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Recent Developments

Countrywide Home Loans Settles New York Loan Pricing Suit

On December 5, New York State’s attorney general announced that his office had reached an agreement with Countrywide Home Loans to settle accusations of biased lending practices. The settlement stems from an investigation into the mortgage lender’s loans to black and Latino customers in New York in 2004. According to Home Mortgage Disclosure Act (HMDA) data, black and Latino customers were more likely than white customers to receive

high-priced loans. The attorney general considered the degree to which legitimate factors, such as borrower credit scores and outstanding debt, increased the loan prices and determined that these factors did not completely explain the higher costs. Furthermore, the difference between loans to whites and loans to minorities was pronounced when loans were generated by mortgage brokers.

While Countrywide denies the allegations and disputes the attorney general’s findings, it agreed to enhance its fair lending monitoring activities, compensate minor-

ity borrowers who were improperly given costlier loans, and institute a \$3 million education program that will help consumers make informed choices about mortgage loan products.

For more information, reference the settlement under press releases, select 12/05/06, at www.oag.state.ny.us/

OFHEO Announces Procedures for Setting Conforming Loan Limit After Housing Price Decrease

The Office of Federal Housing Enterprise Oversight announced its procedures for setting Fannie Mae's and Freddie Mac's conforming loan limits for 2007 in the event of decreasing home prices. The conforming loan limit is the maximum mortgage amount that Fannie Mae or Freddie Mac can buy or guarantee. In 2006, the limit for single family houses in most of the United States was \$417,000.

The conforming loan limit is typically adjusted based on the October-to-October percentage increase in the aver-

age house price. However, because the October 2006 home prices were predicted to be lower than they were one year before, the OFHEO announced procedures for making a downward adjustment.

The OFHEO determined that if the percentage change in home prices is negative, the adjustment to conforming loan limits will be delayed one year and will only be instituted if this second year is also negative. For example, if the October 2006 house prices are less than the October 2005 house prices, the conforming loan limit will be unchanged for 2007. However, if the October 2007 house prices are less than the October 2006 house prices, the 2008 conforming loan limit will be adjusted downward based on the change in home prices the year before (October 2006).

For more information about the procedures, see the OFHEO's news release at www.ofheo.gov/media/pdf/PRConfLoan2007.pdf.

SUMMARY OF FEDERAL LEGISLATION

Enacted Legislation

1. Financial Netting Improvements Act of 2006 (H.R. 5585). Introduced by Rep. McHenry (R-N.C.) on June 12, 2006.

Status: Became Public Law No. 109-390 on December 12, 2006.

This law makes it easier for companies to net out their debts on derivative contracts and reduce the risk of loss in the event of a counterparty going bankrupt. Counterparties to derivative contracts (such as swaps, forwards, and repurchase agreements) will be permitted to offset their obligations to one another in the event of one party's failure. For more information about this law, see *Banking Legislation and Policy*, July-September 2006.

New Legislation

1. Amendment to the Federal Deposit Insurance Act (H.R. 6345). Introduced by Rep. Bachus (R-Ala.) on December 5, 2006.

Status: Passed the House and the Senate; awaiting the president's signature.

This bill was created to correct an omission made in the Financial Services Regulatory Relief Act (S. 2856), which was introduced in May 2006. The Regulatory Relief Act raised the asset threshold from \$250 million to \$500 million for banks to be eligible for streamlined exams. (For more information about the Regulatory Relief Act, see *Banking Legislation and Policy*, July-September 2006.) Under the previous threshold, banks were eligible for the streamlined exam if they received an "outstanding" or a "good" rating. However, the Regulatory Relief Act mistakenly included only institutions with outstanding ratings and neglected to include institutions with good ratings. This bill corrects the omission.

SUMMARY OF FEDERAL REGULATIONS

Board of Governors of the Federal Reserve System

Nontraditional Mortgage Products (10/4)

The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration (together, the Agencies) issued a guidance on nontraditional mortgage product risks. A mortgage product is considered nontraditional if it allows borrowers to defer payment of principal and, sometimes, interest. Examples include "in-

terest-only" mortgages and "payment option" adjustable-rate mortgages that allow borrowers to make lower payments in the beginning of the loan term and larger payments later.

