



BANKING LEGISLATION & POLICY

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Recent Developments

New Risk-Based Capital Rule Issued for Fannie Mae and Freddie Mac

The Office of Federal Housing Enterprise Oversight (OFHEO) issued a final rule on July 19 that outlines new risk-based capital regulations for Fannie Mae and Freddie Mac. OFHEO is the federal agency that regulates Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Loan Mortgage Corporation), which are government-sponsored enterprises (GSEs) operating in the mortgage markets. The two primary activities of Fannie Mae and Freddie Mac are investing in residential mortgages and guaranteeing securities backed by residential mortgages.

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 created OFHEO as an independent regulator in the Department of Housing and Urban Development and directed OFHEO to formulate risk-based capital standards. The act called for a test to determine how much capital Fannie Mae and Freddie Mac would need to hold to survive a 10-year period of severe economic stress. In addition to the capital level determined by the stress test, each enterprise would also be required to hold an additional 30 percent of this amount to protect against management and operational risk.

Fannie Mae and Freddie Mac will spend the next year analyzing the new rule before it becomes effective next fall. OFHEO released all 554 pages of the rule, along with the computer program used to conduct

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the stress test. The actual required level of capital will be calculated using this program and proprietary data provided by the GSEs. OFHEO cautions that estimates generated using publicly available data are unlikely to be accurate. OFHEO Director Armando

Falcon Jr. has said that over the next 12 months he will work with both Fannie Mae and Freddie Mac to implement the new rule and discuss possible changes.

The stress test envisions a scenario consisting of three parts. First, it is assumed

that Fannie and Freddie cannot diversify into new lines of business. Second, there is a very large swing in interest rates (equivalent to a move of 600 basis points in the 10-year Treasury note). Third, there is a decline in home prices as large as any experienced over a 10-year period in the last 20 years in the U.S. The test gauges the losses that would result from very heavy pre-payment activity and numerous defaults on loans that are no longer sufficiently collateralized. The level of required capital is the amount that, in conjunction with any cash flow earned on existing business, would keep the GSEs solvent throughout the 10-year period.

OFHEO will publish required capital levels in February 2002. The GSEs will have until the fourth quarter of 2002 to come into compliance with the new capital requirements. The enterprises have various options as to how to meet the capital requirements. They can satisfy the new capital requirements by raising additional capital, adjusting hedging practices, insuring more of their risks, or retaining more of their earnings.

Interagency Loan-Loss Reserve Policy Statement Issued

The Federal Financial Institutions Examination Council (FFIEC), on behalf of the banking agencies,¹ issued a policy statement on allowances for loan and lease losses (ALLL). Loan and lease loss reserves are reserves held against future losses in an institution's loan and lease portfolio. The policy statement provides guidance for banks and savings institutions in

¹ Board of Governors of the Federal Reserve System (FRB), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC)

implementing ALLL methodologies and documentation processes. The FFIEC proposed this policy statement on September 7, 2000, and requested public comment at that time.

The policy statement offers four main points of guidance. First, it places the board of directors of each institution directly responsible for ensuring that controls are in place to determine the proper level of ALLL. The appropriate level of ALLL is determined by generally accepted accounting principles (GAAP), the goals and policies of the individual institution, and any other relevant ALLL regulations and guidances. Second, the level of ALLL should be based upon the management's best judgment of the credit quality of its loan portfolio as well as any other relevant factors that may impact loan collectibility. Third, ALLL documentation must be consistent with GAAP, the institutions' stated policies, and guidances and policies issued by supervisory agencies. Fourth, institutions' ALLL methodology and documentation processes should be appropriate for their size and complexity. The policy statement was issued on July 6, 2001. For further information see 66 *Federal Register*, pp. 35629-39.

New UCC Collateral Rules Implemented in 46 States

New rules revising Article 9 (Secured Transactions) of the Uniform Commercial Code (UCC) took effect July 1 in 46 states and the District of Columbia. The revisions were approved by the National Conference of Commissioners on Uniform State Laws (NCUSL) in 1999, but were not implemented until July 1, 2001. The revisions address what types of assets banks can accept as collateral and also alter the filing system used to perfect liens. Alabama, Mississippi, Florida, and Connecticut are the only states that have yet to implement the new rules.

