



# BANKING LEGISLATION & POLICY

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## Recent Developments

### **A Connecticut Court Upholds OCC's Preemption of State Laws**

The U.S. District Court for the District of Connecticut ruled that a national bank's mortgage subsidiary is not subject to Connecticut mortgage lending laws because for national banks these laws are preempted by the National Banking Act (*Wachovia Bank N.A. v. Burke*, No. 3:03-cv-0738). Wachovia Mortgage, a North Carolina company, became a wholly

owned subsidiary of Wachovia National Bank on January 1, 2003. Thereafter, it did not renew its state mortgage-lending license in Connecticut, at which time the commissioner filed a cease and desist order against the mortgage company for operating its business without a license.

Wachovia Mortgage and Wachovia National Bank filed suit, contending that the Connecticut licensing laws are preempted by federal law. The National Bank Act gives

the Office of the Comptroller of the Currency exclusive authority to regulate national banks. The commissioner conceded that he could not enforce the Connecticut laws against Wachovia National Bank, arguing that because Wachovia Mortgage is a subsidiary of, and not itself, a national bank, it is subject to the state requirements. The court ruled, however, that the state laws do not apply to Wachovia Mortgage, concluding that "state laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank." Because the commissioner could not enforce the laws against Wachovia National Bank, he could therefore not enforce them against its subsidiary.

### **Citigroup Settles with Federal Reserve over Cease and Desist Order**

Citigroup Inc. and CitiFinancial have agreed to pay up to \$70 million in civil penalties and pay restitution to certain borrowers to settle claims by the Board of Governors of the Federal Reserve System (Board) that the company and its subsidiary violated provisions of the Equal Credit Opportunity Act (ECOA) and the Home Ownership and Equity Protection Act (HOEPA). Specifically, the Board alleged that CitiFinancial attempted to increase joint insurance

sales through a higher volume of co-applicant loans. In doing so, the company violated a provision of the ECOA that prohibits a creditor from requiring the signature of a spouse or other co-applicant on a credit instrument if the applicant qualifies based on his or her own creditworthiness. In addition, the Board argued that CitiFinancial engaged in unsafe and unsound practices in connection with their underwriting and lending practices. Finally, the Board alleged that CitiFinancial committed further unsafe and unsound practices by misleading examiners during interviews with CitiFinancial employees.

While admitting no wrongdoing, Citigroup and CitiFinancial acknowledged the cease and desist order and agreed to provide restitution to borrowers who were affected by CitiFinancial's ECOA violations and unsafe and unsound lending practices. Also, the companies agreed to pay civil penalties of up to \$70 million dollars. That amount may be reduced by as much as \$20 million dollars, to the extent that actual restitution payments are made. The companies are also required to develop audit, training, and internal control programs to address these alleged violations and to prevent their reoccurrence.

## **SUMMARY OF FEDERAL LEGISLATION**

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### *New Legislation*

#### **1. Credit Card Minimum Payment Warning Act (S. 2475).**

Introduced by Sen. Akaka (D-Hawaii) on May 21, 2004.

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

This bill would add a provision to the Truth in Lending Act requiring credit card issuers to include a warning at the top of each customer's monthly billing statement that remitting only the minimum payment will increase the amount of interest paid and the length of time it will take to repay the balance.

The warning would also indicate the number of years and months it would take to pay off the current balance if the consumer made only minimum monthly payments. In addition, the warning would state the total cost to the consumer, broken down into total principal and interest paid, by paying minimum monthly payments. The warning would also inform the consumer of the monthly payment amount that would be required to pay off the outstanding balance in 36 months.

Finally, the notice would include a toll-free number from which consumers could obtain information about credit counseling and debt management services. The bill would require the Board of Governors of the Federal Reserve System and the Federal Trade Commission to jointly issue a rule to establish the toll-free telephone number for the purposes of this act. The telephone number is to be created and maintained by creditors and may refer consumers only to nonprofit credit counseling agencies.

#### **2. Bills to Invalidate the OCC Preemption Regulations (H.R. 4236 and H.R. 4237).** Introduced by Rep. Gutierrez (D-Ill.) on April 28, 2004.

Status: Referred to the House Subcommittee on Financial Institutions and Consumer Credit.

Related Bills: S.J. Res. 31 and S.J. Res. 32

This bill would invalidate the Office of the Comptroller of the Currency's rule (published at 69 *Federal Register*, pp. 1895-1904) that clarifies the scope of the agency's

visitorial powers and describes the activities of national banks that are exclusively governed by the OCC. For more information about the OCC's rule, see *Banking Legislation and Policy*, January-March 2004.

**3. Rural Economic Investment Act of 2004 (H.R. 4295).** Introduced by Rep. Osborne (R-Neb.) on May 5, 2004.

Status: Referred to the House Committee on Ways and Means.

This bill would exempt banks from paying taxes on interest income earned from loans secured by agricultural real estate. The bill defines agricultural real estate as a rural property that is purchased or to which improvements have been made with funds from a real estate loan. The property must be used to produce at least one agricultural product and be the primary residence of the property's owner.

