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HIGHLIGHTS

This issue contains detailed descriptions of:

- [The Treasury's Financial Regulatory Reform Proposal](#), including:
 - [Increased Supervision and Regulation of Financial Firms](#)
 - [Comprehensive Supervision of Financial Markets](#)
 - [Increased Protection for Consumers and Investors](#)
- [Results of the Federal Reserve's Supervisory Capital Assessment Program \(Stress Tests\)](#)
- [Credit Card Accountability Responsibility and Disclosure Act of 2009 Signed into Law](#)
- [A U.S. Supreme Court Decision Affecting Preemption of State Regulatory Authority](#)

In addition, it summarizes [other notable legislative, regulatory, and judicial developments that occurred during the second quarter of 2009](#).

FINANCIAL REGULATORY REFORM PROPOSAL

On June 17, the Department of the Treasury released a [proposal for financial regulatory reform](#) that, if fully implemented, would expand oversight of bank holding companies (BHCs) and other financial holding companies (FHCs). The proposal promotes increasing the supervision and regulation of financial firms and establishing comprehensive regulation of markets for derivatives and securities, protecting consumers from financial abuse by establishing a new Consumer Financial Protection Agency, and giving the Treasury resolution authority for failing financial firms that fall outside the scope of current regulation. Though many of the suggested ideas lack concrete details, the Treasury and members of Congress have begun introducing legislation that would implement parts of the proposal.

Increasing Supervision and Regulation of Financial Firms

The current regulatory regime has difficulty addressing systemic issues, since supervisory responsibility is split among various federal agencies, each with its own rulemaking abilities for the entities it supervises. This fragmentation of oversight, as well as loopholes in the legal definition of a "bank," creates arbitrage opportunities for financial firms, which can switch to a preferred regulator through legal reorganization.

Creating a Financial Services Oversight Council

On July 22, the Treasury issued [draft legislation](#) that would create a new Financial Services Oversight Council to facilitate information sharing between regulatory agencies and identify emerging risks. It would work with the Federal Reserve to identify firms (designated Tier 1 FHCs)

that pose a serious systemic threat to financial stability because of their size, leverage, or interconnectedness.

Any firm designated as a Tier 1 FHC would be subject to increased supervision and regulation from the Federal Reserve, focusing on systemic risk. The capital, liquidity, and risk management standards for Tier 1 FHCs would be stricter and more conservative than those for other financial firms because of their greater systemic risk. The firms would be subject to frequent stress tests and would be required to have resolution plans in place in case they were to fail.

Though Tier 1 FHCs would be subject to the strictest rules, the Treasury plans to propose changes to capital rules to reduce procyclicality by increasing the amount of capital held during boom periods and on risky investments and analyze the feasibility of allowing banks to issue contingent capital instruments (such as debt securities that automatically convert to common equity in periods of stress).

Closing Loopholes in Bank Regulation

On July 23, the Treasury issued [draft legislation](#) that would create a new National Bank Supervisor (NBS) that will conduct prudential supervision and regulation of all federally chartered depository institutions and all domestic branches of foreign banks, with the goal of decreasing opportunities for regulatory arbitrage. The NBS would consolidate and replace the supervisory responsibilities of the Office of the Comptroller of the Currency (OCC), which currently supervises nationally chartered banks, and the Office of Thrift Supervision (OTS), which currently supervises federally chartered thrifts and thrift holding companies. The Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) would retain their authority over state-chartered banks, and the National Credit Union Administration would retain its authority over credit unions.

The bill would require that any company that controls an insured depository institution, regardless of its legal organization, become a BHC and be subject to consolidated federal oversight. Currently, companies that own only an FDIC-insured thrift, industrial loan company (ILC), credit card bank, or trust company are not required to become BHCs and thus are not required to follow the same regulations as owners of other depository institutions. In addition, the bill would eliminate the federal thrift charter, which the Treasury claims is outdated.

Requiring Hedge Funds and Other Private Pools of Capital to Register

On July 15, the Treasury issued [draft legislation](#) that would require hedge funds and other private pools of capital to register with the Securities and Exchange Commission (SEC). Although some private investment funds must currently register with the Commodity Futures Trading Commission (CFTC), and many funds register voluntarily with the SEC, by and large hedge funds, private equity funds, venture capital funds, and other private pools of capital are not required to register with a federal financial regulator.

All advisers to these private capital funds would be required to register with the SEC, and all investment funds advised by an SEC-registered adviser would be subject to regulation regarding recordkeeping, disclosure of investors, creditors, and counterparties, and regulatory reporting requirements. This would allow the SEC to gather information on the systemic impact of private capital fund activity, protect investors, and conduct periodic examinations to determine the soundness of these funds. In addition, this information will allow the Federal Reserve to determine if any of these firms should be designated as a Tier 1 FHC.

Enhance Oversight of the Insurance Sector

Currently, insurance companies are primarily regulated by the states. The Treasury proposes to establish a federal Office of National Insurance (ONI) within the Treasury to develop a modern regulatory framework for insurance. The ONI would be responsible for gathering information and identifying problems or gaps in regulation and would recommend to the Federal Reserve which insurance companies should be regulated as Tier 1 FHCs.