These states have delayed implementation to verify that their filing systems can handle the revisions.

NCUSL has the task of promoting "uniformity in state laws on all subjects where uniformity is deemed desirable and practicable" and is composed of attorneys chosen by each state as representatives. NCUSL typically develops a basic model law and then encourages each state to enact the law. Article 9 of the Uniform Commercial Code – a set of 11 articles of business and commercial laws – addresses what a lender can accept as collateral and how documentation of collateral agreements is to be filed.

The revised Article 9 includes as acceptable forms of collateral items like sales of payment intangibles (e.g., claim on future cash payments) and promissory notes; security interests created by government debtors; health insurance receivables; consignments; and commercial tort claims.

The second part of the revision streamlines the process of perfecting liens, that is, taking legal steps to take ownership of the collateral. Under the previous system a financing statement had to be filed where the collateral was actually located. Collateral that was spread across several states (e.g., a retailer's inventories) required that a financing statement be filed in each state. Lenders seeking to perfect liens would have to therefore file statements in multiple jurisdictions. In the event of default by the borrower it was cumbersome to verify which creditor had priority or which state's laws applied. Under the new system, financing statements are filed only once for each secured transaction, in the Secretary of State's Office in the state where the debtor is located. Now when lenders seek to perfect a lien, they can simply file a financing statement in one place and search in one place to see if their lien has priority.

SUMMARY OF FEDERAL LEGISLATION

New Legislation

1. Save Our Homes Act of 2001 (H.R. 2531). Introduced by Representative Schkowsky (D-IL) on July 17, 2001.

Status: Referred to the Committee on Financial Services.

This bill would amend several statutes to help protect consumers from predatory mortgage lending practices. The bill would add provisions to the Home Ownership and Equity Protection Act of 1994 to cover high-cost mortgages. A high-cost mortgage would be defined as a consumer credit

transaction secured by the consumer's principal dwelling if either: 1) the APR (annualized percentage rate) at origination exceeds the yield on United States Treasury securities of comparable maturities by at least 5 percentage points; 2) the rate is variable but can reasonably be expected to

exceed this threshold; 3) increases in the rate are controlled by the creditor and are not directly tied to changes in an independent, publicly available rate; or 4) the total points and fees on the loan exceed the greater of 3 percent of the total loan or \$1,000. The following practices would be prohibited for high-cost mortgages: 1) call provisions in the terms of the mortgage unrelated to a customer default or sale of property; 2) fees for deferring payments or for contract modifications; 3) making loans to borrowers who have not completed a certified home ownership counseling course; 4) mandatory arbitration clauses; 5) prepayment penalties; 6) negative amortization terms in the mortgage contract; 7) lending without regard to the realistic ability of the borrower to repay the loan; 8) making a new loan to refinance an existing contract when the new loan has no real tangible benefit to the borrower; 9) encouraging a borrower to default; 10) payments to appraisers; 11) the financing of credit insurance policies by the mortgage lender; 12) blank items in the contract to be filled in after signing; and 13) the securitizing of loans that are not in compliance with the terms of this bill.

Lenders would be required to report the annual percentage rate charged on mortgages and home improvement loans in their Home Mortgage Disclosure Act (HMDA) data. Finally, the bill would prohibit exemptions from HMDA reporting. At present, depository institutions with below \$30 million in assets have the option of not submitting certain HMDA required disclosures.

2. Internet Gambling Payments Prohibition Act (H.R. 2579). Introduced by Representative LaFalce (D-NY) on July 20, 2001.

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

Related bills: H.R. 556 and H.R. 2572.

This bill would prohibit the acceptance of credit cards, electronic fund transfers, and checks or other negotiable instruments payable through a financial institution for the purpose of Internet gambling. Creditors, financial institutions, and money-transmitting business would be exempt from liability if they were unaware their services were being used for payment or collection resulting from Internet gambling.

