BANKING LEGISLATION
& POLICY

July - September 2003 Volume 22, Number 3

HIGHLIGHTS

Recent Developments

California Privacy Legislation

Former California Governor Gray Davis signed legislation August 27 that gives California residents the ability to control whether financial institutions can share their private information. The California Financial Information Privacy Act institutes an "opt-in" system in which financial institutions will be required to obtain a consumer's permission before sharing his or her personally identifiable private financial information with nonaffiliated financial companies. Additionally, institutions will be permitted to share personally identifiable information with affiliated companies if they clearly notify consumers of their intent to share the information and the consumers do not object to the information's being shared. If a consumer directs the institution not to share his or her private information, the institution must comply within 45 days of receiving the request.

Institutions will still be permitted to share private information with their wholly owned financial institution subsidiaries if the financial institution and the subsidiary share the same regulator, are engaged in the same line of business, and share a common brand. Financial institutions will be prohibited from discriminating against a consumer solely because the consumer refused to allow the institution to share his or her nonpublic personal information.

The California Financial Information Privacy Act becomes effective July 1, 2004.

The New Basel Capital Accord

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision released an advance notice of proposed rulemaking to implement the international bank capital requirements of the New Basel Capital Accord. The new accord is divided into three pillars. The first pillar specifies how banks will determine the amount of regulatory capital they must hold on their balance sheets. Pillars two and three of the new accord will address supervisory review and market discipline, respectively.

For a more detailed explanation of the proposed rulemaking, see the *Federal Regulations* section. The agencies propose to implement the new accord on January 1, 2007.

Oversight of Government-Sponsored Enterprises

Congress continues to debate the question of who should regulate the federal home loan banks and the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. Currently, the Federal Housing Finance Board (FHFB) regulates the federal home loan banks, and the Office of Federal Housing Enterprise Oversight (OFHEO) regulates the GSEs. However, Congress is considering several bills that would shift that regulatory responsibility. The Housing Finance Regulatory Restructuring Act of 2003 (H.R. 2803), introduced by Rep. Royce (R-CA) on July 21, would establish the Office of Housing Finance Oversight (OHFO) within the Department of the Treasury to regulate Fannie Mae, Freddie Mac, and the federal home loan banks. The bill would abolish the OFHEO and the FHFB.

Rep. Baker (R-LA) introduced another proposal, the Secondary Mortgage Market Enterprises Regulatory Improvement Act (H.R. 2575), that would abolish the OFHEO and transfer regulatory responsibility of the GSEs to the Office of Thrift Supervision (OTS), which would be renamed the Office of Housing Finance Supervision. The OTS is an agency of the Treasury Department, so in this scenario, too, the Treasury Department would have the ultimate authority to regulate the GSEs.

The Federal Enterprise Regulatory Reform Act of 2003 (S.1508), introduced by Sen. Hagel (R-NE), would create the Office of Federal Enterprise Supervision to supervise the GSEs. This bill would also eliminate the OFHEO.

SUMMARY OF FEDERAL LEGISLATION

New Legislation

1. Financial Literacy and Education Coordinating Act of 2003 (S. 1470). Introduced by Sen. Sarbanes (D-MD) on July 28, 2003.

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

Related Bill: S. 1532

This bill instructs the Secretary of the Treasury to establish the Financial Literacy and Education Coordinating Committee. The committee will be composed of the Secretary of the Treasury and representatives from each federal banking agency, the National Credit Union Administration, the Securities and Exchange Commission, and several other departments and agencies. Within one year after the bill's enactment, the committee will develop and implement a national strategy to promote basic financial literacy among consumers. The committee should consult state and local governments and private and public organizations when designing the strategy. The committee will report its progress to Congress annually after the program's development. The committee will strive to coordinate financial literacy and education efforts between federal agencies and those at the state and local level.

2. Transportation, Treasury, and Independent Agencies Appropriations Act (H.R. 2989). Introduced by Rep. Istook (R-OK) on July 30, 2003.

Status: Passed the House; Placed on Senate Legislative Calendar under General Orders.

A provision of the appropriations act would prohibit funds from being used during fiscal year 2004 to finalize, implement, administer, or enforce a January 2003 rule proposed by the Board of Governors of the Federal Reserve System and the Department of the Treasury that would permit banks to engage in real estate brokerage activities.

Pending Legislation

1. Fair and Accurate Credit Transactions Act of 2003 (H.R. 2622). Introduced by Rep. Bachus (R-AL) on June 26, 2003.

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

This bill would extend provisions of the Fair Credit Reporting Act (FCRA) that prevent states from enforcing certain credit reporting laws that are more restrictive than the FCRA. The provisions are set to expire January 1, but this bill would remove the sunset provision to make uniform national credit reporting standards permanent. Other measures in this bill aim to protect consumers from identity theft. (For specific information on the sunset provisions and other measures, see *Banking Legislation and Policy,* April-June 2003.)

Certain amendments were added to the bill before it passed the House. A section of the bill establishes uniform standards for consumer reporting agencies (CRAs) and mortgage lenders to follow when disclosing free credit scores to consumers. For instance, they would be required to explain how the score was derived, when it was calculated, and whether a contributing factor to the score was the number of inquiries about the consumer's credit. Further, federal regulators will develop a system for CRAs to distribute credit reports in a timely and efficient manner.

