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HIGHLIGHTS

This issue contains detailed descriptions of legislative and regulatory proposals related to mortgage and credit markets, a proposed rule defining unfair or deceptive acts or practices in consumer lending, a proposed rule to require creditors to provide risk-based pricing notices to consumers, a proposed FASB rule on disclosure requirements for credit derivatives, and a summary of judicial decisions and legislation affecting the Fair Credit Reporting Act.

In addition, it summarizes other notable legislative, regulatory, and judicial developments that occurred during the second quarter of 2008.

MORTGAGE AND LIQUIDITY DEVELOPMENTS

Over the past few months, Congress and several of the federal financial regulators have proposed new legislation and regulation to address some of the causes and effects of the housing crisis. Among other things, these efforts aim to reduce foreclosures and encourage modification of unaffordable mortgage loans. The Housing and Economic Recovery Act, signed into law on July 30, will affect the Federal Housing Administration (FHA) as well as the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. The Department of Education and Congress have also been working to ensure that students will have continued access to loans despite disruptions in that market. In addition, the Board of Governors of the Federal Reserve has proposed revisions to Regulation Z, which implements the Home Ownership and Equity Protection Act (HOEPA) and the Truth in Lending Act (TILA).[1]

Background

The primary focus in recent months has been on the direct and indirect effects of the deteriorating performance of subprime mortgages. These are housing loans issued to borrowers who are likely to pose a higher risk of default. These loans often have nontraditional features, including low initial payments that reset to a higher level as the loan matures. The subprime market has grown rapidly in recent years. While only 5 percent of all mortgages originated in 1995 were subprime, about 20 percent were subprime by 2005.[2]

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[1] For more information and a summary of these regulatory proposals, see *Banking Legislation and Policy*, Volume 27, Number 1.

[2] Testimony of Sandra F. Braunstein, Director, Division of Consumer and Community Affairs, Board of Governors of the

In May 2008, payments on 17 percent of securitized first-lien subprime adjustable-rate mortgages (ARMs) in the United States were 60 or more days delinquent. An additional 14 percent of first-lien subprime ARMs had already entered the foreclosure process.[3] The increase in subprime delinquencies and foreclosures has been blamed largely on falling house prices and a loosening of underwriting standards. In many cases, lenders failed to verify borrowers' income, assets, and other factors that might affect their ability to repay their loans.

The deteriorating performance of subprime mortgages contributed to the sharp contraction in the liquidity of financial markets that began in early August 2007. Institutions and individuals around the world that had invested in securitized packages of subprime mortgages or commercial paper collateralized with subprime loans suddenly encountered unexpected losses.[4] Some lenders have become more reluctant to lend to leveraged investors and have increased the amount of collateral they require. This, in turn, has forced some investors to liquidate their security holdings in order to reduce their leverage. More recently, the shortage of liquidity has spread to other sectors, including the markets for auction-rate municipal securities, student loans, and mortgage-backed securities issued by government-sponsored enterprises.

At the same time, a number of banks that had previously transferred mortgage-related assets to off-balance-sheet entities found themselves providing substantial liquidity to those entities and eventually taking them back on to their own balance sheets. In addition, many large commercial and investment banks, as well as the GSEs, have suffered substantial credit losses in their own loan portfolios.

Housing and Economic Recovery Act of 2008

The Housing and Economic Recovery Act of 2008 (Public Law No. 110-289) was originally introduced by House Speaker Nancy Pelosi (D-Calif.) and subsequently amended and revised by House Financial Services Committee Chair Barney Frank (D-Mass.) and Senate Banking Committee Chairman Chris Dodd (D-Conn.).[5] It includes provisions that reform oversight of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (FHLBs), offer assistance to homeowners and buyers who are stuck with unaffordable mortgages, reform and modernize the FHA, offer numerous tax breaks to homeowners and buyers, and provide additional resources to states to fund housing programs for low- to medium-income households. The law also modifies the Truth in Lending Act to add certain disclosures for loans in which the required monthly payment can change as with, for example, an adjustable-rate mortgage. The bill is broadly divided into three parts: the first deals with housing finance reform, the second with foreclosure prevention, and the third with tax-related provisions. The bill was signed into law on July 30. The following sections describe a number of the notable parts of the bill.

Federal Housing Finance Regulatory Reform Act of 2008

GSE Oversight Reform, Establishment of the Federal Housing Finance Agency

Public confidence in the abilities of the GSEs Fannie Mae and Freddie Mac has dissipated recently, leading to large drops in the stock prices of these entities and concern about their ability to issue new debt. This has prompted new measures

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Federal Reserve System, before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, U.S. House of Representatives, March 27, 2007.

[3] LoanPerformance ABS Loan Level Data Extract, with calculations by the Federal Reserve Bank of New York.

[4] For more detail on the recent liquidity issues, see *Banking Legislation and Policy*, Volume 26, Number 3, and Volume 27, Number 1.

[5] This description of the Housing and Economic Recovery Act of 2008 is based on the July 22, 2008, draft of the legislation.

by the Department of the Treasury and the Board of Governors of the Federal Reserve to ensure continued access to liquidity for these companies. The first part of this new legislation, dubbed the Federal Housing Finance Regulatory Reform Act of 2008, overhauls the regulation of these enterprises as well as the FHLBs.

Until now, the GSEs and FHLBs have been regulated by the Office of Federal Housing Enterprise Oversight (OFHEO) of the Department of Housing and Urban Development (HUD) and the Federal Housing Finance Board, respectively. Effective immediately, these offices are abolished and replaced by the new Federal Housing Finance Agency (FHFA), an independent agency of the federal government. The director of this agency, appointed by the President to a five-year term, has regulatory authority over the GSEs, FHLBs, and the Office of Finance of the Federal Home Loan Bank System. The director will serve as the chairperson of the new Federal Housing Finance Oversight Board, which will also consist of the Secretary of the Treasury, the Secretary of Housing and Urban Development, and the chairperson of the Securities and Exchange Commission.

Under this legislation, the director of the FHFA will have broad authority over the GSEs and FHLBs to ensure that the entities operate in "a safe and sound manner" to "foster liquid, efficient, competitive, and resilient national housing finance markets."[6] The director's powers include the ability to set minimum levels of capital and reserves, examine the entities and charge penalties for noncompliance, establish goals for programs to ensure affordable or low-income housing, ensure that the entities are being managed effectively and without undertaking excessive risk, and, if they are critically undercapitalized, take control of the entities. Annual reports will be made to Congress on the state of these entities, and these reports will be made available to the public.

[6] Sec. 1102

The GSEs purchase conforming (nonjumbo) mortgage loans in the secondary market, then repackage and sell them as mortgage-backed securities to institutional investors. Currently, they also maintain portfolios of mortgages on their own balance sheets. New conforming loan limits are specified within the bill, starting at $417,000 for a single-family home and adjusted annually for inflation. For high cost areas – those for which the median home price is greater than 115 percent of the specified limit – the GSEs will be allowed to purchase mortgages worth up to the lesser of the area's median home price or 150 percent of the specified limits. This raises the conforming loan limits to $625,000 for the highest priced areas; the current limit for these areas is $550,000.