When an institution offers nontraditional mortgage products, it must verify that the borrower is able to repay the loan, especially when it begins to amortize. Special consideration is warranted when borrowers have high loan-to-value ratios, high debt-to-income ratios, and low credit scores. In addition, institutions should avoid making collateral-dependent loans when borrowers do not other-

wise exhibit the capacity to repay a loan. Further, as credit risk increases, banks are expected to more fully document the borrower's income and debt capacity.

Institutions should also take measures to disclose the risks of nontraditional mortgage products to consumers. When consumers are shopping for a mortgage loan, they should find clear product descriptions that explain the costs, terms, features, and risks of nontraditional mortgage products. Institutions should explain that periodic payments may increase due to interest rate changes or negative amortization. Consumers should be told that negative amortization may result in increasing principal balances and decreasing home equity. If prepayment penalties may be imposed, they should be disclosed to the consumer. In cases where reduced and full documentation loans are available, consumers should be alerted if the reduced documentation loan is offered at a premium. Finally, monthly statements should clearly show payment options and the effect each option has on the outstanding balance, principal amount, home equity, and future payments.

For more information about this guidance, see 71 *Federal Register*, pp. 58609-18.

Electronic Fund Transfers (12/1)

The Board of Governors of the Federal Reserve System issued a final rule to revise Regulation E, which implements the Electronic Fund Transfer Act. The rule requires merchants to notify check-paying customers at the point of sale if they plan to collect fees for insufficient funds electronically. A customer can then decide whether to engage in the transaction. Beginning in 2007, merchants must post this notice in a prominent place near the register and provide a copy to the customer. Also, beginning in 2008, the notice must disclose the dollar amount of the insufficient funds fee and an explanation of how the fee is calculated.

This final rule became effective on January 1, 2007. For more information, see 71 *Federal Register*, pp. 69430-8.

Insider Lending (12/11)

The Board of Governors of the Federal Reserve System (the Board) issued an interim final rule to eliminate some of the reporting and disclosure requirements for banks' insider lending. Insider lending (lending by a bank to its executive officers, directors, and principal shareholders) is restricted by the Federal Reserve Act and the Board's Regulation O. However, the Financial Services Regulatory Relief Act of 2006 eliminated some provisions of the Federal Reserve Act that required disclosures and reports about certain cases of insider lending. (For more information about the Financial Services Regulatory Relief Act, see *Banking Legislation and Policy*, July-September 2006.) This interim final rule eliminates the requirement that member banks' executive officers file a report with their boards of directors whenever they obtain a loan from another bank that is larger than a loan they could receive from their own member bank. In addition, a member bank will no longer be required to file separate reports with its quarterly call reports (reports on condition and income) on extensions of

credit to executive officers since its last call report. Finally, a member bank will no longer have to report or publicly disclose loans to its executive officers from its correspondent banks.

This interim final rule became effective on December 11, 2006, and comments on it were due January 10, 2007. For more information, see 71 *Federal Register*, pp. 71472-5.

Allowance for Loan and Lease Losses (12/13)

The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of Thrift Supervision (together, the Agencies) issued a policy statement on allowances for loan and lease losses (ALLLs). It updates the Agencies' previous statement, in 1993, to ensure consistency with generally accepted accounting principles.

The guidance stipulates that financial institutions should review their loans to determine collectibility and make any necessary changes to their ALLL. Loans may be analyzed in groups if they have similar characteristics. If a financial institution determines that a loan, or any portion of a group of loans, is uncollectible, it should be charged off against the ALLL immediately. Banks should follow the guidelines stipulated in FAS 114 (Financial Accounting Standards Board guidance on *Accounting by Creditors for Impairment of a Loan*) when writing off individual loans, and they should adhere to the guidelines of FAS 5 (*Accounting for Contingencies*) for groups of impaired loans.