## SUMMARY OF FEDERAL REGULATIONS

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### Board of Governors of the Federal Reserve System

#### *Trust-Preferred Securities (5/19)*

The Board of Governors of the Federal Reserve System (the Board) issued a proposed rule allowing bank holding companies (BHCs) to continue to include trust-preferred securities in tier 1 capital, subject to stricter limits. These securities are issued by a special purpose entity (SPE) that is wholly owned by a bank holding company. Purchasers of these securities earn interest rather than dividends paid on traditional preferred stock. BHCs often prefer to issue trust-preferred securities because, unlike dividends, they can deduct interest expense from income and reduce their tax liability.

The Board is proposing to allow BHCs to include certain "restricted core elements" in their tier 1 capital, up to a limit of 25 percent of tier 1 capital, net of goodwill. Restricted core elements include: 1) qualifying trust-preferred securities; 2) qualifying cumulative perpetual preferred stock issued by the BHC; 3) Class B minority interest—a minority interest in qualifying cumulative perpetual preferred stock issued by a consolidated subsidiary that is either a U.S. depository or a foreign bank; and 4) Class C minority interest—a minority interest in qualifying common stockholders' equity or perpetual preferred stock issued by a consolidated subsidiary that is neither a U.S. depository nor a foreign bank.

Any restricted core elements in excess of the 25 percent tier 1 capital limit may be included in tier 2 capital; however Class C minority interest and qualifying trust-preferred securities are subject to tier 2 capital limitations as well. Excess Class C minority interest and qualifying trust-preferred securities, combined with subordinated debt and limited-life preferred stock, should be included in tier 2 capital but should be limited to 50 percent of tier 1 capital.

The Board also expects internationally active banking organizations to limit the aggregate amount of restricted core capital elements included in tier 1 capital to 15 percent

of the sum of all core capital elements, net of goodwill.

Comments on this proposed rule were due July 11. For more information, see 69 *Federal Register*, pp. 28851-60.

#### *Debit Fees (5/21)*

The Board of Governors of the Federal Reserve System (the Board) is conducting a study of debit card fee disclosures. The Board is specifically studying disclosures about fees imposed for point-of-sale purchases. The Board is considering whether current disclosures are adequate or if additional ones might be appropriate. Enhanced disclosures might be included in account holders' periodic statements and might inform the consumer about the amount of each fee imposed, as well as the source and recipient of each fee.

Comments on this notice were due July 23. For more information, see 69 *Federal Register*, pp. 29308-10.

#### *Overdraft Protection (6/7)*

The Board of Governors of the Federal Reserve System (the Board) is proposing a rule to revise Regulation DD by requiring depository institutions to make enhanced disclosures about overdraft and returned-check fees. Specifically, the proposed rule addresses "bounced-check protection" or "courtesy overdraft protection" services. Institutions that provide customers with periodic statements would be required to include the total fees assessed for overdrafts and for returned items for both the period and the year-to-date. The fees could not be combined and represented as fees for insufficient funds. In account opening statements, institutions must disclose that a fee may be imposed in connection with checks, ATM withdrawals, or other electronic fund transfers that overdraw the account.

The proposal also clarifies that banks are prohibited from making misrepresentations or misleading advertisements about customers' existing accounts. The proposal includes examples of these types of misrepresentation, such as representing an overdraft service as a "line of

credit," when the service is subject to the Board's Regulation Z, and representing that the institution will honor all checks or transactions, when the institution retains the discretion to not honor any transaction. In addition, in advertisements about overdraft protection services, depository institutions will be required to include the fee for the payment of each overdraft item, the types of transactions covered, the length of time consumers have to repay or cover any overdraft, and the circumstances under which the institution would not pay an overdraft. The requirement would not apply to advertisements on broadcast media, billboards, and telephone response machines but would apply to print, Internet, and e-mail advertisements.

In addition to the Board's rule, the Federal Financial Institutions Examination Council (FFIEC) developed a proposed supervisory guidance about overdraft protection services. The guidance addresses safety and soundness concerns, legal risks, and best practices for institutions offering overdraft protection services to follow. The guidance also warns institutions offering these services to comply with all applicable federal and state laws.

Comments on the proposed rule and the guidance were due August 6. For more information about the proposed rule, see *69 Federal Register*, pp. 31760-7. For more information about the FFIEC's guidance, see *69 Federal Register*, pp. 31858-64.

#### *Reporting Negative Information (6/15)*

The Board of Governors of the Federal Reserve System (the Board) issued a final rule to provide model notices for financial institutions to use when reporting that they have furnished negative information about an individual to a consumer reporting agency. The Fair and Accurate Credit Transactions (FACT) Act of 2003 requires that consumers receive a written notice when negative information about them has been or might be furnished by a financial institution to a nationwide consumer reporting agency. The model notices alert consumers that late payments, missed payments, and other defaults may be reported to credit bureaus and may be reflected on the individual's credit report. Financial institutions have 30 days to notify a consumer after reporting negative information about him or her to a consumer reporting agency. The model notices are intended to provide a safe harbor from liability under the FACT Act. Institutions that make minor changes to the notice would retain the safe harbor.