The bill contains provisions that maintain the confidentiality of a consumer's medical information. Unless a consumer expressly permits it, medical information cannot be furnished in connection with an insurance transaction or for employment purposes. This information should also not be used in determining a consumer's eligibility for credit. When a firm receives a consumer's medical information for a specific purpose, the firm is prohibited from sharing that information unless it is for the same purpose.

Other amendments require federal regulators to perform several studies. The Secretary of the Treasury will conduct a study of various technologies that can be used to determine who actually performed specific financial transactions. It is hoped that this will reduce the occurrences and costs of identity theft. Next, the Federal Trade Commission (FTC) will perform a study of consumer reports to look for ways accuracy could be improved. The FTC, together with the Office of Fair Housing and Equal Opportunity, will conduct a study of how credit scores affect the availability and affordability of financial products and services. The Comptroller General will investigate whether credit scoring models discriminate on the basis of a consumer's race, gender, religion, or sexual orientation. The Comptroller General will also assess consumers' general financial literacy and knowledge of credit information. The Board of Governors of the Federal Reserve System (the Board) will study the extent to which consumers receive offers for credit or insurance that they did not request. Also, the Board will analyze the potential impact of further restrictions on these offers.

SUMMARY OF FEDERAL REGULATIONS

Department of the Treasury

Patriot Act (7/1/03)
The Treasury Department sought comment on two provisions of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act). Sections of the USA Patriot Act amended the Bank Secrecy Act to help prevent money laundering and the financing of terrorism (see *Banking Legislation and Policy,* October-December 2001). The Treasury Department asked for comments on whether and under what circumstances financial institutions should be required to retain photocopies of documents that were used to verify a customer's identity. Also, the department asked if there could be situations in which the regulations should preclude reliance on certain forms of foreign government-issued identification to verify a customer's identity. In both cases, the Treasury Department chose not to add stricter requirements but to instead rely on the current rules.

Comments on this inquiry were due July 31, and the Treasury Department made its decision September 18. For more information, see 68 *Federal Register,* pp. 39039-41.

Identity Theft (8/12/03)
The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (together, the agencies) have issued a proposed guidance to establish standards to which financial institutions should adhere to safeguard customer information. Pursuant to provisions contained in the Gramm-Leach-Bliley Act, the agencies are directing financial institutions to develop security programs that will ensure the security and confidentiality of customer information and prevent any substantial harm or inconvenience to any customer.

When designing their security programs, financial institutions should assess the risks posed by any internal or external threats to the security of customer information. Next, financial institutions should develop appropriate security measures, such as controlling the access to customer information, performing background checks on employees with access to the information, and developing response programs for instances in which the financial institution believes security has been breached. Financial institutions are also responsible for ensuring that their service providers adopt similar measures to safeguard customer information.

A financial institution's response program should include the following components: an assessment of the situation, notification to the financial institution's primary federal regulator, the filing of a suspicious activity report, and measures to contain, control, and correct the situation. Corrective measures include flagging and monitoring accounts that may have been accessed, securing the accounts, and notifying the customer(s) that may have been affected by the security breach.

Comments on this proposed guidance were due October 14. For more information, see 68 *Federal Register*, pp. 47954-60.

Board of Governors of the Federal Reserve System

Audit Services (8/13/03)
The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (together, the agencies) have issued a final rule to establish more extensive guidelines for debarring or suspending accountants who perform audit services for insured depository institutions with total assets exceeding $500 million. The Federal Deposit Insurance Act authorizes the agencies to suspend, remove, or debar an accountant for "good cause." The agencies would assume there was good cause if an accountant is not properly qualified, engages in knowing or reckless misconduct, violates professional standards, gives misleading information to the agencies, or otherwise acts unlawfully. The agencies may suspend or debar an accountant if he or she gives good cause during an audit of any institution, not just at an audit at an insured depository institution. Further, the agencies may suspend or debar an entire firm or specific offices of a firm if one of the firm's employees gives good cause.

The agencies will hold formal hearings to decide whether to suspend or debar an accountant or accounting firm. The agencies will have the authority to determine whether an accountant should be suspended from a particular depository institution or from all institutions the agencies regulate. The agencies reserve the right to immediately suspend an accountant or firm if, while waiting for formal proceedings, greater harm could come to an insured depository institution by allowing the accountant or firm to continue practicing. The agencies must hold formal hearings within 10 days of issuing an immediate suspension. Suspended or debarred individuals, offices, or firms can apply for reinstatement at any time, and the agencies will consider the application.

This final rule became effective October 1. For more information, see 68 *Federal Register*, pp. 48256-74.

Anti-Tying (8/29/03)
The Board of Governors of the Federal Reserve System (the Board) issued a proposed interpretation to clarify the elements of tying arrangements that are prohibited by Section 106 of the Bank Holding Company Act of 1970. The interpretation describes exceptions to these prohibitions and lists types of conduct and arrangements that are prohibited and permissible.

Section 106 prohibits a bank from imposing certain tying arrangements as well as certain reciprocity and exclusive dealing arrangements on their customers. A tying arrangement is in violation of Section 106 if it involves two or more separate products: the customer's desired product, and one or more separate (tied) products. To be in violation, the bank must force the customer to obtain the tied product from the bank or an affiliate of the bank in order for the customer to obtain the desired product. But this does not apply when the tied product is a traditional bank product (defined as a loan, a discount on a loan, a deposit, or a trust service). Section 106 does not prohibit cross-marketing and cross-selling activities, as long as the bank is merely encouraging, and not requiring, a customer to purchase other products.