Also, the bill would encourage cooperation between the U.S. government and other countries on the issue of money laundering.

A related bill (H.R. 2572) would make it illegal to place an electronic terminal from which consumer credit can be accessed, such as an ATM, in the immediate area of a gambling establishment. The bill would allow a consumer to recover from the terminal's operator funds accessed from the terminal that were lost as a result of gambling, in addition to punitive damages.

3. Consumer Credit Score Disclosure Act of 2001 (S. 1242). Introduced by Senator Schumer (D-NY) on July 25, 2001.

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

The bill would permit an applicant for an extension of consumer credit secured by a dwelling to request a copy of his or her most recent credit score from a credit reporting agency. The agency would also be required to provide the applicant with an explanation of the four most important factors affecting the score. Provisions of contracts that currently prohibit such disclosures would be made void by the bill. A lender that uses a credit score for loans secured by a house must provide the customer with a copy of the credit score that was used.

4. Consumer's Right to Financial Privacy Act (H.R. 2720). Introduced by Rep. Markey (D-MA) on August 2, 2001.

Status: Referred to the Committee on Financial Services.

This bill would amend the Gramm-Leach-Bliley Act by adding several requirements on the handling and use of personal customer information by financial institutions. The bill imposes restrictions on the sharing of personal information by affiliates in a holding company, through an opt-in clause. Financial institutions would be barred from sharing personal information with affiliated or unaffiliated third parties unless the customer gives explicit permission (opts-in) for the sharing of his or her information. The institution must inform the customer about: 1) the types of data collected; 2) its policies addressing the use of customer information; and 3) the procedures available to the customer to review and dispute collected information. These disclosures must be

made at the time an account is opened and then at least annually thereafter. Institutions would not be allowed to discontinue services to a customer because he or she declined to permit the sharing of his or her information.

The bill contains several exemptions. First, the consumer can waive the bill's restrictions on disclosure of personal information. Second, information necessary to carry out a transaction is exempt. Examples of this include processing product requests, servicing accounts, and securitizing loans. The third exemption applies to information disclosures that are necessary to ensure the security of records, to prevent fraud, to control institutional risk, and to resolve customer disputes and inquiries. Fourth, private information could be released to persons with a legal, beneficial, or fiduciary interest in the customer. Fifth, the information could be disclosed to various insurance, financial rating, regulatory, law enforcement, and credit reporting agencies. Also, information required by the financial institution's attorneys, accountants, and auditors is exempt. The information could also be shared with a third party in connection with a due diligence review for a proposed or actual merger or acquisition. Finally, any information that is necessary to comply with state and federal laws and regulation, or to respond to judicial requests, could be released.

Financial institutions would also be prohibited from providing account numbers to affiliated or unaffiliated third parties for use in marketing. Third parties receiving customer information would be prohibited from the further dissemination of that information. Finally, the bill would maintain the current prohibition on providing false information to a financial institution in order to gain confidential customer information or knowingly receiving information gained in this manner. Enforcement authority would be exercised, where appropriate, by the banking agencies, the Securities and Exchange Commission, the National Credit Union Association, the Federal Housing Finance Board, the Federal Trade Commission, state attorneys general, and the insurance authorities of individual states.

5. National Consumer Privacy Act (H.R. 2730) Introduced by Rep. Sessions (R-Texas) on August 2, 2001.

Status: Referred to the House Committee on Financial Services.

This bill would preempt state legislation related to the privacy requirements set out in the Gramm-Leach-Bliley Act (GLBA). GLBA permits states to enact privacy protections more rigorous than those it requires. Many states are currently considering privacy legislation.

The bill would also make permanent certain existing limitations on states' authority to enact laws affecting consumer credit reporting. Under current law, those limitations would expire in 2004.

6. Money Laundering Abatement Act (S. 1371). Introduced by Sen. Levin (D-Mich) on August 3, 2001.

Status: Referred to the Committee on Banking, Housing, and Urban Affairs.
Related bills: H.R. 1114 and S. 398.