This final rule became effective July 16. For more information, see *69 Federal Register*, pp. 33281-5.

#### *Check 21 (6/18)*

The Board of Governors of the Federal Reserve System (the Board) issued a proposed rule to ensure that Regulation J covers the new check processing service options that the Reserve Banks plan to offer when the Check Clearing for the 21st Century Act becomes effective on October 28, 2004. (For more information on the Check 21 Act, see *Bank-*

*ing Legislation and Policy*, October-December 2003.) Regulation J governs the collection of checks and other items by the Reserve Banks. The proposed rule serves mostly to update the definitions in Regulation J, explicitly covering the Reserve Banks' handling of electronic items. The rule also acknowledges the substitute check warranties and indemnity that Reserve Banks and other banks will make under the Check 21 Act when handling a substitute check or a paper or electronic representation of that check. For instance, banks will be required to make the warranty that an item bears all of the endorsements previously applied by parties that handled the item for forward collection or return.

Comments on this proposed rule were due July 26. For more information, see *69 Federal Register*, pp. 34086-91.

#### *Clear and Conspicuous Disclosures (6/22)*

The Board of Governors of the Federal Reserve System (the Board) withdrew proposed revisions to Regulation B (Equal Credit Opportunity), Regulation E (Electronic Fund Transfers), Regulation M (Consumer Leasing), Regulation Z (Truth in Lending), and Regulation DD (Truth in Savings). Each of the regulations requires that "clear and conspicuous" disclosures be made. The proposed revisions, issued in December, attempted to make the definition of "clear and conspicuous" more uniform among the regulations. The Board withdrew the revisions in favor of developing proposals that focus on improving the effectiveness of individual disclosures rather than adopting general definitions and standards applicable across the five regulations.

For more information, see *69 Federal Register*, pp. 35541-3.

### **Office of the Comptroller of the Currency**

#### *Lending Limits (6/10)*

The Office of the Comptroller of the Currency (OCC) issued an interim final rule to permit national banks to make larger residential real estate and small business loans to single individuals. Specifically, the rule will extend by three years its pilot lending program that allows eligible national banks to have increased lending limits for residential real estate and small business loans in states that permit state-chartered banks to have higher lending limits than the federal lending limits. The program was set to expire on June 11, 2004, but banks authorized under the program may continue to lend at the higher limits until September 10, 2004. Banks may be eligible for the program if they meet standards proving they have sufficient capital and good managerial oversight. After being approved by the OCC, an eligible bank may use the special lending limits to lend more to single customers seeking residential and small business loans.

Usually, national banks can lend only 15 percent of unimpaired capital and surplus to a single borrower. Under the program, however, eligible banks may lend up to the

lesser of an additional 10 percent of capital and surplus or the state lending limit, with an absolute maximum not to exceed \$10 million more than the normal lending limit.

This interim final rule became effective June 10. For more information, see 69 *Federal Register*, pp. 32435-6.

#### *Medical Information (4/28)*

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration (together, the Agencies) issued a proposed rule to address sections of the Fair and Accurate Credit Transactions (FACT) Act that relate to consumer reports that contain medical information. (For more information on the FACT Act, see *Banking Legislation and Policy*, October-December 2003.) Generally, the FACT Act prohibits creditors from obtaining and using a consumer's medical information in connection with any decision about the consumer's eligibility, or continued eligibility, for credit. The proposed rule creates exceptions to allow creditors to use the information in certain circumstances.

A creditor may obtain medical information in connection with the extension of credit as long as it is for financial reasons. The information must relate to debts, expenses, income, benefits, collateral, or the purpose of the loan, including the proceeds. Further, the creditor must treat the information in the same manner as it would comparable information that is not medical (for example, the creditor must treat a \$20,000 debt to a hospital the same as it would a \$20,000 debt to a retailer). Also, the creditor may not make a credit decision based on the consumer's physical, mental, or behavioral health, including condition or history, type of treatment, or prognosis.

Other specific exemptions allow a creditor to use medical information in connection with determining a consumer's eligibility for credit when: 1) determining whether the use of a power of attorney or legal representative is necessary and appropriate; 2) complying with applicable local, state, and federal laws; 3) a consumer provides specific written consent for the information to be included in a consumer report from a consumer reporting agency; 4) preventing and detecting fraud; 5) determining and verifying the medical purpose of a loan and the use of proceeds, in the case of credit for the purpose of financing medical products or services; or 6) a consumer, or the consumer's legal representative, requests in writing that specific medical information be used for a specific purpose.

Finally, the proposed rule allows a company to share medical information in a consumer report with its affiliates if the information is: 1) used in connection with the business of insurance or annuities; 2) authorized to be shared under the Health Insurance Portability and Accountability Act of 1996; 3) shared for purposes of section 502(e) of the Gramm-Leach-Bliley Act; or 4) used by the affiliate to make a credit determination, and the affiliate

abides by the rules outlined in this proposed rule.

Comments on this proposed rule were due May 28. For more information, see 69 *Federal Register*, pp. 23380-407.

