

# Financial Services Regulatory Highlights\*

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## The Financial Services Regulatory Landscape

by Roger G. Coffin, Principal

It has become commonplace for commentators and financial services participants to cite increased regulatory burdens imposed in the U.S. as a major impediment to U.S. competition in the global financial services landscape. From Sarbanes-Oxley to the sizable fines and penalties assessed by regulatory agencies for regulatory breaches there is current sentiment that regulatory expectations are higher than at any time in history. Without question, financial services companies in all sectors are currently burdened by a global web of sometime overlapping regulations affecting virtually all of their business activities. It would also seem clear that multiple stakeholders, including Boards of Directors, shareholders, and the media are paying close attention to the effects, and costs, of financial services regulations and the cost of complying with those rules.

What is the state of the regulatory affairs in the U.S.? We offer some thoughts and observations on the broad trends in financial services regulation today. In brief, we believe that regulators will continue to drive risk-based rule-making and examinations while being cognizant of the competitive and cost effects of their actions. Vigorous enforcement of violations should continue, particularly in egregious or highly-publicized cases or failures. Regulators will continue to rely on the industries and their participants to self-regulate. Institutions must create and maintain integrated, enterprise-wide compliance functions that proactively protect the firm from non-compliance. Even in the event of a scaling back of Sarbanes-Oxley or other regulatory requirements, we anticipate regulation will continue to be a top three issue for financial services participants for the foreseeable future.

## Background

In the first few months of 2007, two notable groups have studied regulation in the U.S. and have concluded that excessive regulation and costly litigation are causing a flight of trading, listings and prestige to foreign markets including London. These efforts, the Interim Report of the Committee on Capital Markets Regulation, and a report sponsored by New York City Mayor Michael Bloomberg and U.S. Senator Charles Schumer both concluded that reform was necessary to improve U.S. competitiveness. In addition, the U.S. Chamber of Commerce is expected to issue a report criticizing the SEC and the Bush administration for creating an environment hostile to business.

By contrast, SEC Chairman Christopher Cox recently rebutted these claims, flatly stating "[t]he inference that some have drawn that this competition is caused by regulation is wrong." In addition, the influential Presidents Working Group on Financial Markets, which include the Chairman of the Federal Reserve and Mr. Cox (along with other federal regulators), issued recently a report recommending against direct, hands-on regulation of hedge funds in the U.S. This latter move comes as a bit of a surprise in light of the SEC's campaign (albeit under a previous Chairman) throughout 2005 and 2006 to build a public record for hedge fund regulation and the adoption of a rule (later overturned in court) to do just that. It also may mark a path of divergence from EU supervisors who appear to be building a similar case for hedge fund regulation but have yet to act.

These actions occur amid a backdrop of increased globalization of firms and markets, and, in our view, a trend toward an increased standardization of regulation. In the tech boom of the late 1990s, for example, innovation enabled the creation of new securities trading and processing platforms. Many thought that the globalization of the world's exchanges was at hand. The cross-border mergers undertaken by the NYSE Group and others in 2006 and 2007 demonstrate that a global market is at our door, although later than expected. Actions including the U.K. SFA's MIFID, global implementation of Basle II, EU Solvency II, and increased information sharing and cooperation among the world's banking, insurance and securities regulators point toward a global convergence of regulatory approaches. Outsourcing has further pulled geographies and markets together.

Although the trend toward regulatory harmonization is welcome, we are far from a marketplace where deference to home country regulation and passporting are realities. As a consequence,

globalization comes with a price, as companies must weigh the practicalities of the risk and regulatory climate in a given jurisdiction against the potential for profitability. International regulators have demonstrated that they can take decisive action in the cases of wrong-doing, as the Citigroup Private Banking ban imposed by Japan illustrates. International entrants in the U.S. markets (for example insurance companies) will find a regulatory regime unlike any other.