Because of the current concern about the possibility of a liquidity shortfall at the GSEs, a provision of the bill allows the Secretary of the Treasury to extend more credit or to purchase stock in the GSEs or FHLBs.[7] Under existing law, each GSE may access a $2.25 billion credit line with the Treasury. Under the bill, there is no explicit dollar limit to the credit lines, but to use this new authority, the secretary must make an "emergency designation" that certifies that the assistance is necessary to stabilize financial and housing markets and ensure the availability of mortgage credit to consumers and that it is in the best interests of American taxpayers. Thereafter, the secretary would be required to make reports to Congress and consult with the Federal Reserve Board and the director of the FHFA about the soundness of the GSEs. This authority would expire after December 31, 2009.

To deal with the recent difficulties of the FHLBs, the bill would revise regulations so that they would be able to voluntarily merge and reduce the number of independent districts.

[7] The Board of Governors of the Federal Reserve also temporarily authorized the Federal Reserve Bank of New York to lend to Fannie Mae and Freddie Mac at the primary credit rate through the discount window on July 13.

Affordable Housing Funds Sponsored by GSEs

New funds to support affordable housing would also be established under this legislation. Fannie Mae and Freddie Mac would be required to set aside an amount equal to 4.2 basis points for each dollar of new mortgages purchased after the date of enactment to create a Housing Trust Fund (receiving 49 percent of the GSE transfers) and a Capital Magnet Fund (receiving 26 percent of the GSE transfers), to be managed by the FHA.[8] The remainder of the funds would go to the new HOPE Reserve Fund, discussed in the next section.

The Housing Trust Fund would give grants to states to provide and subsidize low-income rental housing and homeownership initiatives. Funding would be allocated based on demonstrated need. The Capital Magnet Fund would be a special account within the Community Development Financial Institutions Fund. The Secretary of the Treasury would use this fund to make grants to attract private capital and investment to low-income housing projects and economic development or community service activities, such as day-care centers, workforce development centers, and health-care clinics.

HOPE for Homeowners Act of 2008

Of the funds transferred from Fannie Mae and Freddie Mac to the FHA, the Housing Trust Fund, and Capital Magnet Fund, 25 percent will be set aside to create the HOPE Reserve Fund, which would be established under the HOPE for Homeowners Act of 2008. This fund will be used to create an FHA program that helps distressed homeowners and mortgage servicers avoid foreclosure. The fund will be effective from October 1, 2008, to September 30, 2011.

The bill establishes a board of directors of the Hope for Homeowners Program (hereafter the Board) that would consist of the Secretary of Housing and Urban Development, the Secretary of the Treasury, the chairperson of the Board of Governors, and the chairperson of the Federal Deposit Insurance Corporation. Under the program, the FHA will be authorized to insure new mortgages in order to refinance existing senior and junior mortgages for a borrower's primary residence under certain circumstances. This authority expires at the end of the 2010 fiscal year. In total, as much as $300 billion in principal mortgage obligations could be insured.

To qualify, the borrower must demonstrate a lack of capacity to continue paying the existing mortgage on a primary residence, but the borrower need not be delinquent on the mortgage. The borrower cannot have intentionally defaulted on any debt or have furnished false information in order to obtain the current mortgage and must have a total mortgage debt-to-income ratio greater than 31 percent as of March 1, 2008.[9] In addition, the borrower cannot have ownership in another residence. The maximum loan amount eligible would be worth 132 percent of the Fannie Mae and Freddie Mac conforming loan limit and must have been originated on or before January 1, 2008.

The new, insured loan would be a standard 30-year, fixed-rate mortgage. The Board would establish a limitation on origination fees and procedures to ensure that the interest rates charged are commensurate with market rates on similar loans. The principal value of the new mortgage would be based on the borrower's demonstrated ability to pay (from documented and verified income statements) but could not be more than 90 percent of the current appraised value of the property. Thus, the minimum equity in the property at the time of the refinancing would be at least 10 percent.

All existing mortgage lien holders (both senior and junior) must agree to accept the proceeds from the new loan as payment in full on the existing debts. This implies that existing

[8] Sec. 1131

[9] The Board would be authorized to specify a higher debt-to-income threshold if deemed appropriate.

lender(s) would recognize a loss in value of their loans. In addition, any prepayment and refinancing fees in the existing loan contracts must be waived. The FHA would be empowered to "facilitate coordination and agreement among senior and junior lien holders. In particular, the Board is authorized to create standards and policies that would permit junior lien holders to benefit from any subsequent appreciation of the property."[10]

The FHA would collect an insurance premium equal to 3 percent of the mortgage principal at the origination of the HOPE-assisted refinancing. Premiums in subsequent years would be equal to 1.5 percent of the amount of the remaining principal.

Under the bill, both the FHA and the borrower would enjoy a claim to a share of the equity in the property created by the refinancing. Those shares would be determined by the amount of time between the refinancing and the subsequent sale or refinancing. For example, if a sale occurred within a year of the refinancing, the FHA would receive 100 percent of this equity. The FHA's equity share would decline by 10 percentage points for each additional year between the date of refinancing and subsequent sale until the fifth year (or longer), at which point the FHA and the borrower would each have a 50 percent share of this equity. In addition, if the home sells for more than the appraised value at the time of the refinancing, the FHA and the mortgage lender would share equally in this additional equity.

The bill requires that servicers of securitized pools of residential mortgages must act to maximize the net present value of the pooled mortgages to all investors in the pool, unless a contract between the servicers and investors has specified that the servicer may act otherwise. A servicer would be deemed to be in compliance with this duty if he or she facilitates modifications or workouts on mortgage loans either in default or where default is "reasonably foreseeable." Such a workout must offer a higher net present value than would be anticipated from a foreclosure sale.

Secure and Fair Enforcement (S.A.F.E.) for Mortgage Licensing Act of 2008

As part of this bill, the S.A.F.E. Mortgage Licensing Act of 2008 encourages the states, through the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators, to establish a nationwide mortgage licensing system and registry. The act requires all mortgage originators to be licensed under new, uniform rules. The goal is to increase uniformity and accountability among originators and to allow for increased flow of information between originators and regulators.

The standards for licensing of originators are specified in the bill. Applicants for licenses as originators must pass mandatory background checks and cannot have been convicted of a felony within the past seven years. Applicants are also required to receive some education on the legal and ethical aspects of mortgage origination and pass written tests on the subjects. Once a license has been obtained, the originator must continue to take classes in these areas to renew his or her license.

If the FHA determines that within one year of enactment (two years for states with legislatures that meet biennially) a state has not met certain requirements for licensing originators or participation in this new registry system, the FHA may step in and establish such a system. If it is determined that the nationwide mortgage licensing system and registry is failing to meet its requirements, the FHA may take control of that organization as well.

Foreclosure Prevention Act of 2008

FHA Modernization Act of 2008

The second section of the legislation reforms certain policies of the FHA with regard to insuring mortgages and provides emergency

[10] Sec. 1402

assistance for governments facing a rash of abandoned and foreclosed properties. The FHA's mission is to provide insurance on housing loans made by FHA-approved lenders throughout the United States.

Under this bill, the size of mortgages that qualify for FHA insurance increases to the lesser of 115 percent of the median home price in the area or 150 percent of the Fannie Mae and Freddie Mac conforming loan limit. This makes the new limit $625,500 per mortgage for the highest priced areas. However, to qualify, purchasers must make a cash down payment of at least 3.5 percent of the purchase price. Down payments cannot be funded in any part by the seller or any third party that financially benefits from the transaction. This is intended to curb the recent trend toward zero- or low-money-down home purchases that were popular in subprime lending.