This bill would enact a variety of new measures to make money laundering more difficult. First, United States banks would be prohibited from providing banking services – notably correspondent banking services – to foreign banks that have no physical presence in any country (also

known as “shell” banks). Second, this bill would add foreign corruption offenses, such as bribery and theft of government funds, to the list of crimes that can trigger a U.S. money laundering prosecution. Also, federal authorities would have the power to subpoena the records of a foreign bank's U.S. correspondent account. Third, this bill would make a depositor's funds in a foreign bank's U.S. correspondent account subject to the same civil forfeiture rules that apply to depositor's funds in other U.S. accounts.

In addition, this bill would require U.S. banks to improve their due diligence reviews in order to guard against money laundering. Two particular circumstances would mandate improved due diligence: (1) opening a private bank account with one million dollars or more for a foreign person; or (2) opening a correspondent account for an offshore bank or foreign bank in a country posing high money-laundering risks.

7. Identity Theft Prevention Act of 2001 (S. 1399). Introduced by Senator Feinstein (D-CA) on September 4, 2001.

Status: Referred to the Committee on Financial Services.

This bill would amend several consumer

protection statutes to help prevent identity fraud in consumer credit transactions. The Truth in Lending Act would be amended to require credit card issuers to respond to a change-of-address notification from a consumer by sending confirmation of the change in address to the customer's new and former address. A second confirmation would be required if a request for an additional card were made within 30 days of a change-of-address request.

The bill would require a credit bureau to notify card issuers if the address on a new card application does not match the address in the consumer's file. Credit bureaus would also be required to place a fraud alert in the consumer's file at a consumer's request. The alert would inform potential creditors that the consumer does not authorize any extension of credit unless specific verbal authorization is obtained through a telephone number designated by the consumer. The bureaus would also be required, upon any consumer's request, to provide him or her with one free credit report during any 12-month period.

The bill would prohibit the printing of more than five digits of a credit card number used in any transaction. This restriction would not apply to transactions that are recorded in handwriting or via an imprint or copy of the credit card.

SUMMARY OF FEDERAL REGULATIONS

Board of Governors of the Federal Reserve System

Check Truncation Act (7/01)

In July the Board of Governors of the Federal Reserve System sought comments on a new draft Check Truncation Act. The purpose of the draft is to provide a model for legislation to remove certain legal impediments to the adoption of new check processing technologies. Currently, about 70 billion checks are processed each year in the United States. To reduce processing costs, some banks have formed agreements with each other to accept electronic, rather than physical, presentment of checks. But many banks are not part of these agreements and may not wish to invest in the equipment

and software required to accept presentment electronically. Under current law, these banks may insist on physical presentment of checks before paying them.

The proposed legislation would allow banks to continue to truncate a check (i.e., not present the original check for payment) and use electronic presentment for banks willing to accept electronic presentment. Alternatively banks would be permitted to generate a paper copy of an original check (a substitute check) that can then be presented to banks that wish to process checks using their existing check sorting and data processing systems.

The substitute check would be the legal equivalent of the original check as long as certain standards detailed in the legislation

are met. For example, a substitute check must accurately and legibly represent all information on the front and back of the original check, contain an MICR line so it may be processed on check sorting equipment, and bear a legend stating “This is a legal copy of your check.” Any bank presenting a substitute check must make a warranty that the substitute satisfies the requirements to qualify as a legal equivalent of the original and that no one in the presentment chain will be asked to make payment based on a check that has already been paid.

The draft legislation includes indemnity provisions designed to place all parties in the same position they would have been had the original check been presented. If

the recipient of a substitute check suffers a loss that would have occurred even if the original check had been used, the indemnity provisions of existing law would apply. If the loss would not have occurred if the original check had been used, but no warranty was breached, the recipient is entitled to the amount of the check plus interest. If one of the warranties was breached (for example, because the substitute check was illegible) the recipient is also entitled to compensation for losses proximately caused by the breach (consequential damages). A recipient's compensation may be reduced, however, by the degree to which his or her own negligence contributed to the loss.

For more detailed information on the Check Truncation Act, visit the Board's web site: www.federalreserve.gov/PaymentSystems/truncation/draftinfo.htm.

