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Financial Services Report

A report designed to provide news and analysis of recent legal and regulatory developments in the financial services industry

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THE FEDERAL RESERVE AND TRUST PREFERRED SECURITIES

RAP TRUMPS GAAP

It was a clear choice between GAAP (generally accepted accounting principles) and RAP (regulatory accounting practice). Hanging in the balance was approximately $85 billion of trust preferred securities issued by over 800 bank holding companies (BHCs). The accounting profession, through FASB Interpretation No. 46, had already issued guidance effectively disallowing capital treatment for trust preferred securities. On March 1, 2005, the Federal Reserve paid all due respect to GAAP, and then followed its own lead. The result is that billions of dollars of trust preferred securities issued by hundreds of BHCs will continue to receive Tier 1 capital treatment. Just as importantly, trust preferred securities remain a means by which BHCs can augment their capital. However, the rules have changed, reducing the aggregate amount of trust preferred securities that BHCs will be able to include in Tier 1 capital.

The Board had proposed the new rule to amend risk-based capital standards on May 6, 2004. The proposal described three substantive changes to the then-current practice that allowed the use of certain cumulative preferred stock instruments in Tier 1 capital for BHCs: (i) goodwill must be subtracted from core capital elements before calculating permitted trust preferred securities; (ii) Tier 1 capital credit must be amortized of trust preferred securities in the five years prior to maturity; and (iii) internationally active BHCs must limit their trust preferred securities to 15% of Tier 1 capital, net of goodwill.

Interestingly, of the thirty-eight comments the Board received on the proposed rule, only the Federal Deposit Insurance Corporation objected to the continued inclusion of trust preferred securities in Tier 1 capital. The FDIC based its argument on the view that instruments that are accounted for as a liability under GAAP should not be included in Tier 1 capital. The Board did not believe that the change in GAAP accounting for trust preferred securities changed the prudential characteristics that led the Board to first include the securities in Tier 1 capital.

In This Issue

The Board's Final Rule

The Board's final rule addresses both trust preferred securities and also more clearly states the Federal Reserve position on several other capital issues. Some of the highlights are set forth below:

- The Federal Reserve has reworked the definition of "core capital elements" so that it now includes in addition to equity a new concept called "restricted core capital elements." Included within the meaning of "restricted core capital elements" are both qualifying cumulative perpetual preferred stock and trust preferred securities.

- Previously, trust preferred securities eligible for inclusion in Tier 1 capital were limited to 25% of Tier 1 capital. Cumulative preferred stock eligible for inclusion in Tier 1 capital also had its own limitation based upon 25% of Tier 1 capital. Under the new rule, the aggregate amount of all restricted core capital elements are subject to a limitation of 30% of core capital. The regulation provides:

  > Stated differently, the aggregate amount of restricted core capital elements is limited to one-third of the sum of core capital elements, excluding restricted core capital elements, net of goodwill less any associated deferred tax liability.

  Accordingly, trust preferred securities are combined with cumulative perpetual preferred stock in determining whether an institution has met the one-third limitation on the sum of all restricted core capital included in Tier 1 capital.

- Importantly, note the section from the regulation quoted above. In calculating the amount of restricted core capital that may be included in Tier 1, intangible capital is excluded from the calculation. Thus, for many BHCs, particularly those that have engaged in acquisition transactions, the aggregate amount of trust preferred securities includable in Tier 1 capital will be reduced. It could first be reduced by the fact that intangible capital will no longer be used in the calculation. It could also be reduced by the fact that trust preferred securities now must be aggregated with cumulative perpetual preferred stock in determining adherence to the aggregate limitation.

The Federal Reserve also refined a few portions not only on trust preferred securities, but also relative to several general capital positions. With respect to trust preferred securities, the Federal Reserve has made clear it wants a consultation prior to issuance. A BHC "must" (and no longer "should") consult with the Federal Reserve before issuing trust preferred securities. Trust preferred securities will also amortize (similarly to subordinated debt) during the last five years of its existence. The "no call" requirement during the first five years of a trust preferred issuance has disappeared. The subordinated debt issued by the BHC in connection with the trust preferred securities must meet the rules applicable to other subordinated debt, e.g., no credit-sensitive features, and nothing that would interfere with subsequent capital initiatives.