Funds for the insurance will now come from the Mutual Mortgage Insurance Fund, which is established under this bill and replaces the General Insurance Fund.

The premium charged for the insurance is raised from 2.25 percent to 3 percent of the principal at origination. For first-time home buyers who complete financial counseling, the premium would be 2.75 percent of the principal (currently 2 percent) at origination. However, the FHA would be barred from charging risk-based premiums for one year beginning on October 1, 2008.[11]

The FHA must now also provide "adequate" mortgage counseling to home buyers through counselors approved by the FHA and funded through insurance premiums. Origination fees paid to lenders are capped at 2 percent of the principal for the first $200,000 of the home's value and at 1 percent of the value of the home beyond that, with a maximum possible fee of $6,000.

The FHA is also responsible for creating a pilot program for an automated process for lenders to evaluate potential home buyers who lack a sufficient credit history to generate a credit score. The FHA may include information about rent, utilities, and insurance payment histories, among any other instruments it may decide to use, to evaluate potential home buyers. The program expires in five years, and no more than 5 percent of insured mortgages can be underwritten using this alternative scoring system.

Mortgage Protections for Service Members

Another part of this act targets members of the military for special protection. The Department of Veterans Affairs automatically guarantees a proportion of any mortgage loan obtained by a veteran, with a current maximum of $36,000 for the highest priced loans.[12] Under this bill, the amount of a service member's mortgage that the FHA guarantees is increased to 25 percent of the higher of the Fannie Mae and Freddie Mac conforming loan limit or 125 percent of the median area home price, up to 175 percent of the conforming loan limit.

Another provision requires the FHA to provide credit and mortgage counseling for service members returning from overseas duty. Funds are also provided to help pay for home renovations for totally disabled veterans.

Additionally, the bill extends the period after leaving active duty during which veterans are immune from foreclosure. This protection currently runs for 90 days, but the bill extends this period to nine months. This extended protection expires after December 31, 2010.

[11] The FHA published a plan to implement risk-based pricing on May 13, 2008 (73, *Federal Register*, pp.27703-11). This legislation explicitly repeals this plan.

[12] For lower priced loans, a higher proportion of the loan is guaranteed. See section 3703(a)(1) of title 38, United States Code, for a more detailed schedule of the mortgage guaranty amounts.

Emergency Assistance for the Redevelopment of Abandoned and Foreclosed Homes

To help state and local governments address the problem of increased foreclosures in many areas, the bill appropriates $4 billion to be awarded as grants for purchasing and redeveloping abandoned and foreclosed properties. The money will be distributed to the state and local governments based on the intensity of subprime lending, mortgage delinquencies, and homes in the foreclosure process. Any profits earned in the next five years by the local governments from resale of the redeveloped properties would be retained by the municipality to further the program in that area. Five years after the enacting of the program, any profits would be returned to the Treasury.

Tax-Related Provisions

The bill contains many tax breaks for homeowners and buyers. Chief among them is a tax credit for first-time home buyers worth 10 percent of the home's value up to $7,500.[13] This limit decreases proportionally as the taxpayer's adjusted gross income increases past $75,000 ($150,000 for joint filers). The credit works as an interest-free loan and must be paid back in equal installments over the following 15 years. This credit applies to any primary residence purchased after April 9, 2008.

For current homeowners, a federal income tax deduction for local property taxes worth up to $500 ($1,000 for joint filers) is included in the bill. This credit is available only to people who claim the standard deduction on their income taxes and applies to taxable years after December 31, 2007.

Other provisions allow states to issue an additional $11 billion in tax-exempt bonds to fund the construction of low-income housing and the refinancing of qualified subprime loans. These are defined as adjustable-rate single-family residential mortgage loans originated in the years 2002-2007 that are reasonably likely to cause financial hardship to borrowers if not refinanced. This authority expires at the end of 2010.

Part of the cost of these tax provisions will be offset by a tax compliance provision that requires all payment card network providers to report the annual gross amount of transactions of participating merchants located in the United States to the IRS. This requirement applies to any merchant who processes over 200 credit card transactions per year and the sum of those transactions exceeds $20,000. This provision applies to purchases after December 31, 2010.

Other Foreclosure Prevention and Loan Modification Actions

FDIC Home Ownership Preservation Loans

On April 30, the Federal Deposit Insurance Corporation (FDIC) proposed that Congress authorize the Home Ownership Preservation (HOP) Loans program. Designed to protect homeowners with unaffordable mortgages, the program would offer loans from the Treasury Department to qualifying lenders to help pay down up to 20 percent of the principal and restructure the remaining loan. The program would require no repayments to the Treasury for the first five years of the loan so that borrowers could stabilize their financial situations, and the debt to the government would be amortized and retired over the remaining life of the mortgage.

Mortgages for less than $362,000, issued between January 1, 2003, and June 30, 2007, that resulted in a debt-to-income ratio for the borrower of more than 40 percent would qualify for the program. These qualifications are designed to limit the downside risk to the government and ensure that only mortgages that were unaffordable at origination are covered.

Because the loan would help mortgage investors avoid costly foreclosures, certain

[13] A first-time home buyer is defined as an individual or married couple that had no ownership interest in a principal residence during the three-year period prior to purchase of the principal residence eligible for this tax credit (Sec. 3011).

concessions would be required. Every investor that requests the loan would need to restructure the borrower's mortgage so that it was made affordable. New rates would be capped at the Freddie Mac 30-year fixed rate, and the restructured mortgages could result in at most a debt-to-income ratio of 35 percent for the borrower. The investor would also need to pay the Treasury Department's financing costs for the first five years of the loan. The Treasury would have a super-priority interest in the mortgage; if the borrower were to sell, refinance, or default on the property, the Treasury would have a priority recovery for the amount of its loan from any proceeds.

New Internal Revenue Service Procedure on Loan Modifications

On May 16, the Internal Revenue Service (IRS) released Revenue Procedure 2008-28, describing the conditions under which the modification of mortgage loans held by certain securitization vehicles such as real estate mortgage investment conduits (REMICs) or investment trusts will not cause the IRS to challenge the tax status of the loans. The IRS will not challenge mortgages for which the following conditions are satisfied: the residences are owner occupied and contain fewer than five dwelling units; no more than 10 percent of the principal of the total assets held by the REMIC or trust is 30 days or more overdue; there is a significant risk of foreclosure on the existing loan; the terms of the modified loan are less favorable to the lender; and the risk of foreclosure has been substantially reduced because of the modification. The procedure will be in effect on all mortgage modifications made between May 16, 2008, and December 31, 2010.

New OFHEO Rule Increases GSE Capital Requirements

OFHEO issued a final rule (73, *Federal Register*, pp. 35893-96) on June 25, effective immediately, that raises risk-based capital requirements for Fannie Mae and Freddie Mac. The rule amends certain "loss severity" equations that housing finance firms use to calculate losses from foreclosing on properties. Under the old definition, Fannie Mae and Freddie Mac have been able to record profits from foreclosure activities because the equations overestimate their recoveries for defaulted government-guaranteed and low loan-to-value (LTV) mortgages.