#### *Secured Credit Cards (4/28)*

The Office of the Comptroller of the Currency (OCC) issued an advisory letter to warn banks of the risks associated with secured credit cards. Secured credit cards function like unsecured credit cards except borrowers must present collateral to secure all or part of the credit loan. Secured credit cards are usually offered to consumers with little or no credit history or to individuals with a poor credit history. The OCC warns that secured credit cards may increase risks of customer default, create customer confusion, and have other adverse consequences. For instance, the programs may be an unfair practice banned by the Federal Trade Commission Act. Particularly, the OCC found that it is inappropriate for national banks to offer secured credit cards for which security deposits (and fees) are charged to the credit card account, with the result that the consumer has little or no available credit when the account opens. Banks should report all payment performance, including positive performance, to credit bureaus. Banks should not market secured credit cards with credit disability or credit life insurance products.

The OCC discouraged banks from offering secured credit card programs without first ensuring that they will adhere to consumer protection standards and that they will be underwritten, marketed, and managed in a safe and sound manner. The OCC urged banks to consider offering secured credit cards only as part of a "graduation" program in which secured credit card borrowers with good payment histories may progress to an unsecured credit program. Issuers should also consider paying customers interest on security deposits used as collateral for secured credit cards, and issuers should alert customers if they will not be paid interest.

For more information on this guidance, see the OCC's advisory letter, *AL 2004-4*.

#### *Disposal of Consumer Information (6/8)*

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) gave a notice of proposed rulemaking that would require financial institutions to develop, implement, and maintain appropriate procedures to properly dispose of consumer information. The Agencies are proposing to define consumer information as any information that is a consumer report or is derived from a consumer report. Financial institutions would also have to contractually require their service providers to develop appropriate measures for disposing of consumer information, and, when necessary, financial institutions may have to monitor their service providers to be sure they satisfy the requirements. The proposal comes

as a response to provisions of the Fair and Accurate Credit Transactions Act that aim to protect consumers against the risks associated with unauthorized access to information contained in consumer reports, such as fraud and identity theft.

Comments on the proposed rule were due July 23. For more information, see 69 *Federal Register*, pp. 31913-22.

## **Federal Deposit Insurance Corporation**

### *Stored-Value Cards (4/16)*

The Federal Deposit Insurance Corporation (FDIC) gave notice of a proposed rulemaking that would clarify when funds placed on stored-value cards may be considered deposits. The FDIC is revising a 1996 rule on stored-value cards. Stored-value cards store information electronically on a magnetic stripe or computer chip and can be used to purchase goods or services. The card's balance is debited at a merchant's point-of-sale terminal when a consumer makes a purchase.

Under the proposed rule, funds will not be considered deposits if: 1) the issuer of the cards is an insured depository institution (and not an employer or other sponsoring institution); and 2) the depository institution maintains a pooled "reserve account" but maintains no subaccounts or supplemental records reflecting the amount of money owed to particular cardholders. This proposed rule does not apply to closed systems (such as gift card systems sponsored by retailers) in which the merchant receives prepayment from the cardholder and does not receive payment through a bank. The proposed rule does not make any special distinctions for payroll cards, which are cards given to employees in lieu of paychecks. Rather, the rule would determine if the funds underlying payroll cards are deposits (and eligible for deposit insurance) by the same standards applied to all other types of stored-value cards.

Comments on this proposed rule were due July 15. For more information, see 69 *Federal Register*, pp. 20558-66.

## **Federal Trade Commission**

### *Identity Theft (4/28)*

As the Fair and Accurate Credit Transactions (FACT) Act of 2003 directed, the Federal Trade Commission (FTC) issued a proposed rule to address identity theft concerns. (For more information on the FACT Act, see *Banking Legislation and Policy*, October-December 2003.) The rule defines identity theft as a fraud committed or attempted using the identifying information of another person without lawful authority. An identity theft report is a report filed with a law enforcement agency that alleges identity theft with as much specificity as the consumer can provide. Within five days of filing an identity theft report, a consumer may be asked by a consumer reporting agency (CRA) to supply more information.

The FTC is proposing that an active duty alert will remain effective for 12 months, the minimum duration permitted by the FACT Act. If a member of the military should be on active duty for longer than 12 months, he or she may file an additional active duty alert. Finally, the FTC is proposing that CRAs develop and implement reasonable requirements for what information can be considered a consumer's proof of identity. Examples of information that may be considered proof of identity include a consumer's full name, any previously used names, full address, full Social Security number, date of birth, or other information such as a copy of a utility bill or the answer to a question only the consumer could be expected to know.

Comments on this proposed rule were due June 15. For more information, see 69 *Federal Register*, pp. 23370-8.