Electronic Disclosures (8/8/01)

The Board lifted the mandatory compliance date of October 1, 2001, for electronic disclosures under the Equal Credit Opportunity Act (ECOA), Electronic Funds Transfer Act (EFTA), Truth in Lending Act (TILA), and Truth in Savings Act (TISA). For a review of the original interim rules, see *Banking Legislation and Policy*, First Quarter 2001 and Second Quarter 2001. A new compliance date will be set when a permanent final rule is issued. For further information, see 66 *Federal Register*, pp. 41439-40. (Regulations E, M, Z, and DD)

Financial Subsidiaries (8/16/01)

The Board adopted a final rule implementing the financial subsidiary provisions of the Gramm-Leach-Bliley Act for state member banks. The Gramm-Leach-Bliley Act authorizes state member banks that meet certain requirements to control, or hold interest in, a financial subsidiary. The financial subsidiary is permitted to conduct financial activities that state member banks cannot conduct directly. The final rule is the same as the interim rule that was adopted in March 2000, except for a few minor adjustments in response to comments. The interim rule has been in effect since March 11, 2000, and the final rule became effective September 17, 2001. For a summary of the major provisions of the final rule, see the summary of the interim rule in *Banking Legislation & Policy*, First Quarter 2001. For further information, see

66 *Federal Register*, pp. 42929-37. (Regulation H)

Office of the Comptroller of the Currency

Investment Securities and Bank Activities (7/2/01)

The OCC made final a rule that amends its regulations governing investment securities and bank activities. The rule permits national banks to hold certain municipal bonds even if total bond holdings exceed the regulatory limit of 10 percent of the banks' capital and surplus. The Gramm-Leach-Bliley Act established that in addition to U.S. Treasury securities, banks may hold certain types of municipal securities in excess of the 10 percent limit (if the bank is well capitalized).

The rule also clarifies that, unless otherwise provided by federal law or OCC regulation, state laws would apply to operating subsidiaries to the same extent they apply to the parent national bank. This rule became effective August 1, 2001. For further information, see 66 *Federal Register*, pp. 34784-92.

Electronic Banking (7/2/01)

The OCC is proposing to amend its regulations to make it easier for banks to conduct business electronically. The proposed rule is a combination of new and revised regulations, which are divided into three categories: national bank powers, location with respect to the conduct of electronic activities, and electronic safety and soundness requirements.

The OCC will consider the following standards when considering proposed new electronic banking activities: (1) whether the activity is a logical outgrowth of a recognized banking activity, (2) whether the activity strengthens the bank by benefiting its customers and business, (3) whether it presents a risk that banks have experience managing, and (4) whether it is permissible for state-chartered banks.

The proposed rule also addresses two other issues in relation to national bank powers: the ability to act as finders and the ability to act as a digital certification authority. The OCC has been allowing national banks to act as finders and seeks to formalize this stance in this proposed rule. A finder serves as a third party that brings together buyers and sellers of financial and nonfinancial products and services. The proposed rule states that

acting as a finder is part of the business of banking and provides numerous examples of possible finder activities. The rule would prohibit banks from engaging in any activity that would characterize the bank as a broker. Digital signatures allow recipients of electronic messages to verify the identity of the sender. A reliable third party is necessary to provide a public key that assigns and decodes these digital signatures. Banks have been acting in this capacity, and the proposed rule seeks to codify this position. But the OCC is concerned about the risks involved in allowing national banks to act as certification authorities and requests comments on this issue.

The second section of the proposed rule addresses the issue of the location of a national bank. This proposed rule addresses two particular points in relation to this issue. First, the proposed rule establishes that a national bank's location will not be solely determined to be in a particular state by the presence of a technology center (i.e., servers) in that state, an automated loan center in that state, or because customers can access the bank's products electronically in that state. Second, the proposed rule addresses how location is defined for a national bank that conducts business exclusively over the Internet. National banks are permitted by law to charge interest rates that are permitted by the home state (the state where the main office is located) of the national bank in question. For Internet-only banks, the rule establishes that the state listed on the bank's organization certificate (required when each national bank is chartered) is the home state.