In determining estimated credit losses, a bank should first consider the historical loss rate for groups of loans with similar characteristics, but then it should also consider other environmental or qualitative factors that may influence credit losses. Such factors may include changes to lending policies, economic or business conditions, the nature and volume of a loan portfolio, the terms of the loans, the quality of the loan review system, the value of collateral, competition, and legal or regulatory changes.

An institution's management should adopt written procedures to ensure that its ALLL is set at an appropriate level. The procedures should describe an effective analysis of the loan portfolio, institute a loan review system, ensure adequate data capturing and reporting systems to provide information for setting the ALLL, and require periodic validation of the ALLL methodology.

The board of directors is then responsible for overseeing management's ALLL determination. In doing so, the board should review the written policies, ensure that the loan review system is sound, and require management to validate or potentially revise the ALLL methodology.

For more information about this guidance, see www.federalreserve.gov/boarddocs/srletters/2006/SR0617a1.pdf.

Regulatory Capital (12/14)

The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (together, the Agencies) announced that the

Financial Accounting Standards Board's Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (FAS 158), will not affect banking organizations' regulatory capital.

FAS 158 requires banks that sponsor single-employer defined benefit postretirement plans, such as pension or health-care plans, to recognize the overfunded or underfunded status of each plan as an asset or liability on their balance sheets. Then the institutions must make corresponding adjustments to their recorded "accumulated other comprehensive income" (AOCI), which is a component of equity capital. However, the Agencies announced that these changes in AOCI should be excluded from banks' regulatory capital.

For more information about this announcement, see the Agencies' press release at www.federalreserve.gov/boarddocs/press/bcreg/2006/20061214/default.htm.

Risk-Based Capital (12/26)

The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (together, the Agencies) issued a proposed rule to implement new risk-based capital regulations for non-Basel II banks. Banks are subject to Basel II if they have consolidated assets of \$250 billion or more, or consolidated foreign exposures of \$10 billion or more. In addition, banks not meeting these criteria may volunteer to be a Basel II bank. Basel II prescribes "advanced methods" that must be used to calculate risk-weighted assets. Among other provisions, it requires internal assessments of credit risk and operational risk. (For more information about Basel II, see *Banking Legislation and Policy*, July-September 2006.) For banks that are not required to adhere to Basel II, the Agencies propose to offer the option of continuing to operate under existing risk-based capital regulations or adopting a new framework (Basel IA) that is intended to be more sensitive to varying levels of risk.

As a condition of adopting the Basel IA framework, banks must agree to adopt all of its provisions, not just those that are more favorable than existing practices. To adopt the new framework, a bank must inform its primary regulator. A bank may request to convert back to the existing risk-based capital rules at any time, again by informing its primary regulator.

Like existing rules, Basel IA will continue to account for interest rate risk and operational risk implicitly, rather than requiring a separate analysis, as Basel II does. Also, Basel IA will not change the existing leverage ratio requirement (ratio of tier 1 capital to total assets) from the current standard.

The Basel IA framework will add three new risk-weight categories to the existing five categories. The current framework has the following categories: zero, 20, 50, 100, and 200 percent. Banks that adopt Basel IA will also have the following additional categories: 35, 75, and 150 percent. The Agencies intend that this will provide greater

differentiation between degrees of credit exposure.

The Agencies also propose to expand the list of exposures that may be rated by a nationally recognized statistical rating organization (NRSRO). Currently, banks may use an NRSRO's rating to assign risk weights to recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage-backed securities. Banks adopting Basel IA may also use NRSRO ratings to assign risk weights to sovereign debt and debt securities, in addition to debt securities issued by nonsovereign entities and rated loans to nonsovereign entities. These entities include securities firms, insurance companies, bank holding companies, savings and loan holding companies, multilateral lending and regional development institutions, partnerships, limited liability companies, business trusts, special purpose entities, associations, and other similar organizations. If an exposure has two or more external ratings, the bank must use the lowest rating. Similarly, if different components of the same exposure have different external ratings, the lowest rating must be assigned to the entire exposure. And if an exposure has a component with no external rating, the entire exposure must be treated as unrated.

