent, 50 percent, 100 percent, or 150 percent based on the external credit rating of the corporate borrower.

A conversion factor of 100 percent would apply to uncollateralized lending or pledging of bank securities in repo-style transactions. Except for certain low-risk transactions, a minimum risk weight (15 percent) would apply to the collateralized portion of a bank's exposure. The committee proposes to introduce haircuts on collateral to reflect the risk of divergence between the value of the collateral and the bank's exposure.

The committee proposes that credit enhancements be reflected in risk weights only where the credit protection is direct, explicit, irrevocable, and unconditional. Assuming those conditions are met, banks would be able to recognize credit protection provided by sovereigns, banks, and securities firms and corporations with external ratings of A

or higher. The committee proposes a minimum risk weight (15 percent) for loans guaranteed by institutions other than sovereigns or banks.

Internal Ratings-Based (IRB) Approach.

Under the IRB approach banks will use their own internal systems for measuring credit risks to determine regulatory capital. The committee has proposed two levels of the IRB approach—fundamental and advanced. To use either approach, the bank's systems and processes must meet certain minimum standards. The advanced IRB approach is more complicated and requires more data, so banks must satisfy even more stringent requirements before being permitted to use this method.

The bank's portfolio is broken into categories (corporate, retail, bank, sovereign, equity, and project finance), and a capital charge is constructed for each category. This is done by calculating risk weights for each exposure in the category and taking the sum of each of the risk weights multiplied by their related exposure. This total is then adjusted up or down by a factor that reflects the degree of concentration (granularity) in the category.

Under the fundamental approach, the bank assigns a probability of default (PD) within one year to each grade in its rating system (except for sovereign exposure; these default probabilities must be 0.03 percent or higher). The risk weight for a particular grade can then be calculated using a standardized measure of the losses in the event of default for credits in that grade. Risk mitigation methods, such as collateral or credit risk derivatives, would reduce the capital required for a particular credit in a manner similar to the methods of the standardized approach.

Under the advanced approach, a bank is allowed to use its own data and methods to specify more of the variables used in the formulas to determine risk-weighted assets. In particular, qualifying banks could specify the loss given default (LGD) or exposure at default (EAD) and account for the effects of collateral or

credit risk mitigation according to their own internal models. During the first two years after implementation of the accord, banks using the advanced IRB approach would be required to maintain a minimum level of regulatory capital of at least 90 percent of the capital computed under the foundation IRB approach.

Securitized Assets. The risk weighting of asset-backed securities purchased by a bank will depend on the security's rating. Securitized assets that are sold are eligible for a 0 percent risk weight only if the terms of sale satisfy "clean break" criteria, which are similar to the current sale criteria under generally accepted accounting principles (GAAP). Banks must deduct from regulatory capital any first loss credit enhancements they provide. Any liquidity facilities provided would be treated as a commitment and, under the standardized approach, would be subject to a 20 percent conversion factor and 100 percent risk weight. Facilities that are not solely for the purpose of liquidity would be treated as a credit enhancement or a direct credit substitute. Additional capital charges are contemplated for revolving securitizations with early amortization provisions. If a bank engages in implicit recourse—providing support to a securitized pool of assets in excess of its contractual obligations—some or all of those assets could be added back into the bank's risk-weighted assets.

Operational Risks. The committee proposes that regulatory capital requirements reflect operational risks, defined as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events." The committee expects that, on average, the capital charge for operational risk will represent 20 percent of a bank's minimum regulatory capital.

Three separate approaches for calculating operational risks are proposed. The simplest would require that banks hold capital equal to a fixed percentage of its gross income. For more

sophisticated banks, regulatory supervisors could define standardized lines of business as well as indicators of risk exposure and loss factors for each of those lines. For example, the capital charge applicable to asset management might be based upon the total funds under management and a loss factor set by the supervisor. The bank's capital charge for operational risks would be the sum across business lines of a line's exposure factor times its loss factor.