Establishing Comprehensive Supervision of Financial Markets

The introduction of new financial instruments in recent years allowed credit risks to be spread widely across many investors. The Treasury proposes to establish new rules to regulate these financial instruments going forward.

Strengthening Supervision and Regulation of Securitization Markets

One of the problems with ABS and MBS markets, some believe, was that lenders and securitizers had little incentive to consider the performance of the underlying loans once the securities were issued and sold, since the risk was transferred to investors. To align the incentives of lenders and investors, the Treasury proposes that federal banking agencies create regulations that require loan originators or sponsors to retain 5 percent of the credit risk of securitized exposures and to tie compensation for originators and underwriters of securities to the long-term performance of the underlying assets, rather than to the creation of the securities.

To increase transparency in ABS markets, the Treasury recommends that the SEC be given the authority to require ongoing reporting by ABS issuers and to standardize the legal documentation for security transactions in order to help investors make informed decisions.

On July 21, the Treasury issued [draft legislation](#) that would give the SEC greater authority in its regulation of credit rating agencies (CRAs) to promote the integrity of the ratings process. CRAs would be required to manage and disclose conflicts of interest in their ratings and to be more transparent in disclosing their formulas for measuring risk. The Treasury would also search for ways for regulators to reduce their use of credit ratings in supervisory practices.

Creating Comprehensive Regulation of All OTC Derivatives

The Treasury proposes to subject all over-the-counter (OTC) derivatives markets to comprehensive regulations that would limit systemic risk, promote efficiency and transparency, prevent market manipulation, and protect unsophisticated investors. Currently, trades of OTC derivatives such as credit default swaps (CDS) are not executed on regulated exchanges and are almost completely exempt from any oversight by the CFTC.

The Commodities Exchange Act would be amended to require clearing of all standardized OTC derivatives through regulated central counterparties (CCPs) on regulated exchanges. OTC derivatives dealers would be subject to margin requirements, recordkeeping and reporting requirements, and prudential supervision and regulation. The CFTC would have the authority to set position limits for traders in order to prevent market manipulation.

Harmonizing Futures and Securities Regulation

Futures and securities are regulated by the CFTC and the SEC, respectively. However, many of these instruments are economically equivalent and are only subject to different regulations because of their legal classifications. Going forward, the Treasury recommends that the CFTC and SEC work together to more uniformly regulate these products.

Strengthening Systemically Important Payment, Clearing, and Settlement Systems

The Treasury proposes that the Federal Reserve should become the consolidated supervisor of all systemically important payment, clearing, and settlement systems. The Fed would be charged with setting risk management standards for targeted systems and would have the authority to collect information from these systems and perform on-site inspections as necessary. If already established, jurisdiction over a system would remain with the CFTC or SEC, though the Fed would have emergency authority to take enforcement action.

Protecting Consumers and Investors from Financial Abuse

One of the commonly cited culprits for the financial crisis has been the use of complicated mortgages and other financial products. Not all of these products were sold to consumers who could understand and pay for them. To correct this problem, the Treasury proposes to create a single new agency that would focus on writing and enforcing consumer protection regulations.

Creating a New Consumer Financial Protection Agency

To better protect consumers from unfair, deceptive, or abusive acts or practices, the Treasury proposes to create a new Consumer Financial Protection Agency (CFPA). On July 8, the [Consumer Financial Protection Agency Act of 2009](#) was introduced in the House of Representatives. The CFPA would consolidate the consumer protection responsibilities of other agencies with the goal of reducing existing gaps in regulation.

The CFPA would aggregate the consumer protection responsibilities currently shared by the Federal Reserve, the OCC, the OTS, the FDIC, the Federal Trade Commission (FTC), and the National Credit Union Administration (NCUA). Responsibility for services or products already overseen by the SEC or the CFTC would stay with

those agencies. Included in the CFPA's powers would be authority for writing rules, supervising and examining compliance, and enforcing violations.

The CFPA would oversee all companies offering consumer financial services and products, including banks, thrifts, mortgage companies, and bank affiliates that are not currently supervised by a federal regulator. It would seek to ensure that consumers have adequate information to make financial decisions and that consumers are protected from unfair, deceptive, or abusive acts or practices. The CFPA would have sole authority to issue regulations under existing statutes, such as the Truth in Lending Act (TILA), the Home Ownership and Equity Protection Act (HOEPA), the Real Estate Settlement and Procedures Act (RESPA), and others. In addition to regulation, the CFPA would be expected to play a leading role in efforts to educate consumers about financial matters.

The CFPA's regulations would serve as a floor for state regulations. Any state that wishes may pass stricter consumer protection laws than the CFPA.

The CFPA would be authorized to define standards for "plain vanilla" products that are simple and straightforward and to promote these products by requiring firms to offer them alongside exotic products. For example, the features and total costs of a mortgage with a negative amortization feature would be listed next to analogous information for a traditional 30-year fixed rate mortgage. The CFPA would have the authority to review financial contracts and deem them overly complex and issue regulations penalizing such products.