The risk-based capital requirement applied to the GSEs by OFHEO is the amount of total capital – core capital plus a general allowance for loan losses less specific reserves – that an enterprise must hold to absorb projected losses flowing from future adverse interest-rate and credit-risk conditions specified by statute. OFHEO requires that core capital must exceed 2.5 percent of assets plus 0.45 percent of off-balance-sheet obligations (primarily mortgage backed securities). Furthermore, Fannie Mae and Freddie Mac must pass a risk-based capital test that determines their likely solvency under worst case scenarios for house price depreciations leading to far-reaching write-downs of mortgage values. It is the formula for this test that changes under the new rule.

The new definition will require Fannie Mae and Freddie Mac to retain additional risk-based capital to account for potential downward adjustments to firms' balance sheets. The rule analyzes the effects on reserved risk-based capital using data from 2006 and finds that the required reserved capital would have been significantly higher (an approximately 30-50 percent increase) had this new formula been used at the time.[14]

FHA Broadens Mortgage Insurance

On June 9, the FHA issued a waiver for purchasers of foreclosed properties on a rule that requires a 90-day ownership period before the FHA will insure the mortgage. To avoid insuring

[14] For these calculations and the estimated risk-based capital reserve amounts that would have been required, see 73, *Federal Register*, pp. 35894.

mortgages for people who engage in "house flipping" – the practice of buying, then quickly reselling houses at a profit – FHA insurance has typically not been available for property sold within the last 90 days. The FHA believes that extending insurance coverage to investors who purchase foreclosed properties will lower costs to the investors and may help stabilize housing markets in high-foreclosure areas. Thus, the FHA will insure any home that was purchased under foreclosure and waive the 90-day rule in these cases. The waiver will be in effect until June 9, 2009.

Legislation Affecting Student Loans

The market for student loans has received special attention from lawmakers as liquidity has decreased in the U.S. financial system. On May 7, the President signed into law the Ensuring Continued Access to Student Loans Act of 2008 (Public Law No: 110-227). Under this new legislation, the Department of Education will have the power to purchase student loans from lenders in the federal guaranteed loan program as long as doing so would have no cost to the government. The department will also have the ability to designate specific universities as lenders of last resort for students who are unable to otherwise obtain student loans and to request funds from the department to ensure that funds are available for such loans.

In the primary market, the new law increases the limits on federal unsubsidized Stafford loans disbursed after July 1, 2008, by $2,000 per dependent undergraduate student, up to $31,000 over the student's career. For independent undergraduates, the limits are increased by $6,000 for the first two years of study and $7,000 for the second two years, up to a maximum of $57,500. Graduate students' limits will increase by $7,000 or $12,000, depending on the field of study, up from a $10,000 per year base plus additional loans for certain fields.

The College Cost Reduction Act (Public Law No: 110-84), enacted in September 2007, reduced government subsidies to student loan originators that have contributed to a reduced availability of these loans.[15] The increases in loan limits contained in the act are designed to combat those effects.

The law also allows parents to defer repaying PLUS Loans – low-interest student loans for parents of undergraduate, dependent students available through the Department of Education – for up to six months following their dependent student's exit from school. Finally, the law offers some assistance to homeowners having trouble with mortgage payments. If the borrower is less than 180 days delinquent on mortgage or medical bill payments and is not more than 89 days delinquent on any other debt, the borrower will now be eligible for a PLUS loan. Previously, a delinquent mortgage had disqualified borrowers from PLUS loans.

In related legislation, Rep. Paul Kanjorski (D-Penn.) introduced on April 29 the Student Loan Access Act of 2008 (H.R. 5914). The bill would clarify the authority of the Federal Financing Bank to purchase student loans as long as there is no cost to the federal government. The bill has been referred to the House Committee on Financial Services.

PROPOSED UNFAIR OR DECEPTIVE ACTS OR PRACTICES RULE

On May 19, the Office of Thrift Supervision (OTS), the Board of Governors of the Federal Reserve, and the National Credit Union Administration (NCUA) published a proposed joint amendment to Regulation AA (73, *Federal Register*, pp. 28904-64), which defines unfair or deceptive acts or practices (UDAP) in consumer lending and establishes consumer complaint procedures. The proposed amendment targets

[15] For a summary of this act, see *Banking Legislation and Policy*, Volume 26, Number 3.

certain practices of the credit card industry, as well as bank overdraft protection services.[16] Comments from the public were due on August 4, 2008.

Background

Section 18(f)(1) of the Federal Trade Commission Act authorizes the Commission, the Federal Reserve Board, the Office of Thrift Supervision, and the National Credit Union Administration to define and prohibit unfair or deceptive practices by the financial institutions they regulate.[17]

In June 2007, the Federal Reserve Board asked for comments on a proposed amendment to Regulation Z, which implements the Truth in Lending Act (TILA). The TILA, passed in 1968 as part of the Consumer Credit Protection Act, is designed to promote the use of consumer credit by requiring clear disclosures of the costs and terms of lending, including credit cards.

The Fed's proposed amendment would affect the open-end credit (not home-secured) provisions of Regulation Z, with the goal of improving the effectiveness of disclosures that lenders provide to consumers. The comments on this proposal were generally favorable and included suggestions that the Fed take additional action to regulate credit card markets.

In August 2007, the OTS also requested comments to determine whether it should broaden its prohibitions against unfair or deceptive practices. The proposed rule is an outgrowth of that request.

The Proposal

Billing methods used by credit card issuers would be more heavily regulated under this rule. Issuers would be prohibited from treating payments as late unless they have given consumers a "reasonable" amount of time to make the payments. The rule provides a safe harbor for issuers who mail periodic statements at least 21 days prior to the due date.

For credit card accounts that charge multiple annual percentage rates (APRs) – one for balances on purchases and another for cash advances, for example – issuers would be required to allocate payments in excess of the required minimum payment in a way that is no less beneficial than one of three methods. These methods are allocating the entire excess payment to the balance with the highest APR, splitting the payment evenly between the balances, and allocating the payment in proportion to the balances. Issuers would be allowed to create other methods of payment allocation as long as they resulted in interest charges over the life of the loan no higher than those that would result under the least favorable of the methods listed above, and they informed the consumer of the method of allocation. In addition, if an account carries any balances that are subject to promotional or discounted APRs, payments in excess of the minimum would need to be allocated first to balances on which APRs are not discounted.

Under the proposed rule "double-cycle" billing would be prohibited. This is the practice of charging interest based on the average daily balance from the current and previous month's billing cycles if the consumer carried a balance in either month that has not been paid in full.[18]

The proposed rule would also limit potential triggers for "penalty pricing" – the practice of changing the interest rate charged on existing balances when certain events occur. Under

[16] Several bills have recently been introduced into Congress that would increase regulation of the credit card industry. For information on the Credit Cardholders' Bill of Rights Act of 2008 (H.R. 5244) and the Credit Card Reform Act of 2008 (S. 2753), see *Banking Legislation and Policy*, Volume 27, Number 1.

[17] The Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) also have the power to enforce compliance with UDAP regulations by banks, as specified in Section 5(2) of the FTC Act.