The final section of the proposed rule concerns the safety and soundness of shared electronicspace. Internet technology has expanded the opportunity for banks and third parties to join together in marketing relationships. An example would be a national bank having links to retailers on the official bank web site and vice versa. Current OCC regulations allow banks to lease space on bank premises to third parties, under certain conditions. The proposed rule would apply the current system to include bank web pages and other electronic space, but under the same conditions. The conditions are that the bank has to distinguish between its services and those offered by the third party, that the bank does not endorse or guarantee the

products or services of the third party, and all these disclosures have to be simple and conspicuous. Comments were due August 31, 2001. For further information, see 66 *Federal Register*, pp. 34855-64.

Fiduciary Activities (7/2/01)

The OCC published a final rule in order to clarify the standards for national banks to conduct multi-state trust operations.

The final rule allows national banks to operate in a fiduciary capacity in any state that allows its own in-state banks to act in a fiduciary capacity. However, these national banks must be already authorized by the OCC to engage in fiduciary activities. Second, the final rule authorizes national banks, which operate in a fiduciary capacity in one state, to market their services to customers in another state. The final rule also addresses whether trust offices and trust representative offices are considered national bank branches and subject to the McFadden Act. The McFadden Act stipulates that in order for a bank facility to be considered a branch, it must perform at least one of the core branching functions: receiving deposits, paying checks, or lending money. The OCC finds that fiduciary activities are not one of the core branching activities and therefore do not fall under the McFadden Act. Subsequently, the final rule states that trust offices and trust representative offices are not branches unless one of the core branching functions is being performed there. This rule became effective August 1, 2001. For further information, see 66 *Federal Register*, pp. 34792-98.

Assessment of Fees (9/25/01)

The OCC proposed a rule to amend its formula for calculating the semiannual assessment that the OCC charges national banks. The OCC, as set forth in the National Bank Act, funds its activities by assessing fees to those institutions it supervises. The OCC supervises approximately 2,200 national banks and 58 federal branches in the United States.

The OCC uses a formula, based upon the total assets a bank reports in the preceding quarter's call report, to calculate the semiannual assessment fee. The proposed rule would amend this formula by establishing a minimum base amount for the first assessment bracket (for banks with less than \$2 million in assets) and

eliminating the marginal rate formula currently used. The remaining brackets would be calculated as they are currently. Comments were due October 25, 2001. For further information, see 66 *Federal Register*, pp. 48983-85.

Office of Thrift Supervision

Liquidity (7/18/01)

The OTS made final an interim rule that removes a regulation regarding the amount of liquid assets a savings association is required to hold. Section 6 of the Home Owners' Loan Act (HOLA) and subsequent OTS regulations established that savings associations were required to maintain an average of at least 4 percent of their liquidity base as liquid assets. Liquid assets are defined as cash, deposits in insured banks, government-issued or guaranteed obligations, bankers' acceptances, corporate debt and commercial paper, etc. A savings association's liquidity base includes liabilities payable on demand or with remaining maturities of one year or less. The Financial Regulatory Relief and Economic Efficiency Act of 2000 repealed the statutory liquidity requirements for savings associations.

The final rule keeps a provision that requires savings associations to maintain sufficient liquidity to ensure safe and sound operation. The rule also clarifies that an institution's ability to borrow from a Federal Home Loan Bank is a source of liquidity. The rule became effective July 18, 2001. For further information, see 66 *Federal Register*, pp. 37406-07.

Securities and Exchange Commission

Broker/Dealer Rule Postponed (7/18/01)

The SEC announced that it was postponing the deadline for comments and the implementation date of an interim rule on securities broker/dealer activities (see *Banking Legislation & Policy*, Second Quarter 2001 for a summary of the SEC rule). On May 18, 2000, the Commission issued an interim final rule that replaced banks' traditional exemption from SEC supervision with functional exemptions based upon specific securities activities. This interim rule has been received with apprehension from the banking industry and bank regulators. In June, the Office of the Comptroller of the Currency, the Federal

Reserve Board, and the Federal Deposit Insurance Corporation sent a joint letter to the SEC expressing their concern that the new rule was unnecessarily costly and inconsistent with congressional intent as expressed in the Gramm-Leach-Bliley Act.