The CFPA would have the ability to restrict or ban mandatory arbitration clauses in contracts as it sees fit but would not have the ability to pass any usury limit on loans.

Strengthening Investor Protection

On July 10, the Treasury issued [draft legislation](#) to strengthen the SEC's powers to protect investors from fraud. The bill would require increased obligations and disclosure from broker-dealers and investment professionals and would prohibit certain conflicts of interest and sale practices. In addition, the SEC would have the authority to regulate the timing and quality of mutual fund disclosures before the purchase of a fund. To further combat fraud, the bill would allow for offering whistleblowers increased compensation and protection for information that leads to enforcement actions.

The SEC would also be given authority to prohibit or limit mandatory pre-dispute arbitration agreements.

Giving the Treasury Resolution Authority

Resolution Regime for Failing BHCs, Including Tier 1 FHCs

On July 23, the Treasury issued [draft legislation](#) that would give it resolution authority for nonbank financial firms and BHCs, including Tier 1 FHCs.¹ While the FDIC has the authority to effect an orderly resolution of a distressed depository institution, there is no statutory framework for avoiding the disorderly failure of nonbank financial firms. This lack of a resolution regime created difficulties for the federal government in responding to the impending bankruptcies of Bear Stearns, Lehman Brothers, and AIG.

Under this bill, bankruptcy would remain the dominant tool for handling the failure of a BHC, but the Treasury would be able to use this new authority if it determines that there are significant systemic issues. The Treasury's powers would include the authority to put a troubled firm into conservatorship or receivership or to stabilize

¹ The Treasury issued a similar proposal in March 2009, which was discussed in [Banking Legislation and Policy, Volume 28, Number 1](#).

the firm by providing loans to, making equity investments in, or guaranteeing the liabilities of the firm.

Amending the Federal Reserve's Emergency Lending Authority

Section 13(3) of the Federal Reserve Act provides that in "unusual and exigent circumstances," the Board may authorize a Federal Reserve Bank to lend to any individual, partnership, or corporation. This authority has been used recently to lend to individual financial institutions such as AIG and to set up emergency liquidity facilities such as the Commercial Paper Funding Facility. Although in practice the Board has always consulted with the Treasury before taking emergency action, the Treasury seeks to require the explicit written approval of the Secretary of the Treasury before the Board can take such actions in the future.

SUPERVISORY CAPITAL ASSESSMENT PROGRAM RESULTS RELEASED

On May 7, the Federal Reserve released the [results of its Supervisory Capital Assessment Program](#) (SCAP), through which it conducted stress tests on the capital buffers of the nation's 19 largest bank holding companies (BHCs), those with \$100 billion or more in assets.² Ten of the banks were found to be undercapitalized, collectively needing to raise \$74.6 billion to be able to absorb losses if the economy weakens more than expected.

The traditional role of capital, especially common equity, is to absorb unexpected losses and thus to protect depositors and other creditors. The

² These 19 banks are (in alphabetical order): American Express Company, Bank of America Corp., BB&T Corp., the Bank of New York Mellon Corp., Capital One Financial Corp., Citigroup, Inc., Fifth Third Bancorp, GMAC LLC, the Goldman Sachs Group, Inc., JPMorgan Chase & Co., KeyCorp, MetLife, Inc., Morgan Stanley, PNC Financial Services Group, Inc., Regions Financial Corp., State Street Corp., SunTrust Banks, Inc., U.S. Bancorp, and Wells Fargo & Company Bank Holding Company

heightened uncertainty about the future economy led supervisors to believe it would be prudent for large BHCs to hold additional capital against unusually large losses. From the third quarter of 2007 through the end of 2008, losses at these 19 BHCs have been estimated at \$400 billion. The goal of the SCAP was to calculate the amount of capital banks would need to cover their losses in 2009 and 2010 under worsening economic conditions while continuing to make loans to creditworthy consumers and businesses.

Methodology

Details of [the methodology of the tests](#) were released on April 24. Projections were performed under two macroeconomic scenarios: a baseline that was the average of several projections from February 2009 (when the tests began), and a more adverse scenario that reflected the possibility that the recession could be more severe than forecasters had predicted. The more adverse case was not intended to be a worst-case scenario, but rather a plausible, if unlikely, one.³

The SCAP process began with firms estimating their potential losses on loans, assets held in investment portfolios, and trading-related exposures, as well as the firm's capacity to absorb losses through pre-provision net revenue (PPNR) and the resources available from the allowance for loan and lease losses (ALLL) for 2009 and 2010.

For loans, the BHCs were instructed to estimate forward-looking, undiscounted credit (cash flow) losses, rather than discounts related to mark-to-market values. Regulators provided the BHCs with a common set of indicative two-year cumulative loss rates for each of 12 specific loan categories under both the baseline and more

adverse scenarios.⁴ These rate ranges were derived using historical loss experience at BHCs and loan-level quantitative models. BHCs were permitted to submit loss rates outside the ranges but were required to submit strong supporting evidence.