The Agencies also propose to expand the types of recognized collateral beyond the current categories of (1) cash on deposit; (2) securities issued or guaranteed by central governments of OECD countries; (3) securities issued or guaranteed by the U.S. government or its agencies; (4) securities issued or guaranteed by U.S. government-sponsored agencies; and (5) securities issued by certain multilateral lending institutions or regional development banks. Basel IA banks may also recognize long- and short-term debt securities and securitization exposures that are (1) issued or guaranteed by a sovereign that has an issuer rating that is at least investment grade; or (2) issued by either a sovereign or a nonsovereign where the securities are externally rated at least investment grade by an NRSRO.

Basel IA also expands the risk-weight categories for first-lien mortgages on one- to four-family residences. Under current practice, these loans are assigned to one of two categories: 50 or 100 percent. Under Basel IA, banks will use a mortgage's loan-to-value (LTV) ratio to assign the exposure to one of six risk-weight categories that range from 20 percent to 150 percent. LTVs would be calculated on origination and would be updated only when a borrower refinances the mortgage.

Finally, Basel IA will remove the existing 50 percent limit for risk weights for derivative contracts. Because there are now a greater number and variety of counterparties to derivatives contracts, the Agencies believe some warrant a risk weight that is greater than 50 percent. For that reason, the proposal removes the limit and stipulates that a derivative contract's risk weight will now be equal to the risk weight assigned to the counterparty.

Comments on this proposal are due March 26, 2007. For more information, see 71 *Federal Register*, pp. 77446-518.

Broker Exception (12/26)

The Board of Governors of the Federal Reserve System and the Securities and Exchange Commission (together, the Agencies) issued a proposed rule to designate exceptions to the term “broker” for banks under the Gramm-Leach-Bliley Act (GLBA). Before 1999, when the GLBA was passed, banks were exempted from rules that required all securities dealers to register with the SEC as brokers. The GLBA replaced the blanket exemption with 11 specific exceptions, which this proposal implements.

The GLBA creates an exception from broker consideration for banks that contract with third-party registered broker-dealers to offer brokerage services to bank customers. As part of this arrangement, bank employees are permitted to receive a one-time nominal referral fee, as long as the fee does not depend on whether the referral results in a transaction. To be considered nominal, the fee must meet one of three tests. First, it must be no more than twice the average of the minimum and maximum hourly wage for employees in the same job family (for example, all tellers or all loan officers). Alternatively, the fee may be no more than 1/1000th of the average of the minimum and maximum annual salary for employees in the same job family. The second test would require the fee to be no more than twice the employee’s hourly wage. The last test would require the fee to be less than or equal to \$25. All referral fees must be paid in cash, and the fee must be fixed.

Bank employees may receive a higher than nominal fee for referring high net worth customers to a registered broker-dealer. To be considered of high net worth, an institutional customer must have at least \$10 million in investments or \$40 million in assets. Individual customers will be considered of high net worth if they, individually or together with a spouse, have at least \$5 million in net worth, excluding their homes. To receive a higher than nominal fee for referring these customers, a bank employee must not be predominately engaged in making referrals to broker-dealers, and the employee must encounter the customer in the ordinary course of his or her assigned duties at the bank. Further, the employee must disclose to the customer that he or she may receive a higher than nominal fee for the referral, and the fee may be contingent on a transaction’s occurrence.

The GLBA permits banks to engage in securities transactions as either a trustee or a fiduciary without being registered as a broker. The bank must handle the transactions in its trust department or another department that is regularly reviewed by bank examiners. The bank may not publicly solicit brokerage business, except to advertise that they offer the service. Further, the bank’s relationship compensation for the services must be at least 70 percent of the total compensation. This can be calculated on an account-by-account basis or an aggregate basis. Relationship compensation comes from (1) administrative or annual fees; (2) the percentage of assets under management; (3) a flat or capped per order processing fee; or (4) a combination of these fees. To execute the trade of a security under

this section, a bank must direct the trade to a registered broker-dealer, or effect a cross-trade within the bank or between the bank and an affiliated fiduciary.