Tying arrangements are violations only when they are initiated by the bank, not when a customer voluntarily negotiates to obtain multiple products from the bank or its affiliates. Ordinarily a bank would be prohibited from requiring a customer to obtain a product from an affiliate, but exceptions are made to permit a bank to protect its financial interest in credit relationships. For example, a bank can condition the availability of secured credit on a requirement that the customer obtain insurance, for the benefit of the bank, that protects the value of the bank's security interest in the collateral securing the loan. Similarly, banks may not implement exclusive dealing arrangements that prohibit a customer from dealing with the bank's competitor, unless the condition was reasonably imposed in a credit transaction to ensure the soundness of the credit. For instance, a bank may stipulate that a customer not borrow from other sources during the term of a loan.

Comments on this proposed interpretation were due September 30. For more information, see 68 *Federal Register*, pp. 52024-35.

The Board made an additional clarification to its anti-tying restrictions the same day by proposing a rule that would treat financial subsidiaries of state nonmember banks as affiliates of these banks for purposes of section 106 of the Bank Holding Company Act of 1970. Section 106 applies anti-tying restrictions to subsidiaries, but not affiliates, of banks. Subsidiaries of national and state member banks are already treated as affiliates (and not subsidiaries) of their parent.

Comments on this proposed rule were due September 30. For more information see 68 *Federal Register*, pp. 51938-9.

Office of the Comptroller of the Currency

New Basel Capital Accord (8/4/03)
The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (together, the agencies) released an advance notice of proposed rulemaking to implement the new

international bank capital requirements of the New Basel Capital Accord. The new accord is divided into three pillars that respectively address minimum capital requirements, supervisory review, and market discipline.

The first pillar changes the way large internationally active financial institutions in the U.S. calculate minimum capital requirements. Currently, the agencies expect to require about 10 of the largest internationally active U.S. financial institutions (the core banks) to use the new accord's advanced approaches to evaluate credit risk and operational risk. They expect approximately another 10 institutions (opt-in banks) to volunteer to use the advanced approaches. All other U.S. financial institutions (general banks) will continue to apply the existing general risk-based capital rules of the 1988 Basel Accord, with some modifications.

Under the first pillar, core banks and opt-in banks will use new advanced approaches to determine credit and operational risk (the denominator of the minimum risk-based capital requirement ratio). Operational risk is defined as the risk of losses resulting from inadequate or failed internal processes, people, and systems, or external events. Operational risk losses fall under one of the following event categories: fraud, workplace safety, employment practices, damage to physical assets, business disruption or system failures, failed transaction processing, and failure to satisfy obligations to specific clients.

Core banks are defined as banks that have total bank assets of $250 billion or more or have total on-balance-sheet foreign exposure of $10 billion or more. Before they can begin using the advanced approaches, core banks and opt-in banks will have to make a set of public disclosures and meet certain infrastructure requirements and supervisory standards. Once approved, the banks can begin using the advanced internal ratings-based (A-IRB) approach to assess credit risk, and the advanced methods approach (AMA) to assess operational risk.

Under the A-IRB approach for credit risk, supervisors will supply formulas, or risk-weight functions, into which banking organizations would supply their own internal estimates of key risk drivers for different exposures (or pools of exposures). By using the A-IRB approach, banks essentially will be trying to estimate as much as possible the most potential losses in a portfolio over a one-year horizon, to the 99.9th percentile. Then, banks will use this estimate to set the required amount of regulatory capital.

First, users of the A-IRB approach would designate their exposures as belonging to one of the following categories: wholesale (corporate, interbank, and sovereign), retail (residential mortgages, qualifying revolving, and others), equities, securitization exposures, and purchased receivables. Then, for each of the exposures, banks will estimate common risk drivers, such as the probability of default, loss given default, exposure at default, and in some instances, maturity. Banks will be able to take into account collateral, third-party guarantees, and other forms of risk mitigation in their estimates of risk drivers, subject to limitations specified in the rule. The estimates will then be input into the risk-weight formulas to derive a specific dollar amount capital requirement for credit risk that would be converted to a risk-weighted assets equivalent by multiplying by 12.5 (the reciprocal of the 8 percent minimum requirement).

In the 1988 accord, capital was implicitly held for operational risk. But, in the new accord, firms using the A-IRB approach to evaluate credit risk will use the AMA to calculate exposure to operational risk and hold adequate capital to compensate for it. Banks will be expected to estimate the 99.9th percentile of potential operational risk losses that could result over a one-year horizon. Banks will be required to hold an equivalent amount of capital against this exposure.

Before they can use the AMA, banks will have to meet certain minimum standards to show they have adequate internal operational loss data. For instance, banks will have to hold internal operational risk loss data for five years. Then, subject to supervisory approval, banks using the AMA will be able to use their own methodology for assessing exposure to operational risk, some of which can be mitigated by insurance. The bank's estimate of operational risk exposure would then be multiplied by 12.5 to determine a risk-weighted assets equivalent. The denominator of risk-based capital ratios would then be the sum of the risk-weighted asset equivalents obtained for credit risk, operational risk, and market risk. (Along with releasing this proposed rulemaking, the agencies issued a guidance regarding implementation of the A-IRB approach and the AMA.)