### *Free Annual Credit Reports (6/24)*

The Fair and Accurate Credit Transactions Act, enacted in December, requires that the three nationwide consumer reporting agencies (CRAs) provide consumers with a free copy of their credit report each year on request. The Federal Trade Commission (FTC) is requiring the nationwide CRAs to establish and maintain a "centralized source" to accept consumer requests for free credit reports. The centralized source must be accessible through an Internet web site, a toll-free telephone number, and a postal address. The centralized source will become available to consumers on a rolling basis. Beginning December 1, 2004, consumers in western states will become eligible. On March 1, 2005, consumers in midwestern states will have access to the centralized source, and consumers in southern states will become eligible on June 1, 2005. Finally, consumers in eastern states and Puerto Rico and all U.S. territories will become eligible on September 1, 2005.

The final rule permits the centralized source to collect only as much personally identifiable information as is necessary to complete the requests. The information may be used only to process the consumer's request, update the nationwide CRAs' consumer reporting databases, process any other transactions the consumer requests at the same time, and comply with applicable law.

The centralized source is expected to have adequate capacity to accept requests from a reasonably anticipated volume of consumers, but CRAs will have relief from the capacity requirements during times of unusually heavy request volume. During those busy times, CRAs are permitted to place consumer requests in a queue for processing or to ask consumers to try again at a later time.

The final rule also requires nationwide specialty CRAs — CRAs that maintain specific types of files on consumers, such as employment history, tenant history, medical records, and insurance claims — to maintain a toll-free telephone number through which consumers may request a free copy of their credit report once each year.

This final rule becomes effective December 1, 2004. For more information, see 69 *Federal Register*, pp. 35468-502.

## Securities and Exchange Commission

### *Market Timing (4/28)*

The Securities and Exchange Commission (SEC) issued a final rule to improve mutual fund disclosures about market timing and portfolio holdings. Beginning with statements filed on or after December 5, 2004, mutual funds will be required to make improved disclosures in fund prospectuses about the fund's risks, policies, and procedures. First, mutual funds will be required to describe any risks that frequent purchases and redemptions of fund shares may present for other shareholders. They must also state their policies on frequent purchases and redemptions. If they have no such policies, they must state why. In its Statement of Additional Information (SAI), a mutual fund must disclose any arrangements it has to permit frequent purchases and redemptions of fund shares. Insurance companies that offer variable insurance contracts must treat frequent transfers between subaccounts similarly in their prospectuses. Insurance companies must outline the risks of frequent transfers and describe the policies and procedures they have in place to handle frequent transfers. Mutual fund companies and insurance companies must explain, also in their prospectuses, the circumstances under which they will use fair value pricing and the effects of using fair value pricing. (Fair value pricing is a way of determining the value of a fund that might otherwise have a stale price, as in the case of a fund traded on a foreign exchange that closes before the U.S. market.)

Mutual funds and insurance-company-managed separate accounts that offer variable annuities will be required to disclose in their SAIs their policies and procedures about the disclosure of the fund's portfolio securities to any person. They must also state any ongoing arrangements they may have to disclose a fund's portfolio to any person.

This final rule became effective May 28, and statements filed on or after December 5 will be expected to be in compliance. For more information, see 69 *Federal Register*, pp. 22300-12.

### *Foreign Banks (4/30)*

The Securities and Exchange Commission (SEC) issued a final rule to extend an exemption from insider lending rules to eligible foreign banks. The rule defines a foreign bank as an institution that engages directly in the business of banking and has a home jurisdiction other than the United States where it is regulated as a bank. The SEC has an insider lending prohibition that bans, with a few exceptions, domestic and foreign securities issuers from making or arranging for loans to their directors and executive officers. One exemption permits personal loans by insured depository institutions if the loans are subject to the insider lending restrictions of the Federal Reserve Act. Insured depository institutions are defined as banks or savings associations that have deposits insured by the

Federal Deposit Insurance Corporation (FDIC). Since foreign banks cannot have their deposits insured by the FDIC, they do not currently qualify for the bank exemption. However, the final rule would extend the exemption to foreign banks if they meet certain conditions.

Foreign banks, their affiliates, and parent companies may extend, maintain, arrange for, or renew personal loans to or for any of their directors or executive officers if either: 1) they are subject to their home jurisdiction's laws and regulations that require banks to insure deposits or be subject to a deposit guarantee or protection scheme, or 2) the Board of Governors of the Federal Reserve System has determined that the foreign bank is subject to comprehensive supervision or regulation by the bank supervisor in its home jurisdiction. Loans made by foreign banks to officers and executives must have substantially the same terms as those of comparable loans by the foreign bank to unaffiliated individuals. The loans must be available to all employees and not give preference to bank executives and officers. Finally, the loan must receive approval from the foreign bank's supervisor in its home jurisdiction.

This final rule became effective April 30. For more information, see 69 *Federal Register*, pp. 24016-25.

### *Thrift Broker-Dealer Exemption (5/7)*

The Securities and Exchange Commission (SEC) is proposing a rule to exempt savings associations from the Investment Advisers Act in some cases. The Investment Advisers Act regulates the activities of individuals whose regular business involves providing others with advice about securities for compensation. Currently, banks are not considered "investment advisers" under the act, but thrifts are not offered the same exemption. The proposed rule would exempt thrifts from the act when they provide investment advice in their capacity as trustee, executor, administrator, or guardian for trusts, estates, guardianships, and other accounts created and maintained for a fiduciary purpose. Thrifts will also be exempt from the law when offering investment advisory services for a collective trust fund maintained by the thrift. However, thrifts would still be subject to the act's provisions when they provide other investment advisory services, including advising mutual funds, offering managed agency accounts, or providing retail financial planning services.