The regulation also contains transitional rules. The new amount limitations applicable to "restricted core capital elements" do not take effect until March 31, 2009. However, a BHC whose restricted core capital elements cause it to exceed the new limitations "must" consult with the Federal Reserve concerning a plan for no undue reliance on restricted core capital elements. Well-managed institutions will do just that and not wait for the Federal Reserve to raise the issue.

Lastly, the Federal Reserve took the occasion to remind all BHCs about the importance of voting common stockholders' equity. As stated by the Federal Reserve, it is fine that certain elements are included in Tier 1 other than voting common. However, as stated by the Federal Reserve:

> Voting common stockholders' equity, which is the most desirable capital element from a supervisory standpoint, generally should be the dominant element within Tier 1 capital. Thus, banking organizations should avoid over-reliance on preferred stock and nonvoting elements within Tier 1 capital.

Exactly what is meant by "dominant" is left undefined. Clearly, "dominant" is at least 50%. Some have speculated that "dominant" may mean that as much as two-thirds of a BHC's Tier 1 capital should be stockholders' equity.

Implications of the Final Rule

The Board stated that the final rule was adopted to address supervisory concerns, competitive equity considerations and changes in GAAP, as well as to strengthen the definition of regulatory capital by incorporating long-standing Board policies on the acceptable terms of a BHC's capital instruments. This rule may, however, affect acquirers who are currently near the 25% of Tier 1 capital limit and have substantial amounts of goodwill. These acquirers may need to review their capital strategies to address common stock or noncumulative perpetual preferred stock. Investment banking firms are starting to develop entities which would purchase noncumulative preferred stock from multiple issuers. However, the pricing on such instruments suffers due to the lack of any tax advantage. Institutions that want to be considered "well-managed" institutions will carefully review this new regulation to assess their particular situation. Importantly, any institution with "restricted core capital elements" in excess of 30% of shareholder equity will need to develop a plan to come in line with the Federal Reserve's thinking, at least to the extent the institution has been relying upon those "restricted core capital elements" to satisfy Tier 1 capital requirements. Obviously, it is better to have that plan in place before the Federal Reserve asks to see it.

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DO YOU HAVE A PRIVACY RESPONSE PROGRAM?

It was reported this month that both Wachovia Bank and Bank of America notified thousands of customers that information concerning their personal accounts was accessed by people who had no lawful right to the information. In days past, a bank had little guidance as to how it would address such a situation. Nothing specifically required a bank to even advise its customers that an unauthorized disclosure of information occurred.

All of that has changed. The news stories concerning Wachovia and Bank of America are perhaps one of the first examples of the effects of the recently adopted "Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice." 70 Fed. Reg. 15736 (Mar. 29, 2005). The Guidelines, adopted by the federal banking agencies, advise financial institutions of what they are to do in the event of unauthorized disclosures. Importantly, the Guidelines require every financial institution to adopt a "privacy response program."

The Gramm-Leach-Bliley Act did more than just require privacy notices about disclosure practices. The Act also required the banking agencies to establish standards regarding administrative, technical and physical safeguards to ensure the security and confidentiality of customer records. The agencies have adopted the Guidelines to help implement that requirement by requiring every institution to develop a response program in anticipation of the possible unauthorized access to customer information as part of its information security system. Unauthorized disclosure of customer information can occur when an employee (or ex-employee) uses customer information in a manner not authorized, or mistakenly sends the right information to the wrong location. It can happen when a service provider makes a mistake, or when its information is compromised by a computer hacker. It can also occur when an institution knowingly allows access to account information to a third party when that access was not contained in the institution's privacy notice.

The banking agencies recognize that one size does not fit all. An institution's written program "should be appropriate to the size and complexity of the institution and the nature and scope of its activities." However, at a minimum, a response program is expected to have procedures to accomplish the following:

- An assessment of the nature and scope of any incident. Institutions will be expected to understand the who, what, where, when and how much of any incident.