The second pillar of the new accord addresses supervisory review to ensure that an institution holds sufficient capital for its risk profile. The agencies are not planning to establish specific requirements to implement the second pillar because existing rules already adequately meet these standards. U.S. banking organizations are already required to hold sufficient capital relative to risk, and regulators are already permitted to intervene if capital isn't sufficient.

The third pillar requires users of the advanced approaches to make enhanced public disclosures encompassing capital, credit risk, credit risk mitigation, securitization, market risk, operational risk, and interest rate risk. Bank holding companies will be required to disclose, for example, a breakdown of regulatory capital required for credit, operational, and market risk, including making disclosures about exposures the bank has securitized. Banks would be required to describe their methods for tracking and calculating these numbers, and they would be required to disclose their estimates of probability of default, loss given default, and exposure at default.

Comments on this advance notice of proposed rulemaking were due November 3, 2003. For more information, see 68 *Federal Register,* pp. 45899-948. For more information about the guidance regarding implementation of the A-IRB approach and the AMA, see 68 *Federal Register,* pp. 45949-88.

Preemption Powers (8/5/03)
The Office of the Comptroller of the Currency (OCC) issued a proposed rule to clarify the applicability of state law to national banks, identifying state laws that generally are and are not preempted by federal laws. Congress established the OCC, giving it exclusive authority to examine, regulate, and supervise national banks, unless otherwise provided by federal law.

Federal law and judicial precedent has established the following state law restrictions that are preempted for national banks: licensing laws, filing requirements, terms of real estate loans, advertising, permissible rates of interest, permissible fees and non-interest charges, management of credit accounts, due-on-sale clauses, leaseholds as acceptable security, and mandated statements and disclosures. States do retain power to regulate national banks in areas such as contracts, debt collection, acquisition and transfer of property, and taxation, criminal, and tort law.

The proposed rule outlines principles national banks should follow with regard to real estate lending. National banks should not make a loan based predominantly on the foreclosure value of the borrower's collateral. National banks should treat all their customers fairly and honestly by avoiding deceptive practices. Deceptive practices include material and misleading representations, omissions, acts, or practices that are considered unfair and unlawful when they result in an unavoidable substantial injury to a consumer that is not outweighed by the benefits to the consumer. The OCC will also work to ensure that national banks are not engaging in predatory lending practices such as loan flipping, equity stripping, and refinancing of special subsidized mortgage loans.

Comments on this proposed rule were due October 6. For more information, see 68 *Federal Register,* pp. 46119-32.

Georgia Fair Lending Act (8/5/03)
The Office of the Comptroller of the Currency (OCC) decided that portions of the Georgia Fair Lending Act (GFLA) are preempted by federal law and therefore do not apply to the real estate lending activities of national banks and their subsidiaries. Earlier this year, the OCC received a national bank's request for federal preemption of the GFLA (see *Banking Legislation and Policy,* January-March 2003).

The GFLA places certain restrictions on mortgage lending, including limiting late fees and prepayment penalties and prohibiting the financing of credit or debt cancellation insurance. The OCC specifically preempted GFLA provisions that impose conditions on a national bank's exercise of its real estate lending powers, limit the interest a national bank may charge for certain types of loans, limit the non-interest fees a national bank may charge in connection with certain types of loans, and otherwise regulate national banks' operating subsidiaries.

For more information on this preemption determination and order, see 68 *Federal Register,* pp.46264-81.

Community Development (8/15/03)
The Office of the Comptroller of the Currency (OCC) issued a final rule that simplifies the process by which national banks invest in community development projects and expands the list of acceptable public welfare investments. Previously, a public welfare investment had to meet two conditions. The first was that the investment must primarily benefit low- and moderate-income individuals, low- and moderate-income areas, or other areas targeted for redevelopment by supporting at least one of four specific public welfare activities. In this final rule, the list of four specific activities has been deleted. The OCC also permits investments that meet the standards for a "qualified investment" under the Community Reinvestment Act (CRA). The second condition under current rules was that an investment would have to receive community support to qualify. This final rule deletes that requirement.

A national bank's public welfare investments may not exceed 5 percent of its capital and surplus, unless it is both adequately capitalized and obtains permission from the OCC. Public welfare investments may not exceed 10 percent of a bank's capital and surplus. The OCC clarified that a bank should use generally accepted accounting principles to calculate the amount of its investments. A bank may make an investment without the OCC's prior approval, but it must submit to the OCC a self-certification letter within 10 days of making the investment. The letter should describe the nature and amount of the investment. If the OCC does not respond to the notification within 30 days of receiving it, a bank can assume the investment was approved.

This final rule became effective September 15. For more information, see 68 *Federal Register,* pp. 48771-83.

Federal Deposit Insurance Corporation

Living Trust Accounts (6/30/03)
The Federal Deposit Insurance Corporation (FDIC) is proposing two alternatives for depository institutions to assess insurance coverage for living trust accounts. A living trust is a formal revocable trust that the owner controls during his or her life. Upon the owner's death, the trust becomes irrevocable. Under current rules, revocable trusts are insured for up to $100,000 per qualifying beneficiary (if there is more than one), provided that certain conditions are met. Qualifying beneficiaries include the owner's spouse, children, grandchildren, and parents. To qualify for per-beneficiary insurance an account must be "in trust for" or "payable-on-death to" a qualified beneficiary. Also, the beneficiaries must be specifically named in the deposit account records of the depository institution. Finally, account funds must be unconditionally available to the intended beneficiary. If these conditions are not met, the account will be insured for a total of $100,000 only, regardless of the number of qualifying beneficiaries.