For securities held in available-for-sale (AFS) and held-to-maturity (HTM) portfolios, BHCs were instructed to estimate possible impairment based on the elements of each security, including collateral type, vintage, credit rating, credit support, and carrying and market values. If the current level of credit support was insufficient to cover expected losses, the security was written down to fair value, less an other-than-temporary-impairment charge equal to the difference between the book and market values.

BHCs with trading account assets exceeding \$100 billion at year-end 2008 were required to provide projections of trading-related losses, including losses from counterparty credit risk exposures (including potential counterparty defaults).

Institutions were also instructed to estimate the resources they would have available to absorb losses over the two-year horizon. PPNR was defined as net interest income plus noninterest income minus noninterest expense, essentially the income after non-credit-related expenses before the firms took write-downs or losses. They also estimated the portion of their year-end 2008 ALLL available to absorb losses on their loan portfolios.

After firms had completed their calculations, they were submitted to supervisory review committees that evaluated the quality of the firms' submissions. Using firm-specific data on factors such as past performance, portfolio composition, geographic distribution, and business

³ The subjective probability assessments imply a roughly 15 percent chance that real GDP growth could be at least as low, and unemployment at least as high, as assumed in the more adverse scenario. It is assumed that there is a roughly 10 percent probability that house prices will be 10 percent lower than the baseline by 2010.

⁴ Loan types were prime, Alt-A and subprime first-lien mortgages, closed-end junior lien mortgages, HELOCs, commercial and industrial loans, constructions, multifamily, and nonfarm nonresidential commercial real estate loans, credit cards, other consumer loans, and miscellaneous other loans.

mix, as well as a cross-firm comparison, they adjusted the firms' results.

The supervisors also evaluated the composition and quality of the capital in addition to the amount, assessing the level of the Tier1 risk-based capital ratio and the proportion of that ratio that was common equity, since common equity is the first element of the capital structure to absorb losses.

Looking at a combination of these factors, the supervisors determined the size of the capital buffer that each firm needs to raise to ensure appropriate capital in the more adverse scenario. A BHC was considered to require an additional SCAP buffer if its Tier 1 ratio was below 6 percent or if its Tier 1 Common ratio was below 4 percent at the end of 2010 under the more adverse scenario.

Results

Usually, the results of examinations are kept confidential, but the Fed believed that clarity about the SCAP findings would make the exercise more effective at reducing investor uncertainty and restoring confidence in financial institutions.

At the end of the fourth quarter of 2008, capital ratios at all 19 BHCs exceeded the minimum standards, totaling approximately \$835 billion. Under the more adverse economic scenario, analysts estimate total losses for the firms of \$600 billion for 2009 and 2010. Of these losses, \$455 billion would come from residential mortgages and other consumer-related loans. The estimated two-year cumulative loss on total loans was 9.1 percent in the more adverse scenario, higher than that experienced during the Great Depression.

Of the 19 BHCs, 10 were deemed to require additional Tier 1 capital, mostly in the form of common equity. The Fed calculated that these firms needed to raise a total of \$185 billion at the end of 2008 to reach the target SCAP capital buffer. However, after taking into account capital actions that occurred in the first quarter of 2009 – including asset sales, restructured existing capital

instruments, and higher than expected net revenues that allowed the banks to build their capital buffers – the total amount to be raised fell to \$74.6 billion. Bank of America has by far the largest burden, needing \$33.9 billion. Wells Fargo needs \$13.7 billion, GMAC \$11.5 billion, Citigroup \$5.5 billion, Regions Financial \$2.5 billion, SunTrust Banks \$2.2 billion, Morgan Stanley and KeyCorp \$1.8 billion each, Fifth Third Bancorp \$1.1 billion, and PNC Financial \$600 million.

This additional capital represents a one-time buffer and does not indicate a permanent shift in regulatory capital standards.

The BHCs had until June 8 to create detailed plans for raising the required capital and will have until November 9 to implement these plans. If any BHCs are unsuccessful in raising the capital, the Treasury will provide loans through its Capital Assistance Program to cover the shortfall.

BHCs Seek to Repay TARP Funds

On June 1, the Federal Reserve [released the criteria](#) it would use to evaluate applications by BHCs to return capital received through the Troubled Asset Relief Program (TARP). TARP, the Treasury's \$700 billion fund to make strategic investments in the economy, has so far distributed \$203 billion to struggling banks through its Capital Purchase Program (CPP).⁵ In return, the Treasury has received senior preferred shares in the banks, which pay an annual dividend of 5 percent.⁶

To repay the CPP loans, a BHC must first receive approval from its primary federal regulator, which will then forward the application to the Treasury. To be approved, the BHC must be able to demonstrate that it will be able to access long-term debt markets without relying on the Federal Deposit Insurance Corporation's (FDIC)

⁵ As of July 6, 2009. For up-to-date information on TARP distributions, see the "TARP Transactions Report" at <http://www.financialstability.gov/latest/index.html>.

⁶ For more information on the CPP, see [Banking Legislation and Policy, Volume 27, Number 4](#).