Under the proposal, banks are also exempted from registering as brokers if they deposit funds into sweep accounts or money-market funds. To be eligible for the sweep exception, the deposit funds must be invested in no-load, open-end management investment companies’ money-market funds. To be considered no load, the securities must be part of a transaction for which there is no sales charge.

The GLBA also permits banks to perform certain safekeeping or custodial duties on behalf of customers without registering as brokers. For instance, a bank may provide safekeeping services for securities, including exercising warrants or other rights on behalf of a customer, or it may transfer funds or securities, like a clearing agency, during the clearance and settlement of a customer’s securities transactions. The proposal also permits banks to accept orders for securities from employee benefit retirement accounts and individual retirement accounts for which the bank is the custodian or from other custodial accounts.

Comments on this proposed rule are due March 26, 2007. For more information, see 71 *Federal Register*, pp. 77522-50.

Federal Deposit Insurance Corporation

One-Time Assessment Credit (10/18)

The Federal Deposit Insurance Corporation (FDIC) issued a final rule to describe and implement the one-time deposit insurance assessment credit that will be afforded to eligible institutions. To be eligible, an institution must have existed as of December 31, 1996, and it must have paid at least one deposit insurance assessment before then. An institution may also be eligible if it is a successor to an institution that would otherwise qualify. The FDIC defines successor as an institution resulting from a merger or consolidation, as well as a *de novo* institution as of December 31, 1996 (ordinarily not eligible for a credit) that acquired another eligible institution.

The FDIC determined the aggregate assessment amount by applying an assessment rate of 10.5 basis points to the combined assessment base of the SAIF and the BIF as of December 31, 2001. (The assessment base is the amount of all deposits on which an assessment is levied and paid into the insurance funds.) The resulting aggregate assessment credit is more than \$4.7 billion. To determine each eligible institution’s share, the FDIC will calculate the institution’s assessment base ratio as of December 31, 1996. To do that, the FDIC will add the assessment bases of each eligible institution and any successor institutions. This will be the numerator of the assessment base ratio. The denominator will be the aggregate assessment base of all eligible institutions and their successors on December 31, 1996. The FDIC will then multiply that ratio by the aggregate assessment credit to determine each eligible institution’s one-time assessment credit.

Once the FDIC determines each institution's assessment credit amount, it will notify the institution and provide it with 30 days to request a review of either its eligibility or the credit amount.

The FDIC will track each institution's credits and apply them to future assessments to the maximum extent allowed by law. For 2007, credits can be used to pay 100 percent of an institution's assessment. In 2008, 2009, and 2010, credits may be used to pay up to only 90 percent of an institution's assessment. In addition, if the FDIC institutes a DIF restoration plan (if and when the DIF falls below 1.15 percent of all estimated insured deposits), the FDIC may limit the use of credits to pay assessments.

This final rule became effective on November 17, 2006. For more information, see 71 *Federal Register*, pp. 61374-85.

Deposit Insurance Assessment Penalties (11/9)

The Federal Deposit Insurance Corporation (FDIC) issued a final rule to institute penalties for failure to pay deposit insurance assessments on time. For assessments greater than \$10,000, a depository institution will owe 1 percent of the assessment amount for each day the assessment is overdue. For assessment amounts less than \$10,000, depository institutions will owe \$100 for each day the assessment is overdue. Institutions are exempt from paying a penalty on assessments that are overdue because of a dispute with the FDIC over the assessment amount. In addition, the FDIC may modify the terms of any penalty if it determines that an institution had a reasonable cause preventing it from making a timely payment.

This final rule became effective on January 1, 2007. For more information, see 71 *Federal Register*, pp. 65711-3.