Confusion existed under current rules because many living trust accounts specify conditions that must be met before a beneficiary is entitled to his or her funds. These provisions are called "defeating contingencies." When a living trust account has a defeating contingency, it is not eligible for per-beneficiary insurance. For instance, assume an owner of a $200,000 living trust specified that upon his death his son would receive $100,000 if he finished college and his spouse would receive $100,000 unconditionally. Under current rules, this account would not be eligible for per-beneficiary insurance because of the defeating contingency that his son finish college. Therefore, the account would be insured for only $100,000. The FDIC is proposing to amend these rules to simplify them.

The first alternative proposes that living trust accounts be insured for $100,000 per qualifying beneficiary, regardless of any defeating contingencies. The FDIC speculates that this alternative would probably result in an increase in deposit insurance coverage.

Under the second alternative, the FDIC would create a separate category for living trust account coverage and insure such accounts for up to $100,000, regardless of the number of beneficiaries named in the trust, the owner's relationship to the beneficiaries, or any defeating contingencies. This means that depository institutions would not have to keep records of the names of trust beneficiaries and their trust interests. This alternative would likely result in reduced coverage for trust account owners with living trusts naming more than one beneficiary. An owner with over $100,000 in living trust assets can have the funds fully insured, however, by placing up to $100,000 in different FDIC-insured depository institutions using the same trust document.

Comments on this proposed rule were due August 29. For more information, see 68 *Federal Register*, pp. 38645-51.

Payday Lending (7/2/03)
The Federal Deposit Insurance Corporation (FDIC) issued a final guidance describing safety and soundness and compliance considerations for examining state nonmember institutions that have payday lending programs. The guidance outlines the FDIC's expectations for risk-management practices associated with payday lending programs, with particular attention to concentrations, capital adequacy, management of third-party relationships, and consumer protection considerations.

Payday loans are small-dollar, short-term, unsecured loans that borrowers promise to repay out of their next paycheck. Borrowers typically pay a fixed-fee equivalent to a very high rate of interest. Borrowers who seek payday loans typically have cash flow difficulties. In addition, payday lenders generally do not adequately analyze the borrower's credit history. This combination poses a credit risk for insured depository institutions. Banks sometimes enter into third-party agreements in which the depository institution funds the loans that a third-party originates. This relationship can result in increased exposure to transaction, legal, and reputation risks when the arrangement isn't properly monitored and managed.

Examiners may conduct examinations of these third parties. Such exams may review compensation and staffing policies, marketing and pricing policies, management information systems, and compliance with bank policy, outstanding law, and regulations. Examiners may review individual loans for compliance with underwriting and loan administration guidelines. Examiners will assess the risk management programs for relationships between banks and third-party lenders. The arrangements should be governed by a written contract that is approved by the institution's board. Institutions should also develop oversight programs that monitor third-party relationships.

When a bank has a concentration of payday loans, examiners will require institutions to diversify their loan portfolios. A concentration of payday loans would be defined as a volume of payday loans totaling 25 percent or more of a bank's Tier 1 capital. Examiners will also determine capital requirements for payday lending programs by assessing the risk involved with each program. The FDIC suggests that the required level of capital should be significantly higher than other pools of subprime loans, potentially as high as 100 percent of the loans outstanding. The FDIC is requiring that depository institutions charge off payday loans that are not repaid within 60 days of being originated, even if the loan was rolled over during that period.

Payday lenders should adhere to some minimum standards. Institutions should limit the number and frequency of extensions, deferrals, renewals, and rewrites; prohibit additional advances to finance unpaid interest and fees and simultaneous loans to the same customer; and ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained. In addition, institutions should establish a waiting period between the time a payday loan is repaid and another application is made; limit the number of loans per customer that are allowed within a designated time frame; and ensure that a customer have no more than one outstanding payday loan with the bank at any time.

Finally, examiners will evaluate payday lending programs for their compliance with several laws and regulations, including the Community Reinvestment Act, the Truth in Lending Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, and the Fair Debt Collection Practices Act.

For more information on this final guidance, see *www.fdic.gov/regulations/safety/payday/index.html*.

Filing Procedures (8/21/03)
The Federal Deposit Insurance Corporation (FDIC) issued a final rule to clarify certain sections of the Federal Deposit Insurance Act (FDI Act) and include a waiver provision in the FDI Act. The FDIC established a 30-day time period

within which it must respond to institutions that file a response to a notice of intent or temporary order issued pursuant to the FDI Act. The FDIC clarified that for a bank or thrift holding company seeking deposit insurance to be eligible for expedited processing, the institution must have consolidated assets of at least $150 million; a BOPEC rating of at least "2" for bank holding companies and an above average rating for thrift holding companies; and at least 75 percent of its consolidated depository institution assets composed of eligible depository institutions. The FDIC also added a provision that permits the FDIC, at any time, to waive any section of the FDI Act, in whole or in part, for good cause, unless it is prohibited by federal law. Provisions may be waived by the FDIC's own motion or upon petition from an institution if good cause is shown.

This final rule became effective September 22. For more information, see 68 *Federal Register*, pp. 50457-61.