- Notification to the institution's federal banking regulator "as soon as possible" when an institution becomes aware of an incident involving unauthorized access to "sensitive" customer information.

- Where appropriate, notification to law enforcement authorities through the filing of suspicious activity reports ("SARs").

- Containment and control of the incident, for example by freezing or closing affected accounts.

- Notification to affected customers.

The good news is that the Guidelines limit reports to the appropriate banking agency to incidents involving "sensitive" customer information. "Sensitive" customer information means a customer's name, address or telephone number *in conjunction with* the customer's social security number, driver's license number, account number, credit or debit card number or a PIN or password that would allow access to an account. However, there is no such limitation on customer notification requirements. If any customer information is subject to unauthorized access or use, the institution must notify the customer of the incident.

The Guidelines and the requirement for the adoption of a privacy response program present an excellent opportunity to assess your institution's practices. Consider the following:

- Make certain that your institution's privacy notices and customer consents accurately reflect the disclosures that are occurring. If they do not, then your institution is allowing unauthorized disclosures to occur. The fact that your institution knowingly allowed the disclosure to occur will not change the fact that such unauthorized disclosure will be subject to the requirements of the Guidelines.

- Make certain that your institution's service provider is obligated to immediately inform your institution of any incident of unauthorized access. That should be in writing and part of the data processing contract. Financial institutions are responsible for incidents of unauthorized access that occur through the institution's service provider. In other words, if a processor has an incident of unauthorized access, it remains the responsibility of the financial institution to comply with the Guidelines.

- Negotiate the institution's contract with the service provider concerning damages for unauthorized access to customer information. Because it is impossible to predict how a financial institution might be damaged by unauthorized access to customer information, placing a limit on damages should be avoided. Nonetheless, it might be possible to agree to certain minimum damages, such as payment for the cost of notifying customers of any unauthorized access to customer information.

- Limit employee access of all customer information to those who need to know the information.
- Perform background checks on employees.
- Make certain employees are aware of the seriousness of the unauthorized use of customer information, including the potential for SARs. In exit interviews with employees leaving a financial institution, make sure the soon-to-be-former employees understand that they cannot take customer information with them. Employ safeguards to help assure no such information is taken.

Some have expressed concern about the regulatory burden of the Guidelines, that the burden of the notices to the bank regulators will become similar to the burden presented by SARs. Financial institutions cannot be expected to warmly embrace any new compliance burden. However, this should be a manageable situation. The corporate culture inside each depository institution should already be respectful of customer privacy. Moreover, service providers should have the capability of ensuring the confidentiality of customer information. Those service providers that cannot ensure customer confidentiality will not survive. Well-managed institutions will be incorporating the Guidelines into their information technology security policies prior to their next examination.

CONSUMER LITIGATION REPORT

The following is a summary of recent decisions in various consumer class action decisions:

Kruse, et al. v. Wells Fargo Home Mortgage, Inc., et al.–Circuit Courts Split over Whether Section 8(b) of RESPA Is a Price Control Statute

The Second Circuit Court of Appeals has joined the Fourth, Seventh and Ninth Circuit Courts of Appeal in finding that "overcharges" are not a violation of Section 8(b) of the Real Estate Settlement Procedures Act ("RESPA"). An overcharge is simply charging a customer more than the actual cost of a service provided by the lender (e.g., it costs $5.00 to prepare a deed; the lender charges $25.00). The plaintiffs in this case asserted that the lender's practice of charging "unreasonably" high prices for certain settlement services that the lender performed itself (*i.e.*, an overcharge) was a violation of Section 8(b) of RESPA. The plaintiffs relied on a policy statement from the Department of Housing and Urban Development ("HUD") that states that a party may be liable under Section 8(b) when it charges a fee that exceeds the reasonable value of the goods or services provided. The court stated that it did not believe that the actual language of Section 8(b) could be reconciled with HUD's interpretation. The court noted, in particular, that the language of Section 8(b) did not authorize courts to divide a charge into what they or some other person or entity deemed to be its reasonable and unreasonable components. Thus, the court sided with the Fourth, Seventh and Ninth Circuits, rather than with HUD, with respect to whether overcharges are violations of Section 8(b). No appellate court has yet agreed with HUD that an overcharge is a violation of RESPA.