[18] For an example of double-cycle billing, see 73, *Federal Register*, pp. 28922-23.

the proposal, issuers could increase the interest rate only if (1) the rate was variable and the index rate changed; (2) a promotional interest rate had expired; or (3) a payment had not been received within 30 days of the due date. Lenders would always retain the ability to change terms at the expiration of a contract.

The proposal would also limit fees charged when an account is opened (including security deposits and membership fees) to 50 percent or less of the initial credit limit. A lender could charge up to 25 percent of the credit limit in the first billing cycle, and any additional charges (up to 50 percent of the credit limit) would need to be spread evenly over the remaining 11 billing cycles of the year.

Issuers would be prohibited from charging a fee when a credit limit is exceeded merely because of a hold placed on available credit. Fees would be allowed only if the final charge exceeded the credit limit.

Finally, the proposed rule would require banks making firm offers of credit to disclose in a clear and conspicuous way the factors that would determine a consumer's eligibility for the lowest APR and highest credit limit advertised when a range of such options is offered.

The remainder of the proposed rule deals with overdraft services provided by banks. Under this proposal, banks would be prohibited from charging a fee for paying an overdraft on any account unless they provided the consumer with a chance to opt out of the payment of overdrafts and the consumer chose not to do so. Finally, similar to the proposed rule regarding holds on credit cards, banks would be prohibited from charging an overdraft fee on a debit card if the overdraft was solely because a hold was placed on funds in the consumer's account.

Related Action by the Board of Governors of the Federal Reserve

On May 19, the Board of Governors of the Federal Reserve System also published proposed amendments to Regulation DD (73, *Federal Register*, pp. 28739-51) and Regulation Z (73, Federal Register, pp. 28866-901), the rules implementing the Truth in Savings and Truth in Lending acts. Comments from the public on these rules were due on July 18, 2008.

The amendment to Regulation Z would create additional guidelines for billing practices. Any payment on a credit card balance that is received by the issuer by 5:00 p.m. local time on the due date would be counted as on time. If the due date is on a nonbusiness day, any payments received on the following business day would also be counted as on time.

Solicitation practices would also be revised under the Regulation Z amendment. If a creditor requires fees and a security deposit totaling more than 25 percent of the minimum credit limit in order to open an account, the creditor must disclose the amount of credit that would be available after the consumer opens the account. In this case, the consumer has the right to cancel the account before the card is used without paying any fees. Under the proposed rule, fees for transactions in foreign currencies and penalty rates for termination of credit privileges must be disclosed. The proposal would also add a de minimis dollar amount trigger of $1 for disclosing minimum interest or finance charges on both solicitations and applications. Any charges equal to or higher than this amount would need to be disclosed to consumers. Currently, card issuers are not required to disclose any minimum interest or finance charge until application and account opening.

The proposed amendment to Regulation DD would extend the disclosure requirements of banks for overdraft practices. All banks and savings associations would be required to disclose on periodic statements the full amounts of fees charged for overdraft payments and returned items. Also, any institution that provides automated account balance information would be required to disclose the amount of funds available for immediate use without including any potential overdraft funds from the bank whenever the account is accessed.

PROPOSED RISK-BASED PRICING NOTICE RULE

On May 8, the Board of Governors of the Federal Reserve and the Federal Trade Commission (FTC) jointly proposed for comment regulations that would require creditors to provide consumers with a "risk-based pricing notice" when offering them credit on significantly less favorable terms on the basis of information contained in their credit report. Comments were due on August 18.

Background

Under the Fair Credit Reporting Act (FCRA) of 1970, when a firm declines to offer a consumer credit, insurance, or employment in part because of information found in the consumer's credit report, the firm must provide an "adverse action notice" to the consumer.[19] Among other things, the notice informs the consumer that the decision was based in part on information in his or her credit report and that he or she has the right to request a free copy of the report within a certain period of time and the right to dispute any inaccurate information contained in the report. Often, consumers are better able to identify mistakes in their credit reports, and they have strong incentives to correct their reports if they think a mistake has significantly affected their potential access to credit, insurance, employment, or other opportunities.[20]

In recent years some lenders have implemented risk-based pricing.[21] For example, in addition to using credit bureau information to decide whether or not to offer credit to a consumer, a lender may also use it to determine the interest rate the consumer will pay. Thus, it is possible that negative information contained in a credit report may not result in the denial of a loan but might result in the loan costing the consumer more than it otherwise would. Some credit card lenders also perform routine account reviews, adjusting terms based on the current information in the consumer's credit report.

Section 311 of the Fair and Accurate Credit Transactions Act (FACTA) of 2003 amends the FCRA to address risk-based pricing.[22] In particular, it requires a creditor to provide a risk-based pricing notice to consumers who are offered material credit on terms "materially less favorable" than the best terms the firm offers to a substantial proportion of its customers. The act also requires the Federal Reserve and the Federal Trade Commission to jointly issue rules to implement this requirement.

Proposed Rule

The proposed rules specify the content of the risk-based pricing notice, the conditions that trigger an obligation to provide such a notice, and when it should be provided to the consumer. The rules also specify a set of exceptions to this notification requirement and several model notices that creditors could use.

The risk-based pricing notice requirement would apply only to decisions involving the provision of consumer credit. Under the proposed rule, if there is an obligation to provide a risk-based pricing notice, it falls on the original creditor, i.e., the person or firm to whom the obligation is initially payable. Thus, the obligation would not fall on brokers or other intermediaries who locate lenders on behalf of the borrower.

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[19] See 15 U.S.C. § 1681g

[20] For additional information on the issue of mistakes in credit reports and mechanisms for correcting them, see Robert M. Hunt, "A Century of Consumer Credit Reporting in America," Working Paper 05-13 (2005).

[21] For a discussion of the adoption of risk-based pricing in the credit card industry, see, for example, Mark Furletti, "Credit Card Pricing Developments and Their Disclosure," Federal Reserve Bank of Philadelphia Payment Cards Center Discussion Paper 03-02 (2003).

[22] See Public Law 108-59, 117 STAT. 1952.

For the purposes of the rule, the regulators propose to define the "material terms" of a credit offer as the annual percentage rate (APR). For credit cards, the relevant interest rate is the one charged on purchases. Other monetary terms would be used for forms of credit that do not have an APR. For a utility bill or cell phone contract, for example, the relevant terms might be the required deposit or down payment.

The risk-based pricing notice itself would be required to include a number of important disclosures. First, it must disclose that the terms being offered (including the APR) were determined at least in part on the basis of information contained in the consumer's credit report and that those terms may be less favorable than the terms offered to consumers with better credit histories. For notices that result from periodic reviews of an existing account, the disclosure must indicate that the increase in the APR was based at least in part on information contained in the consumer's credit report. The notice must disclose the name(s) and contact information of the credit bureau(s) that provided any reports. It must also inform the consumer of his or her right to request a free copy of the report as long as the request is made within 60 days of receiving the notice. Finally, the notice must include a statement encouraging the consumer to verify the accuracy of the information in his or her credit report and to dispute any inaccuracies he or she may find.

The rule proposes a number of methods a creditor may use to determine whether a consumer has received terms that are materially less favorable than those offered to its other customers. The first is a case-by-case analysis, which would require the firm to compare the interest rate offered to a consumer to the lowest rate offered to a substantial proportion of its customers for the same product. This difference would be deemed "materially less favorable" if it implied that the cost of credit to the consumer would be significantly greater than the cost incurred by these other customers. The proposed rule does not specify a quantitative definition of significantly greater costs.