Comments were due September 4. The implementation date for the rule has been pushed back to May 12, 2002, from its original date of October 1, 2001. The statement issued by the SEC added that it foresees the rule being amended before the implementation date. For more information on the interim final rule concerning broker/dealer activities, see 66 *Federal Register*, pp. 27760-80.

The Federal Housing Finance Board

Expanded Collateral Rule (6/29/01)

On June 29, 2000, the Federal Housing Finance Board issued a final rule that expanded the classes of collateral and increased the amount of other real estate-related collateral that can be pledged for Federal Home Loan Bank advances. These new collateral rules are now beginning to be implemented for the first time by the Federal Home Loan Bank of Seattle. Although Seattle is the first bank to issue its version of the new rules, the Federal Housing Finance Board has said that the other 11 banks have finished writing their rules and they will be put in place this summer.

The rule expands what types of collateral Federal Home Loan Banks (FHLB) can accept. The new types of collateral include small business loans, agriculture loans, or securities representing a whole interest in such loan. The new rule also implements a Gramm-Leach-Bliley provision that eliminates the 30 percent ceiling on the portion of commercial real estate loans that can be used as collateral.

Previously, only banks with less than \$500 million in assets could offer farm loans and small business loans as collateral. This rule eliminates the \$500 million asset limit and expands the types of loans that can be used as collateral. For further information, see 66 *Federal Register*, pp. 44414-32.

SUMMARY OF JUDICIAL DEVELOPMENTS

On July 6, the U.S. Court of Appeals for the Seventh District made a ruling that addresses what constitutes a bank day in relation to federal check processing regulations. The case, *Oak Brook Bank v. Northern Trust Co.* (7th Circuit No. 00-3309), involved a dispute between two banks as to which one was going to be left with \$400,000 in worthless checks (which had been deposited and withdrawn from Oak Brook Bank by a fraud artist). Northern Trust Co. received the checks, refused to pay them, and returned them to the Federal Reserve Bank of Chicago. The case hinged on whether these checks had been returned in a banking day as required under Regulation CC. Regulation CC is a Federal Reserve regulation that governs the availability of funds deposited in checking accounts and the collection and return of checks.

Under Regulation CC, a bank day is “the portion of a day when a bank office is open to the public for carrying on substantially all of its banking functions.” The court held that a Federal Reserve Bank is open to the public when its check processing department is open. Therefore, the banking day in this case is 24 hours, since the Chicago Fed’s check processing department operates 24 hours a day.

On July 23, the United States District Court for the Eastern District of Pennsylvania ruled that a creditor’s claims against a delinquent borrower have precedence over a union’s claim on benefit contributions

that the employer owes. The case, *Summit Bank v. Local Union No. 98, International Brotherhood of Electrical Workers* (E.D. PA No. 00-2990), originated from a lawsuit by the union against DeStefano and Associates. DeStefano and Associates, which had filed for bankruptcy, was delinquent in its contributions to the employee fringe benefits plan. Summit Bank, through a merger, obtained Prime Bank’s perfected lien against the assets of DeStefano and Associates. The court ruled that although the Employment Retirement Income Security Act (ERISA) and the Labor-Management Relations Act (LMRA) “completely controlled the relationship” between the union and the employer, “those statutes do not apply to the relationship between” the bank and the employer. The result of the case was that Summit Bank, not Local Union No. 98, was allowed to collect DeStefano and Associates’ accounts receivable.

On July 26, the U.S. District Court for the District of Rhode Island made a ruling dealing with arbitration clauses in general mortgage agreements. In the case of *Large, et al. v. Conseco Financial Servicing Corp.* (No. 01-140ML, D.R.I.), the judge ruled that consumers who exercise the rescission clause of their mortgage contract must submit their claim to arbitration, if the mortgage agreement contains such a clause.