Advertisement of Membership (11/13)

The Federal Deposit Insurance Corporation (FDIC) issued a final rule to replace the existing bank insurance fund (BIF) and savings association insurance fund (SAIF) membership logos with a new deposit insurance fund (DIF) membership logo. The final rule changes the text to read "each depositor insured to at least \$100,000" to more accurately reflect certain permissible insurance coverage amounts now greater than \$100,000. The new sign will also advertise the FDIC's web address. The signs must be present at each station where insured deposits are received at all insured banks and thrifts. Finally, institutions are prohibited from using the official FDIC logo when advertising nondeposit products (such as insurance products, annuities, mutual funds, and securities) for which the FDIC does not provide insurance coverage.

This final rule became effective on November 13, 2006. For more information, see 71 *Federal Register*, pp. 66098-104.

Deposit Insurance Adjustments (11/30)

The Federal Deposit Insurance Corporation (FDIC) issued a final rule to make deposit insurance adjustments more sensitive to risk. Previously, the FDIC placed depository institutions into one of only three categories of risk

based on their leverage and risk-based capital ratios: "1" for well capitalized, "2" for adequately capitalized, or "3" for undercapitalized. The FDIC then used information provided by the institution's primary regulator to divide the categories into subgroups, with "A" assigned to financially sound organizations with few weaknesses, "B" to institutions with weaknesses that, if not corrected, could put the deposit insurance fund at increased risk, and "C" to institutions with a high probability of loss to the insurance fund unless corrective action is taken. This system allowed for a total of nine risk categories, with a 1A bank being the least risky and a 3C bank being the most risky. These levels of risk were then used to calculate deposit insurance assessments.

Under the final rule, these nine risk categories have been consolidated into four, designated I, II, III, and IV, with category I being the same as the 1A category; II consisting of the old 1B, 2A, and 2B categories; category III comprising the old 3A, 3B, 1C, and 2C categories; and category IV matching the old 3C category.

Within category I, the FDIC now determines risk differently for small and large institutions, as long as they have been in existence for at least seven years. (For purposes of this rule, an institution is considered large if it has at least \$10 billion in total assets.) For small institutions, the FDIC uses the institution's CAMELS* rating and its current financial ratios to determine the assessment rate. For large institutions, the FDIC uses the CAMELS rating plus its long-term debt issuer ratings and financial ratios to determine the assessment rate. New institutions (those that have been in existence for less than five years) in risk category I are assessed at the maximum rate applicable to category I institutions, regardless of their size.

The FDIC published a base assessment rate (the minimum possible rate) for all categories, in addition to the actual assessment rates as of January 1, 2007. The actual assessment rate for category I institutions ranges from a minimum of five basis points to a maximum of seven basis points; for category II institutions, the rate is 10 basis points; for category III, 28 basis points; and for category IV, 43 basis points. This represents an increase of three basis points over base rates.

This final rule became effective on January 1, 2007. For more information, see 71 *Federal Register*, pp. 69282-323.

The Office of Federal Housing Enterprise Oversight

Nontraditional Mortgage Products (12/8)

The Office of Federal Housing Enterprise Oversight (OFHEO) issued two letters that require government

* CAMELS is an acronym for component ratings assigned in a bank examination: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. A composite CAMELS rating combines these component ratings and can range from 1, the best rating, to 5.

sponsored entities (GSEs) Freddie Mac and Fannie Mae to follow the federal banking regulators' guidance on nontraditional mortgage products (see a description of the guidance under the "Board of Governors of the Federal Reserve System" section). The GSEs must develop and implement written policies describing acceptable mortgage products and portfolio limits. In addition, they must ensure that all purchased mortgage products are in compliance with the guidance. The GSEs are required to enhance their performance measures and management reporting to enable earlier detection of increased risk. Further, they must reconsider loan loss allowance amounts to ensure that they account for the credit quality of the portfolio and any conditions that might affect collectibility. Finally, they must retain capital commensurate with the risk characteristics of their nontraditional mortgage loan portfolios.

For more information about this directive, see the OFHEO's website at www.ofheo.gov/media/pdf/PRGuidance121306.pdf.