The other two methods would presume that a consumer is being offered materially less favorable terms if he or she falls below a specified cut-off value in the ranking of the firm's existing customers for the same product.

Under the first method, a consumer with a credit score that falls in the bottom 60 percent of the scores of the firm's existing customers would receive a risk-based pricing notice.[23] The cut-off values would be recalculated every two years. Firms introducing new products would be permitted to rely on third-party data to establish the cut-off value until they had sufficient customers to calculate the value based on internal data. For firms using this approach, an applicant who did not have a credit score would automatically qualify to receive a risk-based pricing notice if his or her application was accepted.[24]

The other approach that lenders would be able to employ is "tiered pricing" – the practice of assigning consumers to one of a discrete number of pricing tiers based at least in part on information contained in their credit reports. If only four or fewer pricing tiers are employed, all consumers who do not fall into the top tier (i.e., receiving the best terms) would receive a risk-based pricing notice. For firms that use five or more tiers, the cut-off is determined by ordering the tiers in terms of their pricing (from best to worst) and identifying the set of tiers (with lower APRs) that account for at least 30 percent of the firm's customers but not more than 40 percent. Any consumer falling

[23] A credit score is a number generated from a statistical model and credit bureau data that can be used to rank order consumers in terms of the likelihood that they will default over a given period of time. For additional details, see Loretta J. Mester, "What's the Point of Credit Scoring?" Federal Reserve Bank of Philadelphia *Business Review* (September/October 1997).

[24] Credit scoring models may not be able to produce a score for consumers with very few items in their credit report. These are sometimes described as "thin files."

outside one of those better pricing tiers would receive a risk-based pricing notice.

Some determinations are specific to credit cards. Under the proposal, when a consumer applies for a credit card in connection with a solicitation offering a range of purchase APRs, and is granted credit at an APR higher than the lowest rate available under that offer, the lender would be required to provide a risk-based pricing notice to the consumer. Any periodic review of credit card accounts that is based at least in part on a credit report and would result in an increase in the interest rate charged to the consumer would trigger the obligation to provide a risk-based pricing notice. This notice must be provided to the consumer no later than five days after the interest rate change went into effect.

For new obligations that would trigger the obligation to provide a risk-based pricing notice, that notice must be provided before the consumer becomes contractually obligated but after the terms of credit have been determined. For open-ended credit, including credit cards, this would be before the first transaction but not before the formal credit approval was communicated to the consumer.

FACTA contains a statutory exception to the risk-based pricing notice requirement for instances where a consumer applies for credit on specific terms and is granted credit on those terms. Thus, under the proposed rule, no risk-based pricing notice would be required when a consumer responds to a prescreened offer of credit at a single, specific APR and is accepted at that rate, even if better terms were offered to many of the firm's other customers.

FACTA permits the regulators to exempt transactions from the risk-based pricing notice requirement in cases where consumers would not significantly benefit from receiving the disclosures. The regulators have proposed a number of these. First, they propose to exempt prescreened offers of credit even where the terms offered are determined at least in part by information contained in the consumer's credit report. However, this does not rule out the possibility that the lender would subsequently be obligated to provide such a notice, as described above, if the consumer responds to a solicitation describing a range of APRs.

The regulators also propose an exemption for creditors who provide all their applicants with an alternative "credit score disclosure," described below, at no cost to the consumer. Typically, consumers pay $5-$10 to obtain their credit score. The regulators have concluded that if consumers are receiving a credit score disclosure, there would be little incremental benefit to also providing them with a risk-based pricing notice.

A credit score disclosure would include the consumer's actual credit score and the date it was calculated. It must also include information about the distribution of that credit score across the population or a description of how the consumer's score compares to those of other consumers. For consumers without a credit score, the regulators have proposed alternative language that could be used in the notice (the rule includes an example in a model disclosure).

The disclosure must also include information describing credit reports, credit scoring, and how these are often used in the underwriting process. The notice must specify the name and contact information of the bureau(s) that provided the credit report or score. The notice must include a statement encouraging the consumer to verify the accuracy of the information in his or her credit report and to dispute any inaccuracies he or she may find. It must also inform the consumer of his or her right to obtain a free copy of his or her credit report every 12 months from each of the three national credit bureaus. [25]

[25] In contrast, consumers who receive a risk-based pricing notice may obtain a free credit report regardless of whether they had exercised their right to a free report within the last 12 months.

PROPOSED FASB RULE ON DISCLOSURE REQUIREMENTS FOR CREDIT DERIVATIVES

On May 30, the Financial Accounting Standards Board (FASB) issued a proposed staff position that would strengthen disclosure requirements for credit derivatives and financial guarantees by amending FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. The rules would require the sellers of financial guarantees—that is, the parties that assume credit risk under the contracts—to disclose additional information in their financial statements and would amend the disclosure requirements for derivatives to match the disclosure requirements for guarantees.

Background

A credit derivative is a contract whose price and value derive from the creditworthiness of a specific firm, group of firms, or an index based on a group of firms or securities. Credit default swaps are the most common type of credit derivative, although many other products exist, including credit spread options and credit index products. The market is growing rapidly: According to FASB, the estimated notational amount of outstanding credit default swaps was $62.2 trillion in December 2007, nearly twice the amount outstanding a year earlier, although entities typically enter into many offsetting trades, so their net positions are much smaller.

FASB believes that since the sellers of financial guarantee contracts and credit derivatives face many of the same risks and rewards, they should be subject to similar disclosure requirements. The main difference between the two types of instrument is that, in general, the party guaranteed under a financial guarantee contract owns the underlying guaranteed obligation, while the party guaranteed under a credit derivative contract often does not.

In past months, sellers of credit default swaps have incurred losses when many of the obligations they guaranteed defaulted or changed in value. As a result, some of these sellers' credit ratings have been downgraded or are at risk of being downgraded. Some market participants believe that in their current form, disclosure requirements for credit derivatives and financial guarantees do not adequately capture the instruments' potential risks.

Under Interpretation No. 45, FASB currently requires the sellers of financial guarantees and some, but not all, credit derivatives to disclose information about the nature and terms, maximum amount potentially payable, fair value, recourse provisions, and collateral provisions of each instrument or group of similar instruments in their financial statements. No such disclosures are currently required for instruments covered by Statement No. 133.

Proposed Amendments

Amendments to the disclosure requirements of Statement No. 133 would apply to all credit derivatives that are within the statement's scope, including some embedded derivatives. The proposed amendments would require the seller of a derivative to disclose the nature of the derivative, including its approximate term, the reasons for which the seller is entering into the contract, events or circumstances that would require the seller to perform under the contract, and the current status of the derivative's payment/performance risk, as indicated by external credit ratings of the underlying obligation or internal categories or groupings based on the seller's risk management. Sellers would also be required to disclose the maximum potential amount they could be required to pay in the future under the derivative, as well as the derivative's fair value. Finally, the proposed amendments would require sellers to outline the nature of any recourse provisions that would allow them to recover payments from a third party and any collateral or third-party assets that they could use to recover payments made under the derivative contract.

Interpretation No. 45 already contains all of these requirements, except for the disclosure about payment/performance risk. To make disclosure requirements uniform across the two rules, FASB proposes to require that sellers of instruments covered by Interpretation No. 45 disclose the current status of the instruments' payment/performance risks, using the same indicators mentioned in the amendments to Statement No. 133.