Comments on this proposed rule were due July 9. For more information, see 69 *Federal Register*, pp. 25778-90.

### *Regulation B (6/30)*

The Securities and Exchange Commission (SEC) issued a proposed rule, Regulation B, to implement provisions of the Gramm-Leach-Bliley Act (GLBA) that outline the activities banks may engage in without registering as brokers under the Securities and Exchange Act. The networking exception allows banks to partner with

broker-dealers in offering their customers a wide range of financial services, including securities brokerage. Under this exception, a broker-dealer offers brokerage services to bank customers and shares compensation with the bank. Unregistered bank employees would be allowed to receive incentive compensation in the form of a nominal one-time fee for referring bank customers to the broker-dealer. The SEC defines a nominal fee as either the employee's base hourly rate of pay, a \$25 flat rate, or an inflation-adjusted amount based on \$15 in 1999.

The trust and fiduciary account exception allows a bank to receive "sales compensation" for making transactions for its customers in a trustee or fiduciary capacity. Under this exception, a bank must conduct the transactions in its trust department or another department that is regularly evaluated by bank examiners. Banks must be "chiefly compensated" for securities transactions by "relationship compensation" (such as an annual fee, a percentage of assets under management, or a flat or capped per order processing fee). This means that relationship compensation must exceed sales compensation on an account-by-account basis. A bank may also assess its compensation on an aggregate basis using a nine-to-one ratio for relationship to sales compensation.

The proposed rule also outlines a bank custody exception that gives a bank, acting as a custodian, legal certainty that it may engage in certain securities transactions while holding the funds and securities related to the transactions. Permitted transactions include the safekeeping of securities, settling trades, investing cash balances as directed, collecting income, pricing securities positions, and providing recordkeeping and reporting services. The exception extends to individual retirement accounts, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plans for which a bank acts as a custodian. A bank may accept securities orders so long as the fees it receives for clearing and settling securities transactions do not vary based on whether the bank accepts an order to purchase or sell a security. The rule would grandfather all existing custody accounts to avoid disrupting existing custody relationships.

Other exceptions include the sweep accounts exception, which allows a bank to participate in mixed product arrangements in which the bank offers a mutual fund "sweep" service linked to deposit accounts. The affiliate transactions exception applies to a bank making trades for the accounts of its affiliates, other than those that are registered broker-dealers or engaged in merchant banking. Affiliates, including operating subsidiaries and other subsidiaries of the bank, may not use the bank exceptions and exemptions from the definitions of broker and dealer. Another proposed exception would permit a bank to conduct broker-dealer business with offshore, non-U.S. persons on an agency or riskless principal basis. Another general exemption, not tied to any GLBA provisions, would allow banks to buy and sell money market securities for bank customers who are "qualified

investors," a person who directs the purchase of securities from any cash flows that relate to an asset-backed security that has a minimum original asset amount of \$25 million, and for other customers for whom banks act in a trustee or fiduciary capacity, or in an escrow agent, collateral agent, depository agent, or paying agent capacity.

Comments on this proposed rule were due August 2. For more information, see *69 Federal Register*, pp. 39682-739.

## **Office of Thrift Supervision**

### *Assessments and Fees (5/28)*

The Office of Thrift Supervision (OTS) issued a final rule to replace examination fees for savings and loan holding companies (SLHCs) with semi-annual assessments. The OTS will charge a base assessment amount and will add up to three additional components to the base amount. The additional assessments will be based on the SLHC's asset size, its risk or complexity, its organizational form, and its condition. For more information, see a summary of the proposed rule in *Banking Legislation and Policy*, January-March 2004.

This final rule became effective July 1, 2004. For more information, see *69 Federal Register*, pp. 30554-71.

## **Department of Housing and Urban Development**

### *Loss Mitigation (4/14)*

The Department of Housing and Urban Development (HUD) issued a proposed rule to provide for treble damages for mortgage lenders that fail to engage in loss mitigation techniques. Loss mitigation is an attempt by a lender to help a borrower avoid foreclosure even if the borrower is unable to make payments and is in danger of defaulting on the loan. Under the proposed rule, when a borrower misses three monthly mortgage installments, mortgage lenders are required to assess all of the loss mitigation strategies that are available each month. The lender should document which of the strategies are used to help mitigate losses in the situation. HUD will evaluate mortgage lenders' loss mitigation performance by rating them within a range from 1 (for the best performers) to 4 (for mortgage lenders who engage in little to no loss mitigation). When these lenders fail to engage in appropriate loss mitigation strategies, they may be subject to a penalty equal to three times the amount of any mortgage insurance benefits they claim. Additionally, when a mortgage lender files a claim, it must include all documentation showing proof of attempts to engage in loss mitigation. If a lender is thwarted because of a natural disaster or because of an ineligible or uncooperative borrower, the lender will not be held responsible for failure to mitigate losses.