Asset-Backed Commercial Paper

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (together, the agencies) issued an interim final rule and a notice of proposed rule-making to address banking institutions' balance-sheet treatment of asset-backed commercial paper (ABCP) programs. Banking institutions typically design ABCP programs to provide funding to corporate customers. ABCP programs are special-purpose entities that purchase asset pools from or extend loans to those customers. A banking organization's sponsorship of an ABCP program gives the program a better credit rating and typically lowers borrowing costs for their customers.

In January, the Financial Accounting Standards Board issued interpretation No. 46, which requires certain off-balance-sheet enterprises, referred to as variable interest enterprises (VIE), to be consolidated onto the balance sheet of the company that is the VIE's primary beneficiary (for more information, see *Banking Legislation and Policy*, January-March 2003). Because of that interpretation, some ABCP programs would be consolidated on the bank balance sheet beginning in the regulatory reporting period ending September 30, 2003. The agencies believe that this could result in inappropriate risk-based capital requirements. Therefore, the agencies issued an interim final rule that allows banking institutions to exclude ABCP program assets from calculations of their Tier 1 and total risk-based capital ratios for quarters ending September 30, 2003, December 31, 2003, and March 31, 2004. Also, during these quarters, any minority interest in ABCP programs would be excluded from the minority interest component of Tier 1 and total risk-based capital. However, banks must include in risk-weighted assets the credit equivalent of any exposures, such as credit enhancements, that the institution provides to ABCP programs.

In the separate proposed rulemaking, the agencies propose to convert short-term liquidity facilities (with an original maturity of one year or less) provided to ABCP programs to on-balance-sheet credit equivalent amounts using a 20 percent credit conversion factor, as opposed to the 50 percent conversion factor currently applied to commitments with an original maturity of greater than one year. This amount would then be risk-weighted according to the underlying assets of the obligor. A single banking organization would not be required to hold risk-based capital for its overlapping exposures. If different banking organizations have overlapping exposures in an ABCP program, each would have to hold risk-based capital for the maximum amount of its own exposure.

The agencies are also considering applying an early amortization capital charge to securitizations of revolving retail credit facilities that include early amortization provisions. This is expected to apply mostly to credit card securitizations. This charge will be applied to an institution's off-balance-sheet interest when the excess spread associated with the early amortization provision reaches a certain level. The charge would increase as the spread comes closer to triggering the early amortization event, therefore reflecting the increasing risk associated with reaching that trigger. The agencies are seeking comment on whether to apply such a charge.

Comments on this proposed rule were due November 17. For more information, see 68 *Federal Register*, pp. 56568-86.

Office of Thrift Supervision

Debit Incentive Programs (7/23/03)

In a May 29 letter that was released to the public July 23, the Office of Thrift Supervision (OTS) issued a legal opinion saying that customers of federal savings associations may earn rewards by using Visa U.S.A. debit cards without violating a Home Owners Loan Act (HOLA) provision that prohibits payment of interest on demand deposits. In the proposed scenario, Visa wished to offer rewards to customers when they accessed their demand deposit accounts using signature debit. However, a section of the HOLA does not permit institutions to pay interest on demand deposits. The Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation have defined interest as being "any payment to or for the account of any depositor as compensation for the use of funds constituting a deposit." The OTS reasoned that the rewards would not constitute interest because they would not be directly or indirectly related to or dependent on the balance in a demand deposit account. Therefore, offering rewards on signature debit transactions does not violate the HOLA. For more information, see the legal opinion at *www.ots.treas.gov/docs/56304.pdf*.

Voluntary Audits (9/8/03)

The Office of Thrift Supervision issued a final rule that permits small, nonpublicly traded, highly rated savings associations to obtain voluntary independent audits from the same auditor who performs nonaudit services, such as bookkeeping, financial information systems design, appraisal, and valuation and actuarial services. Essentially, the proposal will allow institutions that file voluntarily to be exempt from Securities and Exchange Commission independence rules that prohibit auditors of companies to, at the same time, provide that company with nonaudit services. Voluntary filers will be required to comply with independence standards established under the American Institute for Certified Public Accounts' Professional Conduct Code.

This final rule became effective September 8. For more information, see 68 *Federal Register*, pp. 52831-2.

Fiduciary Powers (9/9/03)
The Office of Thrift Supervision (OTS) issued a final rule allowing federal savings associations to create, without OTS approval, a new agency office to conduct fiduciary activities. The new agency office must be in the same state for which the savings association already has OTS-approval to conduct fiduciary activities. If the agency office is in a different state, the savings association must file a notice with the OTS within 10 days of establishing the agency office.

This final rule became effective September 9. For more information, see 68 *Federal Register*, pp. 53024-6.

SUMMARY OF JUDICIAL DEVELOPMENTS

Credit card issuers do not have a duty to protect non-customers from identity theft

On August 11, the South Carolina Supreme Court ruled that a bank did not have a duty to protect a non-customer from having his identity stolen to fraudulently obtain credit and accumulate debt (*Huggins v. Citibank, N.A.*, No. 25691). The plaintiff, Huggins, brought suit against Citibank, Capital One Services, and Premier Bankcard after the banks issued a line of credit in Huggins' name to an impostor who had stolen his identity. The impostor accrued debt in Huggins' name and didn't pay the banks. As a result, the banks attempted to collect the debt from Huggins. Huggins claimed the banks were negligent for not verifying the impostor's identity before offering him credit. He argued that the banks have a duty to protect potential victims of identity theft from impostor fraud. Subsequently, the banks filed a motion to dismiss the claim, saying that because Huggins was not their customer, they owed him no duty.