Comments on the proposed staff position were due on June 30. If adopted, the new requirements will become effective for financial statements issued for fiscal years and interim periods ending after November 15, although FASB encourages early application of the requirements.

JUDICIAL DECISIONS AND LEGISLATION AFFECTING THE FCRA

Courts have reached a number of decisions this quarter involving provisions contained in the Fair Credit Reporting Act (FCRA). Additionally, on June 3 the President signed the Credit and Debit Card Receipt Clarification Act of 2007 (Public Law No: 110-241), amending the FCRA.

Among other things, the FCRA regulates the collection and distribution of information about consumers' access to credit and their repayment behaviors. Specifically, it lays out the steps that must be taken by credit reporting agencies (CRAs) and information furnishers[26] to protect consumers' credit histories from unfair or inaccurate information. It is primarily enforced by the Federal Trade Commission (FTC).

"Firm Offer of Credit" Under the FCRA

On April 16, the U.S. Court of Appeals for the Seventh Circuit affirmed decisions on three putative class action suits that alleged unsolicited mailers had violated the Fair Credit Reporting Act (FCRA) by advertising "firm offers" of credit. Under the letter of the law, a consumer must initiate a transaction before a firm may obtain his or her credit information. However, the FCRA allows firms to purchase prescreened name and address lists from CRAs as long as the firms plan to make "firm offers of credit or insurance" to those prescreened consumers. In all three cases, consumers sued creditors under the FCRA for failing to meet the "firm offer" requirement.

In *Murray v. New Cingular Wireless Services, Inc.* (7th Cir., No. 06-2477, 4/16/08), the court ruled that an offer of free merchandise can function as a firm offer of credit. The defendant had sent a mailer offering a "free" cellular phone with the purchase of one year of service. The judge ruled that this is not a FCRA violation, concluding that since the phone was bundled with the service contract the cost of the phone was implicitly financed via monthly payments under the contract. The court saw the payment for the phone as being deferred and amortized over the length of the service contract, thus making the entire offer one of credit. The court also recommended that at least an eight-point type be used to print terms and conditions to be considered "conspicuous," but Cingular's use of six-point type was neither willful nor reckless and thus not a FCRA violation.

In *Bruce v. KeyBank N.A.* (7th Cir., No. 06-4368, 4/16/08), the plaintiff argued that KeyBank's offer of home equity financing was not firm because it did not state all material terms and conditions. The court ruled that a prescreened mailer need not specify all the terms and conditions of the offer, since that would be impossible in a short mailer and would only confuse the consumer. The court also ruled that the lender may reserve the right to present a range of potential terms and

[26] Information furnishers are typically creditors such as banks and other issuers of mortgages, credit cards, and automobile loans.

change the specific offer as more detailed information is learned about the consumer.

In *Price v. Capital One Bank (U.S.A.), N.A.* (7th Cir., No. 07-2370, 4/16/08), Capital One's offer of a Visa credit card was challenged because it did not state a minimum line of credit, making its value uncertain. The plaintiffs argued that under the court's previous decision in *Cole v. U.S. Capital, Inc.* (7th Cir., No. 03-3331, 4/15/04) the offer needed to have value. But the court found that *Cole* applies only in situations in which merchandise is offered along with the credit and is thus irrelevant. In this case, the court ruled that if the offer is purely for credit, the creditor's intent to realize the offer is more important than its value.

In a similar opinion on March 19 by the U.S. Court of Appeals for the First Circuit in *Sullivan v. Greenwood Credit Union* (1st Cir., No. 07-2354, 3/19/08), the court reached the same conclusions as the Seventh Circuit in *Bruce* and *Price*. This confirms for lenders that "an offer of credit meets the statutory definition so long as the creditor will not deny credit to the consumer if the consumer meets the creditor's pre-selection criteria." In addition, the offer need not specify every material term and condition as long as these are disclosed to the consumer before the parties enter into the contract.

Damages for Neglect by an Information Furnisher

On May 14, the U.S. Court of Appeals for the Fourth Circuit affirmed a jury's award of $1,000 in statutory damages and $80,000 in punitive damages (*Saunders v. Branch Banking and Trust of Virginia*, 4th Cir., No. 07-1108, 5/14/08). The plaintiff had disputed the delinquent status of an auto loan with BB&T Bank because the delinquency had been caused by the bank's error. The bank failed to furnish the dispute information to the CRA TransUnion as required by the FCRA, damaging the plaintiff's credit score and hampering his ability to obtain another loan at a reasonable interest rate. The court ruled that BB&T willfully withheld the information, leaving the plaintiff financially vulnerable. The decision also affirmed the award as being neither excessive nor arbitrary, despite having punitive damages 80 times the statutory damages. Although punitive damages are often capped at 10 times the statutory damages, the court found the amount necessary to serve as a deterrent to this conduct.

Credit and Debit Card Receipt Clarification Act of 2007

On June 3, the President signed into law the Credit and Debit Card Receipt Clarification Act of 2007 (Public Law No: 110-241), retroactively eliminating some potential liability of merchants who accidentally violated the Fair and Accurate Credit Transactions Act (FACTA) by printing the expiration date of credit and debit cards on receipts.

FACTA, enacted in 2003, amended the FCRA to require that merchants not print credit card expiration dates on receipts and print at most the final five digits of credit card numbers. In recent years, customers have brought hundreds of suits against merchants who violated this statute.

Believing that FACTA's wording was confusing, Congress passed the Credit and Debit Card Receipt Clarification Act to protect merchants who had misunderstood the law. The act declares that any merchants who printed expiration dates between December 4, 2004, and the passage of the act could not be held as being in willful violation of the statute. The only exceptions are for cases where the merchants' errors led to the theft of consumers' identities, but no such cases have been reported.

This law appears to supersede all currently pending suits under the statute and has already led to the vacating of at least one previously settled case (*Ehrheart v. Verizon Wireless,* W.D. Pa., No. 2:07-cv-01165, 6/13/08).

Federal Legislation

Bank and Thrift Regulatory Relief Act

On April 15, House Financial Services Committee member Dennis Moore (D.-Kan.) introduced the Bank and Thrift Regulatory Relief Act of 2008 (H.R. 5841) to relax some lending restrictions on thrifts that would allow them to better compete with commercial banks. The bill would eliminate the limit on small business and other commercial nonmortgage loans, currently capped at 20 percent of assets, and instead give the Office of Thrift Supervision (OTS) the ability to set new limits. The bill would also raise aggregate loan limits on nonresidential mortgages from 400 percent to 500 percent of the thrift's total assets, remove limits on investments in auto lending, relax certain disclosure practices, and allow thrifts to pay interest on checking accounts. The bill has been referred to the House Financial Services Committee.

Flood Insurance Reform and Modernization Act

On May 13, the Senate passed a bill (H.R. 3121) to reform the National Flood Insurance Program and reauthorize the program through 2013. The bill would forgive the $20 billion debt of the Federal Emergency Management Administration (FEMA) to the Treasury, which it has indicated it will be unable to pay back. In exchange, FEMA would be required to make more frequent reports to Congress on its financial strength and to retain more capital for the National Flood Insurance Program.