Temporary Liquidity Guarantee Program (TLGP) and must demonstrate that it has access to public equity markets. In reviewing the application, the Fed will also consider whether the BHC can repay the Treasury and still be able to lend to creditworthy consumers and businesses, how the repayment will affect its regulatory capital ratio, and whether the BHC will be able to meet its obligations to counterparties. Finally, to receive approval, the BHC must have a robust long-term capital assessment and long-term management process geared toward maintaining a prudent level of capital given its activities and risk profile.

On June 17, seven of the BHCs that were subject to the SCAP announced that they had fully repaid the Treasury for funds received under the TARP. The firms had borrowed a total of \$61 billion through the CPP. JPMorgan Chase & Co. repurchased \$25 billion in preferred stock, the largest amount provided to a single company under the CPP. Among other SCAP firms, Goldman Sachs and Morgan Stanley each repurchased \$10 billion of preferred shares, U.S. Bancorp \$6.6 billion, American Express Co. \$3.39 billion, BB&T Corp. \$3.1 billion, and the Bank of New York Mellon Corp. \$3 billion. In addition, the firms paid dividends owed to the Treasury that collectively totaled more than \$1.5 billion.

As of July 6, 2009, 32 banks had repaid a total of \$70 billion in capital, leaving \$133 billion in CPP disbursements outstanding.

In addition to the preferred shares, each bank issued warrants to the Treasury to purchase common stock worth 15 percent of the amount of the preferred stock. On June 26, the Treasury released its [guidelines for banks to repurchase these warrants](#). If a bank wishes to repurchase the warrants, it must submit a proposed fair market valuation for them within 15 days of repaying its CPP loans. The Treasury will have 10 days to accept or reject the offer, based on its own valuations derived from financial pricing models and observing market prices of comparable traded

securities. If the offer is rejected and the two sides cannot reach an agreement on the price, independent appraisers will be brought in to determine a final fair value. The Treasury will publish proposed valuations, thereby discouraging low-ball offers. If a firm decides not to repurchase its warrants, the Treasury will sell them through an auction process

Under the terms of the Emergency Economic Stabilization Act of 2008, which established the \$700 billion TARP, any funds repaid are supposed to be recycled back into the program so that the Treasury may continue to make emergency loans without having to request additional funds from Congress. However, [H.R. 2745](#) (TARP Repayment and Termination Act of 2009) was introduced on July 8, calling for the Treasury to gradually wind down the program by returning the repaid amounts to the general fund.

CREDIT CARD ACCOUNTABILITY RESPONSIBILITY AND DISCLOSURE ACT

On May 22, President Obama signed into law the Credit Card Accountability Responsibility and Disclosure (Credit CARD) Act of 2009 ([Public Law No. 111-24](#)). The law amends the Truth in Lending Act (TILA) to prohibit a number of misleading or predatory practices by credit card issuers. Provisions of the law protect consumers by limiting fees and interest charges and requiring enhanced disclosures. It also contains provisions that affect prepaid gift cards. Most of the provisions of the law will become effective nine months after it was signed, except as otherwise specifically provided in the legislation.

The bill was originally introduced in the House on January 22, 2009, by Rep. Carolyn Maloney (D-N.Y.). A previous version of the bill was introduced in the House in 2008 ([H.R. 5244](#)) but was not passed. For more information on this version of the bill, see [Banking Legislation and Policy, Volume 27, Number 1](#).

Consumer Protection

Amendments to the TILA will now require a card issuer to notify a customer at least 45 days before the effective date of an increase in the customer's annual percentage rate (APR).

Customers will have the option of canceling the account prior to the rate increase. The APR on an account may not be increased for at least one year following its opening, and any promotional rate must last at least six months.

Retroactive increases on existing balances are strictly prohibited, unless the increase is solely due to the expiration of a promotional rate or the completion of a workout or temporary hardship arrangement; if the APR is variable and indexed to some other rate; or if the customer has not made the minimum payment within 60 days.

Under this law, universal default – the practice of increasing the APR on a customer's account due to delinquency or default on another account – is prohibited. In general, the issuer must reassess any factors that led to an APR increase every six months and determine whether the factors have changed and the APR should be decreased.

Any penalty fees charged need to be "reasonable and proportional" to the penalty. The Board of Governors of the Federal Reserve is required to issue a final rule within nine months to establish what constitutes reasonable fees.

"Double-cycle" billing – the practice of charging interest based on the account's average balance over the last two billing cycles – is also now prohibited.⁷ Practitioners of this method had been able to charge interest on amounts paid off during the previous cycle's grace period if any balance had carried over to the current period, thereby increasing total interest charges in the long run. Double-cycle billing is especially costly to

consumers who carry a large balance or who wish to pay off their balance over a period of time.

If the issuer offers over-the-limit protection for an account but charges a fee when a transaction causes the account balance to exceed the authorized credit limit, the customer must now expressly opt in to such coverage. In addition, an over-the-limit fee may be charged only once during a billing cycle and only once in each of the next two billing cycles, unless the consumer obtains additional credit or pays down the balance to below the limit and subsequently exceeds it again.