To establish a claim for negligence, the plaintiff would have to show that 1) the banks owed him a duty of care, 2) they breached that duty by negligent act of omission, and 3) the breach proximately caused damage. The court expressed concern for the growing problem of identity theft, but it failed to find that the banks, without having a customer relationship with Huggins, owed a legal duty of care to him. Further, the court mentioned that several pieces of state and federal legislation provide relief for victims of identity theft. The court concluded that the "legislative arena is better equipped to assess and address the impact of credit card fraud on victims and financial institutions alike."

Illegal fee-splitting case reinstated by Seventh Circuit

The plaintiffs, Gregory and Margaret Weizeorick, filed suit against ABN AMRO Mortgage Group (AAMG) for allegedly splitting with a closing company a fee for services that AAMG didn't perform, in violation of Section 8(b) of the Real Estate Settlement Procedures Act (RESPA) (*Weizeorick v. ABN AMRO Mortgage Group Inc.,* No. 02-2801).

The fee was charged for recording the release of AAMG's lien on the Weizeoricks' mortgage when they sold their home, but AAMG didn't record the release, and the closing company did. In the settlement statement, the Weizeoricks were to pay $10 to AAMG for a "Recording Discharge/Release of Lien Fee" and $26.50 to the closing company for a "Release Fee." The plaintiffs alleged that the total recording fee was $36.50, of which AAMG received an unearned portion of $10, constituting an illegal fee-split under RESPA.

In the first round of legal proceedings, a district court dismissed the plaintiffs' case, saying that the plaintiffs did not successfully allege that AAMG accepted an unearned portion of a fee. The district court ruled that because AAMG and the closing company each independently charged the Weizeoricks a standard fee for the recording service, there was no split of an unearned fee to a third party. On appeal, though, the U.S. Court of Appeals for the Seventh Circuit reversed the district court's dismissal and remanded the case for further proceedings.

The Seventh Circuit court ruled that even though AAMG was on the receiving end of the fee-split, liability is placed on both the giver and receiver of an alleged illegal kickback according to RESPA. Therefore, AAMG did not need to have control over or knowledge of the fee-split for the Weizeoricks to make the allegation that a third party to their real estate transaction accepted a portion of a fee that was unearned. The court of appeals decided that the district court would have to determine whether the alleged fee-split was actually unearned.

Lenders do not need to state a specific dollar figure when disclosing a final payment amount

The U.S. Court of Appeals for the Seventh Circuit ruled that a lender does not need to give the specific dollar figure of a final payment amount to satisfy the Truth in Lending Act's (TILA) requirements as long as the lender provides the borrower with enough information so that he or she could reasonably calculate the amount (*Carmichael v. The Payment Center Inc.*, No. 02-3958). The plaintiffs, Harry and Louise Carmichael, brought suit against The Payment Center Inc. (PCI), for not specifically stating in dollar terms the final balloon payment amount that the Carmichaels would owe in the 13th month after accepting a $69,000 loan. PCI did, however, disclose the interest rate (12 percent) the Carmichaels would pay on the loan and the dollar amount ($709.74) of each of the 12 monthly payments preceding the final balloon payment. From this, the court ruled, a reasonable consumer could calculate the final amount owed in the balloon payment, and therefore, PCI did not violate the TILA's requirements.

The court examined the text of the TILA and construed that a lender's giving a specific dollar figure was one way, but not the only way, to disclose an amount. The Carmichaels complained that because PCI made glaring mistakes in the loan document (overstating the finance charge as $188,716.76 and the total payments as $257,716.76), it was impossible to calculate the actual amount due in the final payment. Further, the Carmichaels argued that because this information was inaccurate and PCI did not disclose the amount of the final payment, the Carmichaels should have been entitled to an extended three-year period in which they could rescind the loan.

The court ruled that even though the loan documents were obviously flawed, it was "ridiculous" to think that one would be expected to pay over $257,000 dollars on a $69,000 loan. Further, the court said that the TILA was meant to protect consumers from lenders' underestimating payments, not from overestimating them. Finally, the court ruled that because the information in the loan documents was found to adequately meet the TILA's requirements, the Carmichaels were not entitled to an extended recision period.

Credit card issuer will face judicial proceedings for changing a "fixed" APR

The U.S. Court of Appeals for the Third Circuit reinstated a case to determine whether a credit card issuer violated the Truth in Lending Act (TILA) by raising what was promised to be a low "fixed" annual percentage rate (APR) (*Roberts v. Fleet Bank (R.I.),* No. 01-4420). Fleet Bank sent to the defendant, Denise Roberts, credit card solicitation materials including an introductory flyer, a solicitation letter, a "Pre-Qualified…Invitation," and an Initial Disclosure Statement. The materials touted the card's 7.99 percent fixed APR and claimed that the APR was "NOT an introductory rate" and wouldn't "go up in just a few months." The materials also depicted a Schumer box, a table of basic credit card information required under the TILA, that listed two specific circumstances that could change the APR: 1) if the prospective cardholder failed to meet any repayment requirements; or 2) upon closure of the account. After accepting the invitation, Roberts received her credit card and cardholder agreement that restated the 7.99 percent APR and repeated the circumstances under which it could change. The agreement also said that Fleet had "the right to change any of the terms…at any time."