Comments on this proposed rule were due June 14. For more information, see *69 Federal Register*, pp. 19906-13.

### **Regulation Z's Exclusion of Over-Limit Fees from Finance Charges Is Reasonable**

The U.S. Supreme Court overturned an appeals court ruling, saying that the Board of Governors of the Federal Reserve System (the Board) has the authority to make rules excluding credit card over-limit fees from the definition of "finance charges" (*Household Services Inc. v. Pfennig*, No. 02-857). Originally, Sharon Pfennig brought suit against her credit card issuer, Household Credit Services. She claimed that although she had a credit limit of \$2000, Household approved transactions that allowed her balance to go beyond the account limit. Household then imposed an over-limit charge each month that her account balance exceeded \$2000. Household did not disclose the fees as part of the finance charges, as Pfennig argued it should have done under the Truth in Lending Act (TILA).

TILA regulates, among other things, the disclosures that credit card issuers must make to consumers. TILA gives the Board the authority to issue regulations to implement the act. In this case, the court found that TILA did not unambiguously include or exclude over-limit fees from finance charges. After reviewing the Board's interpretation in Regulation Z, the court found that the Board explicitly excluded over-limit fees from finance charges, saying that the charges are not automatically recurring and are imposed only when a consumer defaults on a credit agreement. Therefore, while over-limit charges might be relevant to a consumer's credit decision, they are not as relevant to determining the true cost of credit. The Supreme Court found that the Board's decision was reasonable and that Regulation Z's standard was clear and easy to apply.

### **State Laws May Apply to Federal Thrifts Under Choice of Law Contracts**

In early April the U.S. Supreme Court declined to hear an appeal challenging a decision that permits state laws to apply to a federal savings association if the thrift included the state laws in customer contract agreements (*Wells v. Chevy Chase Bank, F.S.B.*, No. 41). In September 2003, Maryland's highest court, the Court of Appeals, overturned a lower court's ruling and determined that because Chevy Chase Bank included a Maryland state law as a "governing law" in its cardholder agreement, Chevy Chase subjected itself to the state law, even though it would ordinarily be preempted by the Home Owners' Loan Act, a federal law. The court ruled that the bank prepared the agreement and referenced the state law, so it should be expected to honor the terms of the agreement, including the requirements of the state law.

America's Community Bankers, the Connecticut Bankers Association, the Maryland Bankers Association, the New Jersey League of Community Bankers, and the North

Carolina Bankers Association together, in support of Chevy Chase Bank, petitioned the U.S. Supreme Court to review the Maryland Appeals Court's decision (No. 03-918). The groups expressed concern that the decision might undermine the federal preemption framework that the Office of Thrift Supervision and the Office of the Comptroller of the Currency have been trying to reinforce.

### **Supreme Court Declines to Block Class Action Suit Against Allstate**

The U.S. Chamber of Commerce (Chamber) filed a brief with the U.S. Supreme Court requesting that it review a decision to allow a class action lawsuit against Allstate Corporation that claimed the insurance company violated the Fair Housing Act (FHA) by using credit scores to price insurance policies (*Allstate Corporation, et al., v. DeHoyos, et al.* No. 03-1214). In September 2003 the U.S. Court of Appeals for the Fifth Circuit was divided in a ruling that permitted the class to form. The class alleges that Allstate's use of credit-scoring programs to evaluate risk has a disparate impact on non-Caucasians, which is illegal discrimination under the FHA. Allstate contended that disparate impact claims under the FHA, a federal law, were precluded by the McCarran-Ferguson Act. Allstate argued that the McCarran Act was established by Congress to ensure that the insurance industry was regulated by state, not federal, law. The court of appeals rejected that argument, saying that Allstate failed to show any state law with which the federal civil rights law conflicts and were offering no more than a "field preemption" argument. On April 26, the Supreme Court denied the Chamber's petition to retry the case.

### **Bank Sends Customers Misleading Account Notices After a Merger**

The U.S. Court of Appeals for the First Circuit ruled that Fleet National Bank violated the Truth in Savings Act (TISA) by sending inaccurate and misleading account notices to customers after its merger with BankBoston (*Barnes v. Fleet National Bank, N.A.*, No. 03-1027). The appellant, Deborah Barnes, brought suit against Fleet after she received a notice from the bank that her account terms would be changing as a result of Fleet's acquisition of her bank, BankBoston. The notice alerted Barnes that her BankBoston account would be switched to the type of Fleet account that was most similar to hers and that she didn't need to do anything because the conversion would happen automatically. However, the Fleet account chosen would have required Barnes to keep an average monthly balance that was double her current account's requirements or else be subject to a fee that was close to double her current account's fee. The notice also contained conflict-

ing and misleading statements about the dates on which the changes would become effective. Not wanting to raise her monthly balance or incur higher fees, Barnes hurried to switch her account before April 12, thinking that was the effective date.