If different APRs apply to different portions of the balance on an account, the issuer will now be required to credit payments over the minimum first to the portion of the account with the highest APR. The only exception is if there is any balance on which interest was deferred for at least the previous two billing cycles and that deferral period is expiring, that balance must be credited first.

Subprime, or "fee harvester," cards are also now subject to certain rules. A card is defined as subprime if its terms require the consumer to pay any fees (other than late fees, over-the-limit fees, or fees for payment returned for insufficient funds) in the first year in excess of 25 percent of the total authorized credit. Under this law, the credit available from the account may not be used to pay these fees. This provision is intended to help avoid the overuse of credit by subprime borrowers, who will no longer be able to open a credit card account by charging the opening fees to that credit card.

Additional provisions specify how issuers must handle payments and what is considered an on-time payment.

Enhanced Disclosure Requirements

Under the bill's enhanced disclosure requirements, card issuers must now give consumers printed warnings on periodic statements about the interest that will be charged if only the minimum is paid. The issuers will have to indicate the number of months it would take to

⁷ For an example of double-cycle billing, see page 28 of the Government Accountability Office's [report on credit card practices](#) from September 2006.

repay the balance if only the minimum is paid each month and the total cost of such a payment stream, as well as the monthly amount the consumer would have to pay to eliminate the balance within 36 months. The Federal Reserve is charged with creating a standardized template that all issuers will have to use to convey this information.

In addition, card issuers must make clear and conspicuous disclosures on periodic statements of due dates for payment and any penalty fees or interest that will be charged for late payments. Under this legislation, any payments made at a local branch on the due date must be counted as on time.

Protecting Young Consumers

Issuers are now prohibited from pre-approving consumers who are under 21 for credit cards; the consumer must now submit a written application. A card may then be issued to the applicant only if the account is co-signed by someone who is 21 and has the means to repay the loan, such as a parent, guardian, or spouse. Once the account has been opened, the credit limit on the account may be increased only if the co-signer also approves it.

The legislation also enacts new rules for issuers who wish to partner with universities to offer cards to students. Institutions of higher education and card issuers must publicly disclose any marketing agreements. Issuers are prohibited from offering any “tangible item” to induce students to apply for a card if the offer is made on or near a college campus or at any event sponsored by the college. In addition, Congress recommends that colleges limit the number of locations where issuers may market credit cards and offer debt education and counseling sessions for students.

Gift Cards

New rules will also exist for general-use prepaid cards, gift certificates, and store gift cards. An inactivity fee may be charged only if the card

clearly and conspicuously states its frequency and amount or if the card has not been used in 12 months; the inactivity fee may be charged only once a month. Cards may not expire for at least five years from issuance. These rules do not apply to prepaid telephone cards or to cards that are reloadable and not marketed as gift cards.

PREEMPTION OF STATE REGULATORY AUTHORITY

On June 29, the Supreme Court of the United States upheld an injunction against the attorney general of the state of New York, who had asked various national banks to provide certain nonpublic information so he could determine if the banks had violated New York’s fair lending laws ([*Cuomo v. Clearing House Association, et al.*](#), U.S., No. 08-453, 6/29/09). The court ruled that a state attorney general may not act as a supervisor of national banks to conduct examinations or request records. However, the court did find that an attorney general may bring a suit against a national bank to enforce a state law and, through normal judicial proceedings, may be entitled to examine the bank’s records.

In 2005, the attorney general of New York, “in lieu of subpoena,” sent letters to several national banks asking that they provide certain nonpublic information about their lending practices. The attorney general sought the information to investigate possible violations of the state’s fair lending laws. The Clearing House Association, a banking trade group, and the Office of the Comptroller of the Currency (OCC) brought suit to block the information request, arguing that OCC regulations authorized under the National Bank Act (NBA) prohibited this state enforcement action against national banks. A federal court granted the injunction, which the U.S. Court of Appeals for the Second Circuit affirmed.

At issue was the definition of what constitutes “visitorial powers” on the part of state governments. Section 484(a) of the NBA (Title 12,

U.S.C.) states that “no national bank shall be subject to any visitorial powers except as authorized by Federal law.” When the OCC subsequently wrote its rule (12 CFR §7.4000) on visitorial powers, it specifically prohibited “state officials from exercising visitorial powers with respect to national banks, such as conducting examinations, inspecting or requiring the production of books or records of national banks, or prosecuting enforcement actions, except in limited circumstances authorized by federal law.” Otherwise, national banks would face a patchwork system of regulators, each with its own supervisory regime.

All of the Supreme Court justices concurred that the OCC was correct to prohibit examination of national banks by state regulators to avoid this result, but they disagreed as to whether enforcement actions should be on the list of visitorial powers. To prohibit enforcement actions implies that, though states may pass valid banking laws, they may not enforce them against national banks.

However, the court has historically “understood ‘visitation’ as [the] right to oversee corporate affairs, quite separate from the power to enforce the law.” Thus, the majority of the court found that the OCC’s prohibition against state

enforcement actions was inappropriate and outside the scope of its regulatory power. When an attorney general brings a civil suit against a national bank, he is acting in the role of “sovereign-as-law-enforcer,” which is not an exercise of visitorial powers. Those powers are applied only when the state acts as “sovereign-as-supervisor,” examining banks or requesting records.