Financial Accounting Standards Board

Exception to Derivative Contract Accounting (10/25)

The Financial Accounting Standards Board (FASB) proposed to offer a narrow exception from rules that require derivative contracts to be marked to market under FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*. Statement 155 requires banks to separate derivatives from mortgage-backed securities and asset-backed securities that contain loans with embedded call features. Once separated, the derivatives must be marked to market, or updated to reflect changes in value. Under FASB's proposed exception, however, securitized interests are exempt from this requirement if (1) the investor does not have the right to accelerate the settlement of the securitized interest, and (2) the embedded derivatives are only tied to call options (prepayment risks) of the underlying financial asset.

For more information about this proposal, see FASB's website at www.fasb.org/derivatives/issueeb39.shtml.

SUMMARY OF JUDICIAL DEVELOPMENTS

National Bank Act Does Not Preempt State Age-Discrimination Law

The U.S. Supreme Court declined to hear an appeal of a ruling that the state of Washington's anti-age-discrimination law applies to national banks (*U.S. Bank National Association v. Kroske*, No. 05-1607). The case stems from Kathy Kroske's termination from her position as assistant vice president at US Bank. Kroske, a 51-year-old branch manager, claimed that she was given fewer opportunities and advantages than her younger counterparts in other Washington branches. When her branch failed to consistently meet its targets, she was fired and replaced by a younger, less experienced person. Kroske claimed that her termination by US Bank violated the Washington Law Against Discrimination (WLAD), but US Bank contended that WLAD is preempted by the National Bank Act (NBA), which gives national banks permission to dismiss officers "at pleasure."

The U.S. Court of Appeals for the Ninth Circuit ruled that the NBA did not preempt the WLAD. The court considered Congress's intent when it granted authority to national banks to dismiss officers at pleasure and found that this provision of the NBA was not meant to completely preempt state employment laws for national banks. The NBA was established to ensure financial stability at banking institutions by allowing them to discharge employees who were believed to compromise an institution's integrity. Congress's intent was not to permit discrimination, which is further evidenced by its recent measures aimed at preventing it, specifically the Age Discrimination in Employment Act (ADEA). The WLAD is modeled after and similar to the ADEA. Therefore, the court ruled that Kroske's age discrimination suit could not be dismissed because of preemption by the NBA. When US Bank appealed, the U.S. Supreme Court declined to review the decision.

OCC May Decide Whether Civil Suit Parties May View a National Bank's Suspicious Activity Report

The U.S. Court of Appeals for the Fifth Circuit ruled that the Office of the Comptroller of the Currency (OCC) may use its discretion in deciding whether a party to a civil suit can see a national bank's suspicious activity report (SAR) (*Bizcapital Business and Industrial Development Corp. v. Comptroller of the Currency*, No. 06-30032). The case was originally brought against the OCC by Bizcapital. Bizcapital sought the disclosure of any SARs filed by Union Planters Bank concerning Media Direct and its principal agent, Raymond Reggie. Bizcapital insisted that the SARs were critical to a civil suit that was pending between it and Union Planters Bank. The OCC denied the request, claiming that it violated provisions of the Bank Secrecy Act. Bizcapital appealed to a federal district court, which ruled against the OCC, saying that the decision to categorically deny all requests for SARs was "unlawful." Therefore, the court ordered the OCC to disclose Union Planters Bank's SARs.

On appeal, the U.S. Court of Appeals for the Fifth Circuit reversed the district court's ruling, saying that the OCC may use its discretion in determining whether to disclose SARs. The court overturned the ruling that required disclosure by the OCC and ordered the OCC to review Bizcapital's request again, even though it still may deny it.