The court did side with HUD and the Eleventh Circuit, however, rather than the Fourth, Seventh and Ninth Circuits, with respect to "mark-ups." The plaintiffs also alleged that the lender's practice of adding an additional amount to a fee charged by a third-party settlement service provider (e.g., a filing fee is $10.00; the lender charges $25.00) without performing additional services was a violation of Section 8(b). The court noted that the language of Section 8(b) regarding mark-ups was ambiguous. HUD's policy statement indicated that mark-ups were a violation of Section 8(b). The court then stated that it was proper to defer to HUD's interpretation to resolve the ambiguity in the language because, among other things, HUD's interpretation was the product of careful consideration issued in response to a previous decision stating that mark-ups were not a violation of Section 8(b) of RESPA. Thus, the court stated that the plaintiffs had stated a valid claim with respect to mark-ups.

Thus, the Second and Eleventh Circuits agree with HUD that a mark-up is a violation of RESPA. Three other appellate courts (Fourth, Seventh and

Ninth Circuits) have found that mark-ups do not violate RESPA. *Kruse, et al. v. Wells Fargo Home Mortgage, Inc., et al.*, 383 F.3d 49 (2d Cir. 2004).

Koons Buick Pontiac GMAC Inc. v. Nigh–Supreme Court Affirms That 1995 Amendments to TILA Did Not Increase Statutory Damages in Cases Involving Personal Property Loans

The U.S. Supreme Court has resolved a split between the Fourth and Seventh Circuits regarding the effect of the 1995 amendment to the Truth in Lending Act ("TILA"). The 1995 amendment added a subsection that increased the statutory damages available in cases involving closed-end mortgage loans to a minimum of $200 and a maximum of $2,000. The plaintiff in *Koons* argued that the 1995 amendment removed the cap for statutory damage claims on all other loans. The Fourth Circuit agreed with the plaintiff and held that, under TILA as amended, a purchaser of an automobile could recover statutory damages in an amount equal to twice the finance charge ($24,192.80 in this case). The Seventh Circuit had previously determined that the 1995 amendments did not increase the amount of available statutory damages with respect to personal property loans. The court reviewed the legislative history of the 1995 amendment and stated that it was clear that Congress intended the 1995 amendment to create harsher penalties only for closed-end mortgage violations of TILA. Thus, the amendment increased the minimum and maximum statutory damages for closed-end loans to $200 and $2,000 respectively, and retained the $100 minimum and $1,000 maximum for all other loans. The court then noted that an interpretation of the 1995 amendment which would allow a claimant to recover greater damages for a TILA violation involving a personal property loan (e.g., $24,192.80) rather than a closed-end mortgage loan (e.g., $2,000) was not consistent with common sense. **The court found that the 1995 amendment to TILA did not increase the amount of statutory damages for violations of TILA other than violations involving closed-end loans secured by real property. *Koons Buick Pontiac GMC, Inc. v. Nigh*, 125 S. Ct. 460 (2004).**

Blinco, et al. v. Green Tree Servicing LLC–Non-Signatory, Assignee Servicer Can Invoke Arbitration Clause of Promissory Note in RESPA Suit

In this consolidated decision, the 11th Circuit Court of Appeals ruled that an assignee of a mortgage note could invoke the arbitration clause contained in the note with respect to class action suits brought by plaintiffs alleging a violation of Section 6 of RESPA. Specifically, plaintiffs brought suit against Green Tree Servicing and Green Tree Lending (collectively, "Green Tree") alleging that Green Tree failed to provide proper notice of the assignment (from Conseco to Green Tree) of servicing rights of plaintiffs' mortgages. Green Tree, a non-signatory to the note, removed the actions to federal court and sought to stay the litigation and compel arbitration. Green Tree claimed that it should be allowed to invoke the arbitration clause contained in the note assigned to it because the note was the basis for its relationship with the plaintiffs. The plaintiffs contended that Green Tree's position as independent statutory servicer of their note gave rise to their claims and that servicing is severable from the mortgage and note; thus, the arbitration clause had no nexus to the plaintiffs' claims. The court, in siding with Green Tree, first noted the "unquestionably strong federal policy of favoring arbitration" and that any doubts regarding the scope of an arbitration provision should be resolved in favor of arbitration. The court then found that the plaintiffs' RESPA claims against Green Tree derived from the note containing the arbitration clause, and that the language of the arbitration clause was broad enough to allow Green Tree to invoke it. Thus, Green Tree could invoke the arbitration clause to resolve the plaintiffs' claims. *Blinco, et al. v. Green Tree Servicing LLC*, 400 F.3d 1308 (11th Cir. 2005).