## Regulatory Policy in Action

When we consider how the regulatory community in both the government and private sector is implementing these and other policy directives several common themes appear to emerge. The first is the embracing of prudential, "risk-based" rulemaking and examination behavior. Broadly stated, the risk based approach seeks to focus regulatory resources into the material areas of market activity that could pose significant, or even systemic risk. This translates into an examination protocol where, for example, a banking or securities examiner would invest significant pre-field visit time looking at the subject institution through a variety of lenses to pinpoint areas for field work. Regulators have developed sophisticated examination tracking and analysis tools to assist in this process. This contrasts to a "check the box" approach where examinations were more standardized and driven by inventories of rules rather than business conduct.

The second common trend is linked to the first and may be characterized by an increasing desire on behalf of the U.S. regulatory community for institutions to self-regulate. Driven in part by the size and scope of today's diversified financial institution, and limited qualified regulatory resources, self-examination, remediation and reporting is a regulatory expectation, if not a requirement. This has manifested itself in heightened expectations on

the internal audit and compliance department. As regulators utilize a variety of certification processes to incent firms to discover and remediate their own flaws, the internal audit and compliance department themselves have become more important to, and subject to, enhanced regulatory scrutiny.

As a result, the growth and development of centralized corporate or enterprise, compliance functions emerges as another trend embraced by banking, insurance and securities regulators. A central compliance function generally is a group that exists in addition to the compliance function embedded in a line of business and whose mandate is to drive standardization, common approaches to monitoring and testing, and training. A central compliance function is ideally suited to identifying common trends or issues within an organization and directing resources accordingly. Leading financial services players are currently building out their central compliance functions but are struggling to find the right balance between centralized functionality and line of business overlap. Guidance from the regulatory community would be welcomed to set expectations in this important area.

### **Sector Snapshots**

A brief industry sector overview reinforces the commonality of issues facing participants and the approaches taken by their respective regulators. In the insurance industry, cost pressures, increased competition from international and other entrants, need for product and technological innovation and demographic shifts are top of mind for industry executives. Increased cost of compliance and demands to improve risk management techniques, together with concerns regarding privacy, data security and operational risk draw resources and spend as well. High profile fines including AIG's record \$1.6 billion bid rigging payment have focused attention on previously little known business practices. As in other sectors, more regulations, and strict enforcement and magnified cost for non-compliance have upped the stakes for the insurance industry. Indeed, as federal securities regulators and state insurance commissions continue to focus on the insurance industry, the potential for a single, unified federal insurance regulator, although supported in principal by many large insurers, may actually be diminished, as states defend their jurisdiction and roles. Two related but potential areas of focus for regulatory concern are conflicts of interest within the industry and the transparency of fee arrangements.

Likewise, in the banking and securities industries, competition, consolidation and increased regulatory and operational risk are

major drivers. U.S. banks find themselves in generally strong financial position, but are pressured by the markets to create and sustain growth. New products, increased customer focus, and international expansion are avenues to achieve growth and scale. At the same time, the costs associated with Basle II, USA PATRIOT Act compliance, and managing reputation and political risks are escalating. Investment banking activity is strong, but pressures from the private equity sector have added a new source of financing as an alternative to the public securities markets. While we see a risk-based approach in policy making and rule promulgation, penalties for malfeasance are severe, both domestically and in foreign markets.

Asset management firms find themselves in a global, increasingly transparent marketplace that rewards innovation and performance more quickly than ever before. New products and markets, like China, India and Western Europe offer risks but also opportunity for asset growth. Rules adopted by the SEC in response to the market timing and late trading scandals have added significant cost structure however, and margins are under pressure from a variety of sources. In the alternatives space, although direct US regulation of hedge funds is off the table for now, we believe aggressive use of other tools, such as insider trading and anti-fraud measures will be brought to bear on the market. Of particular concern is the potential for brokers or other intermediaries to pass information on to their hedge fund clients who use this information in trading schemes.