The most sophisticated banks may be permitted to develop and use their own estimates of these factors. For each business line defined by the supervisor, a bank would determine an appropriate exposure indicator, the probability of a loss event, and the resulting loss given that the event occurs. The product of these three variables yields an expected loss for the business line, which is then translated into a capital charge according to a regulatory formula.

Supervisory Review. The committee's proposal identifies principles designed to assist supervisors in evaluating how effectively banks are assessing their own capital needs. The proposal calls on supervisors to review the bank's internal capital adequacy assessments and strategies, in addition to the bank's ability to comply with regulatory capital ratios. Supervisors should require that banks operate above minimum regulatory capital ratios. The proposal also advocates early intervention by supervisors to prevent capital from falling below the minimum level required by the banks. The supervisor should also be able to implement a rapid remedial action if capital is not maintained or restored by the institution.

A bank's internal model must adequately assess all risks—credit, market, interest rate, etc.—to which the institution is exposed. The bank's management must be aware of changes to its risk profile and the accompanying effect on its capital needs. The proposal calls on supervisors to use a host of tools, such as on-site examinations, off-site reviews, discussions with management,

and periodic reporting, to evaluate financial institutions' internal models and their estimates of regulatory capital. Supervisors are encouraged to pay special attention to those institutions whose stress tests indicate a precipitous drop in the economic value of the institution as a result of a large interest rate shock or other exogenous factors.

Market Discipline. The proposal supports the view that market forces have

a fundamental role in ensuring that banks maintain appropriate capital adequacy. For the market to exert discipline, there must be an adequate level of transparency. To that end, banks must disclose all information that could change or influence an assessment of its capital adequacy. The proposal divides disclosures into two groups: core and supplementary. Core disclosures convey vital information for all institutions and are essential to the basic function of

market discipline. All banks are expected to provide core disclosures. Supplementary disclosures depend on the risk exposure, capital adequacy, and models used to calculate the bank's capital requirement. Banks would be required to make the full range of disclosures to qualify to use the IRB approach.

The complete proposal can be viewed or downloaded at <http://www.bis.org/publ/bcbsca03.pdf>. Comments were due May 31, 2001.

SUMMARY OF JUDICIAL DEVELOPMENTS

The Supreme Court's refusal to entertain the appeal of a Third Circuit arbitration ruling strengthened the position of creditors who use arbitration provisions in consumer credit contracts. The case, *Johnson v. Telecash Inc.*, 3rd Circuit No. 00-5047, centers on a short-term high-interest loan made by Telecash in 1998. The loan contract contained a clause stating that all disputes arising from the transaction must be settled through binding arbitration. Johnson filed suit in the district court of Delaware, alleging that Telecash violated the Truth in Lending Act (TILA) and the Electronic

Fund Transfer Act. Telecash moved to stay proceedings and compel arbitration.

The district court, finding an inherent conflict between mandatory arbitration clauses and the protections afforded consumers by TILA and EFTA, ruled against the defendant. Upon appeal, the circuit court found that there is no irreconcilable conflict between mandatory arbitration and the implied social policy goals of TILA.

The circuit court concluded that "... nothing in the legislative history or the statutory text of the TILA clearly expresses congressional intent to

preclude the ability of parties to engage in arbitration" Furthermore, the Supreme Court has clarified that when arbitration will preserve a plaintiff's substantive rights, a mandatory arbitration clause does not impede the deterrent function of a statute.

Still, many consumer groups are concerned that even if arbitration preserves an individual consumer's rights under TILA, the removal of TILA's class action threat will eliminate a powerful incentive for financial institutions to adhere to the requirements of the act.

SUMMARY OF THIRD DISTRICT DEVELOPMENTS

New Jersey

On March 8, Senators Allen and Kosco introduced SB 2187, which would prohibit certain predatory lending practices. The bill defines and targets high-cost home loans. Lenders would be

prohibited from creating a negative amortization schedule, charging balloon payments, charging points or fees if the new high-cost loan is replacing an old high-cost loan held by the same lender,

and engaging in other practices commonly associated with predatory lending.

Prepared by the Research Department

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