The case involved a mortgage agreement between William and Diane Large and

Conseco Financial Corporation, which included a requirement that all disputes be resolved through arbitration. After agreeing to the contract, the Larges informed Conseco of their intention to rescind the mortgage agreement. The Larges were attempting to rescind the agreement based on their contention that Conseco had failed to make the proper disclosures as required by the Truth in Lending Act and the Home Ownership and Equity Protection Act. Conseco did not agree to the rescission of the mortgage agreement, contending that the Larges had agreed to submit all claims to arbitration.

The court, citing a 1967 U.S. Supreme Court decision, *Prima Paint Corp. v. Flood & Conklin Mfg. Co.* (388 U.S. 395), explained that “the Supreme Court has held that a rescission request does not preclude arbitration where a litigant seeks rescission based on a federal statute.” In their suit, the Larges’ contention was that the whole loan agreement was invalidated by Conseco’s actions. They did not attack the arbitration clause in the loan agreement individually. The court, siding with Conseco, said, “Prima Paint makes clear that absent an attack on the specific arbitration clause included in a contract, general rescission claims are resolvable by arbitration.” Since the Larges were not addressing the legality of the arbitration clause of the contract, the court ruled that the arbitrator would be able to resolve all the legal matters concerning the loan agreement.

SUMMARY OF THIRD DISTRICT DEVELOPMENTS

New Jersey

In the case of *Associates Home Equity Services Inc. v. Troup* (NJ Superior Court Appellate Division No. A-3410-00T1F), the Appellate Division of New Jersey Superior Court ruled that mortgage lenders in this case could be sued for reverse redlining and that lenders buying loans in the secondary market could be sued based upon the actions of the loan’s originator. Redlining is the practice of denying the extension of credit to specific

geographic areas because of income, race, or ethnicity of its residents. Reverse redlining is when a mortgage lender targets high-cost loans to a particular area based upon demographic information like average income or racial composition.

The case stems from a home improvement loan that was made in the fall of 1995 in Newark, New Jersey. East Coast Mortgage Corp. of Clark, New Jersey, originated a 15-year loan for \$46,500. The loan had an

11.65 percent interest rate, adjustable after six months. In addition, the family in question had to pay fees of approximately 4 percent of the loan. Shortly thereafter, the loan was sold by East Coast Mortgage to Associates Home Equity. The loan went into default in the spring of 1998 and Associates subsequently foreclosed on the loan. The Troups sued Associates, East Coast, and the contractor who recommended East Coast Mortgage Corp.

The lawsuit alleged that the contractor and East Coast Mortgage had discriminated against the family and failed to make the proper disclosures. Because Associates had pre-approved the loan and thus knew the terms and conditions, it was also sued for predatory lending.

The trial court dismissed the suit by the Troups because of the expiration of the statute of limitations of the relevant laws in the case. The appeals court reversed part of the trial court's decision and upheld part of it. The appeals court ruled that the defendants (the Troups) could pursue their suit alleging that the plaintiffs had engaged in predatory lending. This ruling was based upon the principle of "equitable recoup-

ment," which allows the defendant the right to have the claim of the plaintiff reduced or eliminated by reason of breach of contract or duty by the plaintiff. The appeals court also said that East Coast Mortgage could be held liable for the actions of the contractor and that Associates could be held liable for what East Coast did.

Pennsylvania

On August 15 the Pennsylvania Insurance Department finalized new privacy regulations for insurance companies and other financial institutions. The new regulation will enforce portions of the Gramm-Leach-Bliley Act of 1999, in order to protect the financial privacy of

Pennsylvania insurance consumers. Insurance companies and other financial institutions in Pennsylvania will be required to send annual notices informing their customers of privacy policies. In addition, the regulation will require companies to provide customers the opportunity to deny permission for their private information to be shared with nonaffiliated third parties. These opt-out clauses must be written in a reasonably understandable format and clearly marked for the customer. For further information on the new financial privacy regulations in Pennsylvania, visit the Insurance Department's web site at www.insurance.state.pa.us.

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