In this particular case, the court upheld the injunction of the attorney general’s request for information because there was no threat of immediate enforcement action. If the request had not been voluntarily honored, the attorney general would have issued a subpoena for the records under his own authority, which certainly falls under the definition of visitation and is prohibited.

However, the court ruled that if a state attorney general brings suit against a firm or obtains a judicial search warrant based on probable cause, he is not exercising visitation. In court, the attorney general is treated as a litigant, subject to the normal rules of procedure and discovery. The court leaves it to judges to “prevent ‘fishing expeditions’ or an undirected rummaging through bank...records for evidence of unknown wrongdoing.” The court notes that in the state of New York, civil discovery is far more limited than the range of visitorial powers.

Federal Legislation

Enacted Legislation

Fraud Enforcement and Recovery Act of 2009

On May 20, the President signed into law the Fraud Enforcement and Recovery Act of 2009 ([Public Law No. 111-21](#)). The law expands the general securities fraud statutes of the federal criminal code to include fraud involving options and futures on mortgage-backed securities (MBS). The law also redefines the term “financial institution” to include mortgage lending businesses, outlaws fraud related to the Troubled Asset Relief Program, and expands anti-money-laundering statutes.

Preventing Mortgage Foreclosures and Enhancing Mortgage Credit

On May 20, the President signed into law a bill to prevent mortgage foreclosures and enhance mortgage credit ([Public Law No. 111-22](#)). The first part of the legislation, the Helping Families Save Their Homes Act of 2009 (H.R. 1106), was discussed in detail in [Banking Legislation and Policy, Volume 28, Number 1](#). The second part of

the legislation, the Homeless Emergency Assistance and Rapid Transition to Housing Act of 2009, offers funding and assistance to services and advocates that target the homeless.

Federal Regulation

Board of Governors of the Federal Reserve

Legacy Commercial Mortgage-Backed Securities Now Eligible as Collateral for TALF Loans

On May 19, the Board of Governors of the Federal Reserve [announced](#) that it would begin accepting certain commercial mortgage-backed securities (CMBS) as collateral for loans made through its Term Asset-Backed Securities Loan Facility (TALF). Eligible CMBS must have been issued before January 1, 2009, and must have the highest credit rating available. Loans will be for either three or five years, with fixed annual interest rates of 1 percent over the five-year or three-year LIBOR, respectively. Loans will be for the par value of the CMBS, less a haircut. CMBS with an average lifespan of five years or less will face a 15 percent haircut. This haircut increases by 1 percent for each one-year increase in average lifespan, to a maximum of 25 percent. CMBS with an average lifespan over 10 years are not eligible.

Extensions of and Modifications to Liquidity Facilities

On June 25, the Board of Governors of the Federal Reserve issued a number of [extensions of and modifications to its liquidity facilities](#). Extended through February 1, 2010 are the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), Commercial Paper Funding Facility (CPFF), Primary Dealer Credit Facility (PDCF), and Term Securities Lending Facility (TSLF). The temporary reciprocal currency agreements between the Fed and other central banks have also been extended to February 1, 2010. The authorization for the Money Market Investor Funding Facility (MMIFF) was not extended, and it will be closed. Because of decreased demand, the size of upcoming Term Auction Facility (TAF) auctions will be decreased. For the TSLF, Schedule 1 and Options Program auctions will be suspended, and Schedule 2 auctions will be reduced in frequency and size.

Federal Deposit Insurance Corporation

Community Banking Advisory Committee Established

On May 29, the Federal Deposit Insurance Corporation (FDIC) established the FDIC Advisory Committee on Community Banking ([74, Federal Register, pp. 27141-2](#)). The committee will provide advice and recommendations on policy issues that have a particular impact on community banks throughout the United States, including a focus on rural areas.

Changes to the Debt Guarantee Program

On June 3, the FDIC issued two final rules that amend the Debt Guarantee Program (DGP) of the Temporary Liquidity Guarantee Program (TLGP). Through the DGP, described in detail in [Banking Legislation and Policy, Volume 27, Number 4](#), the FDIC guarantees certain newly issued senior unsecured debt for financial institutions. The first amendment extends the window for participating institutions to issue new guaranteed debt from June 30, 2009, to October 31, 2009 ([74, Federal Register, pp. 26521-5](#)). However, for debt issued on or after April 1, 2009, a 25-basis-point surcharge will be added to the normal 25-basis-point fee for the guarantee. The second amendment allows the FDIC to guarantee certain mandatory convertible debt (MCD) issued by a participating institution, as long as the institution receives permission from the FDIC to issue the MCD ([74, Federal Register, pp. 26941-5](#)).