The program would also be expanded: areas determined to be at high risk of flooding would be required to purchase flood insurance, and FEMA would be able to increase its premiums charged based on the calculated risks. Penalties for noncompliance would increase from $350 to $2,000 per violation per household. Responsibility for enforcement would be split among the states and FEMA. The bill has been passed back to the House, which has appointed a conference to work on resolving differences between the version of the bill they passed on September 27, 2007, and the Senate's amended version.

A Bill to Prevent the Implementation of the Unlawful Internet Gambling Enforcement Act

On June 25, the House Financial Services Committee voted down a bill (H.R. 5767) to stop the Treasury and Federal Reserve from implementing any of the regulations prescribed in the Unlawful Internet Gambling Enforcement Act, 31 U.S.C. § 5631, passed in 2006. Banks have complained that the law burdens them with enforcing Internet gambling prohibitions without any clear guidance on what to detect or prevent. Opponents of the bill worried that it would weaken restrictions on Internet gambling by reducing the role of federal regulators in this area.

State Legislation

Tax Incentives for Asset Management Firms in Delaware

On June 3, Delaware Governor Ruth Ann Minner (D) signed into law legislation that gives certain financial services companies a tax incentive to locate operations in Delaware. The law allows asset management corporations with sales in multiple states to compute their Delaware state corporate income tax based solely on the proportion of their sales in Delaware.

Federal Regulation

Department of Housing and Urban Development

Deadline for Comments on Proposed RESPA Rule Extended

On March 14, the Department of Housing and Urban Development (HUD) issued a proposed rule that would amend its implementation of the Real Estate Settlement Procedures Act (RESPA). Comments on the proposal have been extended from May 13 to June 12. For analysis of the rule, see *Banking Legislation and Policy*, Volume 27, Number 1.

Federal Deposit Insurance Corporation

Interim Covered Bond Rule Issued

On April 15, the Federal Deposit Insurance Corporation (FDIC) issued an interim statement addressing how investors can access the collateral behind covered bonds (mortgage-backed bonds sold by depository institutions) if the issuing bank is taken over by the FDIC. Under the interim rule, investors will have access to the collateral 10 days after the institution defaults on payments, as opposed to the usual 90 days. The rule applies to covered bonds that meet certain qualifications for having high-quality mortgages or AAA-rated mortgage-backed securities as collateral. The comment period ended on June 23.

Office of the Comptroller of the Currency

Banks Can Briefly Hold Commercial Property

On April 3, the Office of the Comptroller of the Currency (OCC) issued a letter stating that subsidiaries of national banks may briefly hold property as part of a purchase of loans from a real estate trust as long as the bank has a contract to sell the property right away. There are strict regulations on property ownership by banks, but allowing these transactions should ensure the quick transfer of property.

Risk Management Guidance of Payment Processors

On April 24, the OCC issued a bulletin presenting guidance to national banks for dealing with entities that process payments for telemarketers and other risky merchant clients. The bulletin stresses effective due diligence, underwriting, and monitoring by banks of such clients to ensure that fraudulent or improper activity is not being conducted.

New Rule Eases Regulations on National Banks

On April 24, the OCC issued a new rule (73, *Federal Register*, pp. 22216-52) that relaxes some restrictions on national banks with the goal of making them more competitive with state-chartered banks, hedge funds, and investment banks. The range of investment securities that national banks may buy and sell will increase under the rule. The current regulation specifies certain securities that are currently eligible for trading by banks, but the OCC will now be able to approve transactions of new types of securities on a case-by-case basis. National banks will also have broader authority to act as financial guarantors or sureties. Additionally, the rule streamlines many application processes for national banks and allows them to make some filings after the fact. The rule took effect on July 1.

Joint Release

Illustrations of Hybrid ARM Products

On May 22, the OCC, Board of Governors of the Federal Reserve System, Federal Deposit Insurance

Corporation, Office of Thrift Supervision, and National Credit Union Administration, jointly released illustrations of hybrid ARM products to assist and guide banks in implementing new consumer protection protocols from the agencies' Statement on Subprime Mortgage Lending, issued on July 10, 2007. Illustrations are not required, but banks are required to present clear and balanced information to consumers about such products. For more information on the statement, see *Banking Legislation and Policy*, Volume 26, Number 3.

State Regulation

Interstate Agreements

Regulations Eased for Bank Branches in New Jersey, New York, and Pennsylvania

On April 15, the banking regulators of New Jersey, New York, and Pennsylvania signed a memorandum of understanding that will ease the regulatory burden on state-chartered banks with branches in other states. Under the new regulation, bank branches will be subject to supervision by their home state's regulators but not any other state's regulators.

Judicial Rulings

Circuit Court Rulings

Auto Lenders Can Try to Recover Debts from Bankrupt Borrowers

On May 19, the U.S. Court of Appeals for the Tenth Circuit ruled that auto lenders can obtain a deficiency judgment for the balance of a debt obligation that is not satisfied by the value of the collateral surrendered by the borrower (*DaimlerChrysler Financial Services America LLC v. Ballard (In re: Ballard)*, 10th Cir., Nos. 07-5109 and 07-5112, 5/19/08). On June 27, the U.S. Court of Appeals for the Fourth Circuit issued a similar ruling in *Tidewater Finance Co. v. Kenney* (4th Cir., No. 07-1664, 6/27/08). These cases both stem from Chapter 13 bankruptcy filings by the defendants, who had purchased vehicles within 910 days of filing for bankruptcy and attempted to surrender their vehicles in full satisfaction of the debt, despite the fact that the vehicles were worth less than the debt owed. The appeals courts ruled that the creditors may file for a deficiency judgment under these circumstances, reversing decisions by lower courts that creditors did not have standing to make these claims due to a hanging paragraph in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 11 U.S.C. § 1325(a), which specifically excludes these "910 claims" from bifurcation into secured and unsecured claims prescribed under 11 U.S.C. § 506.

District Court Rulings

Mortgage Lender Negligence

On April 10, a Federal Court in the Eastern District of Pennsylvania dismissed a putative class action lawsuit against Countrywide, SunTrust, nBank, and other lenders claiming negligence by the lenders in dealing with a deceptive mortgage broker (*Jones v. ABN Amro Mortgage Group, Inc.*, E.D. Pa., No. 07-4328, 4/10/08). The plaintiffs allege that the broker defrauded over 800 borrowers in a Ponzi scheme that went bankrupt. They further allege that the broker was the servicing agent of the lenders, and that the lenders are thus liable for the broker's actions. The court dismissed the suit, ruling that the mortgage contract prevents the plaintiffs from suing in tort, and that there was no written or common law relationship that made the broker a servicing agent of the lenders.

Settlements

MasterCard Settles Antitrust Suit with American Express

On June 25, MasterCard Worldwide agreed to pay American Express Co. up to $1.8 billion to settle an antitrust lawsuit begun in 2004 (*American Express Travel Related Services Company, Inc. v. Visa U.S.A. Inc.*, S.D. N.Y., No. 04-8967, 11/15/04). MasterCard will pay 15 percent of American Express's United States Global Network Services billings during the quarter, up to a maximum of $150 million per quarter for the next three years. American Express had sued Visa and MasterCard for attempting to block merchants using their networks from also using the American Express network. Visa settled the case out of court in 2007.

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