Barnes brought suit against Fleet, alleging that the bank violated TISA and a Massachusetts consumer protection statute by sending out inaccurate and misleading notices. She alleged that the bank did not accurately convey the actual effective date of her new account's terms and fees. Barnes asserted that by explicitly saying the account changes would take effect April 12, the bank did not clearly and conspicuously indicate the correct effective date. The court agreed, ruling that it was unreasonable to expect Barnes to ignore the letter's plain statement that the changes would take effect on April 12 and instead calculate the effective date differently. The court said, "This convoluted method of disclosure does not even come close to satisfying the 'clearly and conspicuously' standard."

Barnes also alleged that it was misleading to tell customers they need not do anything because their accounts would be automatically switched to the Fleet account that most closely matched their current account. The court agreed that Fleet's implication that the conversion from BankBoston to Fleet accounts would have little or no effect on account terms was misleading, in violation of TISA.

The court reversed a district court's granting of summary judgment for Fleet and granted summary judgment to Barnes. The case was remanded for further proceedings to determine statutory damages and to consider Barnes's motion for class certification.

### **Court Rejects Allegations That the FDIC Wrongly Calculated a Deposit Assessment**

The U.S. Court of Appeals for the District of Columbia Circuit dismissed banks' claims that the Federal Deposit Insurance Corporation (FDIC) miscalculated a one-time special deposit insurance assessment mandated by the Deposit Insurance Funds Act (Funds Act) (*Wells Fargo*

*Bank, N.A., et al., v. Federal Deposit Insurance Corporation*, No. 03-5198). In 1996, Congress was beginning to worry that the Savings Association Insurance Fund (SAIF) was undercapitalized and passed the Funds Act to require the FDIC to impose a one-time assessment on deposits to bring the fund up to the designated reserve ratio, which was 1.25 percent of estimated insured deposits. To calculate the assessments, the FDIC determined the total amount of SAIF-insured deposits to be \$688.1 billion. In its calculation, the FDIC included adjusted attributable deposit amounts (AADA), or SAIF-insured deposits that had been acquired by a Bank Insurance Fund (BIF) member. Next, based on the amount of insured deposits, the FDIC calculated that the required designated reserve ratio was \$8.6 billion, and to reach that amount, the fund would need an additional \$4.5 billion. To meet that goal, the FDIC assessed 65.7 cents for every \$100 of insured deposits.

Several dozen financial institutions requested a refund from the FDIC, saying that the agency miscalculated the assessment by including AADA deposits. The banks claimed that if the AADA deposits had not been included, their assessments would have been about \$800 million lower, arguing that the AADA deposits should not have been included because they had been acquired by BIF members and therefore were not a part of the SAIF. The court ruled that this argument relies on the assumption that an institution could not be a member of both the BIF and the SAIF. The court pointed out that the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), the act that created the BIF and the SAIF, never precluded an institution from membership in both funds. And since the Funds Act takes its definitions of "SAIF member" and "BIF member" from FIRREA, the court could not find that the Funds Act precluded membership in both funds. Therefore, the court found that Congress did not clearly mean to exclude AADA deposits from the assessment formula, and the court affirmed a district court's dismissal of the case.

## **SUMMARY OF THIRD DISTRICT DEVELOPMENTS**

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### **New Jersey**

On May 26 the Supreme Court of New Jersey ruled that the Office of Thrift Supervision (OTS) did not overstep its bounds by issuing a rule in 1996 that permitted state-chartered lending institutions to charge prepayment penalties in alternative mortgage transactions (AMTs), even when the lender's state prohibited the fees (*Glukowsky*

*v. Equity One Inc.* No. A-22). The case arose after Equity One charged Mark Glukowsky a prepayment penalty on his "balloon loan" alternative mortgage transaction. Glukowsky sued the lender, contending that Equity One violated a New Jersey law that prohibits prepayment fees on AMTs. Equity One argued that it was permitted to charge the fee because in 1996 the OTS issued a rule, under the

Alternative Mortgage Transactions Parity Act, that allowed state-chartered lenders the same ability as federal lenders to charge prepayment penalties on AMTs. At issue was whether the OTS exceeded the scope of its authority by issuing the regulation. The court ruled that the OTS was reasonable in its interpretation of the Parity Act and that it was within the agency's authority to issue the regulation, which was later revised in 2002.

### **Pennsylvania**

The Federal Trade Commission filed a consent decree with the U.S. District Court for the Eastern District of Pennsylvania that will require a debt collector to pay a \$1.5 million civil penalty and refrain from future violations of the Fair Credit Reporting Act (FCRA) (*U.S. v. NCO Group, Inc.*, No.

992-3012). The FCRA requires, among other things, that anyone reporting information to credit bureaus about a delinquent account that has been placed for collection or written off must report the actual month and year the account first became delinquent. This date is used by credit bureaus to measure the maximum seven-year reporting period the FCRA requires and helps ensure that outdated debts do not appear in a consumer's credit report. NCO Group was charged with violating the law by reporting delinquent accounts using dates that were later than the actual delinquency dates. NCO Group, without admitting liability for any of the allegations, agreed to pay the \$1.5 million penalty and take measures to ensure compliance with the FCRA in the future.



FEDERAL RESERVE BANK OF PHILADELPHIA

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