Proposed Phase Out of the Transaction Account Guarantee Program

On June 23, the FDIC issued for comment two possible alternatives for phasing out the Transaction Account Guarantee (TAG) component of the TLGP ([74, Federal Register, pp. 31217-22](#)). Through the TAG, described in detail in [Banking Legislation and Policy, Volume 27, Number 4](#), the FDIC guarantees all funds held in qualifying non-interest-bearing transaction accounts (such as corporate payroll accounts) for participating financial institutions. The proposed phase-outs would either allow the TAG to expire on December 31, 2009, as originally planned, or extend the TAG through June 30, 2010. If the TAG is extended, annual fees charged to insured institutions that choose to stay in the program would increase from 10 basis points to 25 basis points. Comments were due by July 30, 2009.

Risk Weighting for Modified Mortgages Clarified

On June 23, the FDIC, in conjunction with the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Board of Governors of the Federal Reserve, issued an interim final rule clarifying the risk weight that institutions must apply to mortgages modified under the Making Home Affordable Program when calculating regulatory capital requirements ([74, Federal Register, pp. 31160-7](#)). Loans modified under the program will retain the risk weight assigned prior to modification, as long as the loan continues to meet other prudential criteria. The rule went into effect on June 30, 2009.

Proposed Changes to the Community Reinvestment Act

On June 23, the FDIC, in conjunction with the OCC, OTS, and Federal Reserve, proposed two changes to the Community Reinvestment Act (CRA), as required by recent legislation ([74, Federal Register, pp.31209-17](#)). First, it would require agencies to take into account low-cost education loans made by institutions to low-income borrowers when making CRA evaluations of the institutions. Second, for non-minority-owned and non-women-owned financial institutions, the agencies must take into account their cooperation with minority-owned and women-owned financial institutions and low-income credit unions in capital investment, loan participation, and other ventures when making CRA evaluations. Comments were due on July 30, 2009.

Proposed Guidance on Funding and Liquidity Risk Management

On June 23, the FDIC, in conjunction with the OCC, Federal Reserve, OTS, and National Credit Union Administration (NCUA), issued for comment proposed guidance that summarizes the principles of sound liquidity risk management that federal agencies have issued in the past and brings them into conformance with recommendations issued by the Basel Committee on Banking Supervision in September 2008 ([74, Federal Register, pp. 32035-44](#)). Comments are due on September 4, 2009.

Federal Housing Finance Agency

FHLB Membership for Community Development Financial Institutions

On May 15, the Federal Housing Finance Agency (FHFA) proposed to allow non-federally insured, CDFI Fund-certified community development financial institutions (CDFIs) to become members of a Federal Home Loan Bank (FHLB) as long as they meet the eligibility requirements specified in the rule ([74, Federal Register, pp. 22848-67](#)). The newly eligible CDFIs include community development loan funds, venture capital funds, and state-chartered credit unions without federal insurance. This would give the CDFIs access to the FHLBs' long-term, low-cost funding to assist them in making mortgage loans to low-income households.

Financial Accounting Standards Board

Statements Issued Pertaining to Securitization and Special-Purpose Entities

On June 12, the Financial Accounting Standards Board (FASB) published two statements that will apply to firms beginning in 2010. [Statement 166](#), *Accounting for Transfers of Financial Assets*, will require more disclosure about transfers, especially securitizations, and instances in which companies have continuing risk exposure to transferred financial assets. It eliminates the concept of a qualifying special-purpose entity (QSPE) and changes the treatment for transferred financial assets. [Statement 167](#) revises FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*. Going forward, the determination of whether a company is required to consolidate an entity that is insufficiently capitalized or not controlled through voting will be based on the entity's purpose and design and the company's ability to direct the entity's activities.

Judicial Rulings

Circuit Court Rulings

Balance Transfer Between Credit Cards Voidable Under Bankruptcy Law

On March 27, the U.S. Court of Appeals for the Sixth Circuit upheld a bankruptcy court's ruling to void a balance transfer from one credit card to another by a consumer who filed for bankruptcy shortly thereafter ([Yoppolo v. MBNA American Bank NA \(In re Dilworth\)](#), 6th Cir., No. 08-3389, 3/27/09). The customer used a Citi-issued credit card to pay off a \$10,500 balance on an MBNA-issued credit card less than one month before she filed for bankruptcy protection. Such preferential treatment of creditors by a debtor is not allowed once the customer has filed for bankruptcy, and the trustee sought to void the transfer under section 547(b) of the bankruptcy code. The bankruptcy court agreed with the trustee, because the customer had exhibited significant control over distribution of the funds when she decided to pay MBNA instead of other creditors.

Creditors Must Return Seized Automobiles Once Owner Files for Bankruptcy

On May 27, the U.S. Court of Appeals for the Seventh Circuit overturned a bankruptcy court's ruling, finding that a lender must return a repossessed vehicle to an owner if the owner files for Chapter 13 bankruptcy protection and has any equity interest in the vehicle ([Thompson v. General Motors Acceptance Corporation, LLC](#), 7th Cir., No. 08-2077, 5/27/09). The court ruled that holding the car after the bankruptcy filing violated provisions of the bankruptcy code that freeze a borrower's assets until reviewed by a bankruptcy judge. The lender can still seek assurance that its interests will be protected.