Thirteen months after Roberts received her card, Fleet increased the card's APR to 10.5 percent. Roberts filed this suit alleging Fleet had violated the TILA by not clearly and conspicuously stating in the Schumer box that the card's APR was subject to change at any time. Fleet argued that the Board of Governors of the Federal Reserve System has provisions that prohibit the bank from making a "change in terms" provision in the Schumer box.

The court concluded that it was not Fleet's obligation to disclose the change in terms provision, but it was its obligation to disclose the APR in the Schumer box. Looking at the Schumer box, the court ruled that it was just as reasonable, if not more reasonable, for a consumer to conclude that the 7.99 percent APR could be changed only under the two listed circumstances as it would be for a consumer to conclude that Fleet could change the APR at any time. Therefore, the court reversed the district court's dismissal and reinstated the case for further proceedings.

Visa's and MasterCard's exclusionary rules violate the Sherman Antitrust Act

The U.S. Court of Appeals for the Second Circuit affirmed a district court's ruling that Visa U.S.A and MasterCard violated the Sherman Antitrust Act by promulgating exclusionary rules that preclude their member banks from offering other brands of credit cards (*United States of America v. Visa U.S.A, Inc., Visa International Corp., and MasterCard International, Inc.*, No. 02-6074).

Visa and MasterCard are each joint ventures owned by the banks that are members of the network. As part of their agreements with the member banks, Visa and MasterCard allow the banks to issue both Visa and MasterCard credit cards, but the member banks are prohibited from issuing other brands of credit cards. The U.S. Department of Justice contends that this is a violation of the Sherman Antitrust Act, a law prohibiting the restraint of trade and commerce. A district court ruled that the exclusionary rules do restrict trade and issued an injunction. The credit card companies filed an appeal.

The appeals court affirmed the district court's ruling for the following reasons. First, the court found that Visa and MasterCard, together and independently, had an appreciable market power, as evidenced by their ability to successfully prevent their member banks from issuing American Express- or Discover-branded credit cards. Next, the court found that this restraint was harmful to competition because only Visa and MasterCard are able to compete for issuing banks' business. The court failed to find that this harm to competition was outweighed by any pro-competitive benefits. Therefore, the district court's prior ruling stands.

Federal lender is subject to a state law even though it is preempted by federal law

Maryland's highest court, the Court of Appeals, ruled that a group of borrowers may sue a federal lender for not complying with a Maryland state law that governs changes in terms for credit card agreements, even though the state law is preempted by federal law (*Wells v. Chevy Chase Bank, F.S.B.*, No. 41). Borrowers David Wells, Sharon Goldenberg, and John Dovel accused the lender, Chevy Chase Bank, of breaking the terms of its cardholder agreement by not complying with a section of the agreement entitled "Governing Laws." In that section, Chevy Chase referenced Subtitle 9 of the Commercial Law Article, Md. Code (Subtitle 9). Maryland's Subtitle 9 addresses the form of the notice required when a cardholder agreement is amended. Specifically, if a lender is changing the terms of an agreement and the change will increase interest rates, finance charges, or other fees, or if the amendment would change how rates, fees, or charges are computed, Subtitle 9 requires the lender to alert borrowers in a clear and conspicuous written notice 25 days before a change in terms will be effective. When Chevy Chase amended the terms of its agreement with the borrowers, the lender did not give 25 days' advance notice but included the notification with the borrowers' statements.

Both parties agree that Subtitle 9 is preempted by the Home Owners' Loan Act, a federal law, but the appellants argued that because Chevy Chase incorporated Subtitle 9 into the cardholder agreement, the lender is contractually obligated to comply with Subtitle 9. The Maryland Court of Appeals agreed with the appellants (reversing a lower court ruling), saying that the governing provision Subtitle 9 was brought into the case by the lender, not the borrowers. Therefore, because Chevy Chase prepared the agreement referencing Subtitle 9, the lender should be expected to honor the terms of the agreement, including the requirements of Subtitle 9. The court remanded the case for further proceedings.

SUMMARY OF THIRD DISTRICT DEVELOPMENTS

Pennsylvania

On August 11, the Pennsylvania Secretary of Banking sent a letter warning state-licensed mortgage lenders and brokers to send applicable notices to borrowers applying for covered loans, or else face certain consequences. Pennsylvania's Mortgage Bankers and Brokers and Consumer Equity Protection Act (MBBCEPA) defines a covered loan as a mortgage loan with an original principal balance of less than $100,000 that meets certain interest rate and fee thresholds. The MBBCEPA requires mortgage brokers and lenders, in conjunction with these covered loans, to send borrowers a notice informing them of the terms of such loans. The lender or broker is required to send the notice to the borrower at least three days prior to the consummation of the loan and maintain evidence of the borrower's receipt of the notice. If a lender or broker fails to provide notice, the Pennsylvania Department of Banking may take any of the following actions: 1) require the lender to lower the interest rate of the loan to a point at which the loan is no longer a covered loan and refund to the borrower any interest amount the lender obtained while the loan was a covered loan; 2) require the lender to refund the amount of the borrower's fee that was above the covered loan fee threshold; and 3) suspend, revoke, or refuse to renew the lender's or broker's license.

Prepared by the Research Department. For further information, contact Joanna Ender at 215-574-4102 or joanna.m.ender@phil.frb.org.
To subscribe to this publication please contact the Publications Desk at 215-574-6428 or lois.newell@phil.frb.org.