Banks Owe No Fiduciary Duty to Noncustomers In Fraudulent Scheme

The Virginia Supreme Court ruled that when a person opens a bank account for the benefit of a third party, the third party is not a bank customer who is owed a fiduciary duty (*Collins v. First Union National Bank*, No. 052647). The case was brought against First Union National Bank by foreign nationals who were defrauded of close to \$2

million in a scheme developed by two FUNB customers, James O'Connor and James Geisler. O'Connor and Geisler advertised to the foreign nationals that they could help them earn a visa to enter the United States at a reduced cost. They collected between \$100,000 and \$150,000 from each individual and deposited the money into accounts set up "for the benefit of" the foreign national at FUNB. However, O'Connor and Geisler had exclusive control over the accounts. After falsely promising visas in exchange for the deposits, O'Connor and Geisler removed the money from the accounts and put it into another under their control. The defrauded foreign nationals filed suit against FUNB, claiming that it owed them a fiduciary duty since they were customers of the bank, or at least third parties to the transaction that was intended to benefit them.

Upon consideration, the Virginia Supreme Court ruled that the foreign nationals were neither customers nor third parties in the transaction, which exempted FUNB from owing them a fiduciary duty. Because they had not contracted with the bank and had no signatory power over the accounts, the court found that they were not customers of the bank. Instead, O'Connor and Geisler were the customers, and the foreign nationals had contracted separately with them. Further, the court found no evidence that O'Connor, Geisler, and the bank opened the accounts under an agreement that they were intended to benefit the foreign nationals. The law requires such an agreement in order for the foreign nationals to be owed a fiduciary duty. Without the agreement, the court ruled in favor of FUNB, saying that it was not liable for the investors' losses.

SUMMARY OF THIRD DISTRICT DEVELOPMENTS

PA – The Commonwealth Court of Pennsylvania overturned the Pennsylvania Department of Banking's approval of a credit union's proposed charter conversion (*Pennsylvania Bankers Association v. Pennsylvania Department of Banking*, No. 397 M.D. 2005). Belco Community Credit Union proposed to convert from an occupation-based credit union to a community-based credit union. After the conversion, it would permit membership to anyone who lived, worked, worshiped, volunteered, or attended school in any one of seven Pennsylvania counties. Banks in the area challenged the conversion, saying it was a violation of federal and state law, that it harmed them, and was not in the public's interest. The Pennsylvania Department of Banking rejected the banks' challenge. Further, because the department failed to act on the credit union's proposal within 30 days, the proposal was deemed approved. The banks appealed the approval by filing suit in the Commonwealth Court of Pennsylvania.

The court ruled that the credit union's application to convert its charter required a hearing, which the Pennsylvania Department of Banking failed to provide. Thus, the banks were deprived of their right to formally contest the conversion. Therefore, the court overruled the approval of the credit union's conversion, remanding it for a hearing, at which all interested parties may present their arguments in favor of or against the conversion.

NJ – The New Jersey Senate passed a bill (S. 547) that would require financial institutions to obtain approval from customers before sharing their personal information with unaffiliated third parties. The New Jersey Financial Information Privacy Act would require consumers to complete an "opt-in" form, permitting their personal informa-

tion to be shared with nonaffiliated third parties. Financial institutions are barred from requiring consumers to opt-in before receiving a product or service; however, the institutions may offer incentives to encourage consumers to opt-in. This bill does not prohibit financial institutions from sharing personal customer information with third parties with whom they jointly offer financial products or services.

DE – The Delaware Chancery Court blocked a hedge fund's request to inspect the books and records of a company whose stock it had recently purchased (*Polygon Global Opportunities Master Fund v. West Corporation*, No. 2313-N). Polygon Global Opportunities is a hedge fund that invests in event arbitrage situations. Polygon decided to invest in West Corporation after the company announced that it would undertake a leveraged recapitalization, which the hedge fund thought would present an attractive risk arbitrage opportunity. Polygon later asked to review West Corporation's books and records so that it could determine whether to seek an appraisal of the company, investigate alleged breaches of fiduciary duty that occurred before the fund's stock purchase, and communicate with other stockholders to encourage them to seek an appraisal.

The court denied Polygon's request for West Corp.'s books and records, saying that it already had enough information to determine whether it should seek an appraisal. Further, the court said that the hedge fund did not have a legitimate purpose for investigating alleged wrongdoing that occurred before the firm purchased shares of the stock. Finally, the court ruled that the books and records were not required for Polygon to communicate with other shareholders.