"The court, in siding with Green Tree, first noted the 'unquestionably strong federal policy of favoring arbitration' and that any doubts regarding the scope of an arbitration provision should be resolved in favor of arbitration."

Rodrigues, et al. v. Members Mortgage Co, Inc., et al.–Federal Courts Split on Whether TILA Rescission Actions Are Appropriate for Class Certification

The U.S. District Court for the District of Massachusetts recently held that it is proper to certify a class which is seeking rescission under TILA. This decision is consistent with a previous decision of the U.S. District Court for the Eastern District of Pennsylvania which also found that it was proper to certify a class seeking rescission under TILA. However, a U.S. District Court in California and the Fifth Circuit Court of Appeals both previously rejected claims that it is proper to certify a class seeking rescission under TILA. In *Rodrigues*, the plaintiffs claimed that the lender provided incorrect information regarding their right to rescind the mortgage. The lender provided correct information for its existing customers, but not for new customers who were refinancing debt with other lenders, like the plaintiffs. The lender argued that Section 1640 of TILA permits class actions for damages but is silent as to class actions for rescission. Thus, the lender stated, Congress did not intend to authorize class actions for rescission. The District Court disagreed, stating that there was nothing in TILA that specifically prohibited class certification for claims seeking rescission under TILA. The court then found that the standard requirements for class certification (*i.e.*, numerosity of class; commonality, typicality and adequacy of questions of law; and predominance of common issues) were present in this case and certified the class. The Seventh Circuit Court of Appeals has not yet addressed this issue. *Rodrigues, et al. v. Members Mortgage Co., Inc.*, 226 F.R.D. 147 (D. Mass. 2005).

Stanley v. Household Finance Corporation III –Failure to Provide Proper Notice of Rescission Results in TILA Liability; However, Court May Condition Right of Rescission

In a bankruptcy matter, the U.S. Bankruptcy Court for the District of Kansas found that a lender's failure to provide clear and conspicuous notice of a debtor's right to rescind subjects the lender to TILA liability. The court also stated, however, that the court has discretion in setting conditions to the debtor's exercise of the right to rescission. In this case, the debtor claimed that he had three years to rescind the loan because he was not provided with proper rescission notice at the time of closing. Specifically, the lender had failed to "check" the appropriate box on the right to rescind form provided to the debtor. The lender argued that all information required to be disclosed under Regulation Z, including rescission rights, was included in the form. The court acknowledged that upon close scrutiny, all of the required information may have been provided; however, the court stated that TILA and Regulation Z require that disclosures be clear and conspicuous. A borrower should not have to examine documents with close scrutiny to determine his or her rescission rights. The failure to mark the appropriate box concerning the debtor's right to rescind resulted in a disclosure that was not clear and conspicuous as required by TILA. Thus, the debtor had three years in which to rescind the loan.

". . . a lender's failure to provide clear and conspicuous notice of a debtor's right to rescind subjects the lender to TILA liability."

The court next considered the lender's argument that the debtor should not be allowed to rescind the mortgage without first paying off the remaining principal amount owed. The court acknowledged that a number of circuits have previously found that a court has equitable powers to condition a debtor's right to rescission. After considering the history and interpretation of TILA, the court agreed that it had the power to condition the debtor's exercise of the rescission right under TILA. To that end, the court has ordered a hearing to determine if it should condition the debtor's right to rescission on the debtor's prior payment of all outstanding principal. *In re Stanley*, 315 B.R. 602 (D. Kan. 2004).

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