### **Final Thoughts**

It is always interesting to speculate on the effect that a change in the political balance will have on the regulatory landscape. As the Bush administration enters its back nine, and with Democratic control of the House, many suggest that business groups will seize this opportunity to attempt to create a more business friendly

regulatory climate while Republicans maintain control of the White House. It is interesting to note however, that the recent run-up of regulations occurred during a period of relative economic stability and growth, and with Republicans dominating Washington. This, and history suggest that it is difficult to correlate politics to the tactical realities and operations of the regulatory agencies and departments. Instead, we note that, to a large extent, the approaches taken by the various sector regulators appear to be moving toward convergence around common standards: risk-based self assessment; enterprise wide compliance; and self-regulation. Infractions, particularly those that are deliberate, and cause damage to customers or markets, subject the offending firm to significant,

material financial penalty. And, despite the pressures on the industry, financial services firms continue to be profitable. The markets, characterized by new entrants and competition, technological innovation, and geographical and demographic change, appear to be fundamentally strong and able to withstand failures and crises without systemic disruption.

If you have any questions about this article, please contact Roger Coffin.

## SEC Seeks Time for Investors and Brokers to Respond to Court Decision on Fee-Based Accounts

[On May 14, 2007, the SEC announced that it would ask a court to allow four months for investors and brokers to respond in light of a court decision affecting an estimated one million fee-based brokerage accounts.](#)

In asking for a 120-day stay of the ruling of the U.S. Court of Appeals for the District of Columbia Circuit in *Financial Planning Association v. SEC*, the SEC announced it would not seek further review of the March 30, 2007 decision that affects customer accounts holding an estimated \$300 billion. In a 2-1 decision the court vacated Rule 202(a)(11)-1 on the basis that the SEC had exceeded its authority under the Investment Advisers Act of 1940 in promulgating the rule.

The court's decision primarily affects fee-based brokerage accounts, not the traditional commission or advisory accounts that comprise the majority of accounts with brokers. Customers may ask their

brokers if they are affected by this decision. The SEC suggested that investors carefully consider changes to their accounts.

The SEC will consider whether further rulemaking or interpretations are necessary regarding the application of the Advisers Act to these accounts and the issues resulting from the court's decision.

The SEC will also work with individual brokerage firms during the transition period as they respond to the March 30 decision. The goal will be to provide customers of the firms with the information and time they need to determine the appropriate form of securities services for them.

## TRIA Hearings Continue in House; Extension Legislation Expected Soon

[On April 24, 2007, the House Financial Services Committee, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises held a hearing on "Policy Considerations for Extending the Terrorism Risk Insurance Act \("TRIA"\) in Washington, DC. This followed a similar hearing held in New York City on March 3. Both hearings included testimony from insurance and real estate industry executives. The New York City hearing](#)

[also featured testimony from New York Mayor Michael Bloomberg, US Senator Charles Schumer, and New York State Insurance Superintendent Eric Dinallo. The U.S. Senate Committee on Banking, Housing, and Urban Affairs held a similar hearing in February.](#)

TRIA was initially signed into law in 2002 and was set to expire in 2005 before it was extended through December 31, 2007. It established a government reinsurance facility to provide reinsurance coverage to insurance companies following a declared terrorism event. Though initially intended as a temporary measure to help the industry recover from 9/11, calls for a permanent or long-term extension of the Act have grown as the current expiration date approaches. Industry groups and legislators are in agreement that a more permanent solution is needed.

The four major industry groups lobbying for a long-term extension are the Coalition to Insure Against Terrorism Risk ("CIAT", representing real estate developers, manufacturers, and other affected industries), the American Insurance Association ("AIA"), the Property Casualty Insurers Association of America ("PCI"), and the National Association of Mutual Insurance Companies ("NAMIC"). In addition, New York City and State politicians have aggressively supported the measure.

While there is general consensus among both Democratic and Republican members of the committee on the need for at least

another extension of the program, debate has focused on the length of that extension and the need to add additional provisions to the program. Principal among these is the desire of industry groups to drop the distinction between domestic and foreign acts of terrorism (currently only foreign acts are covered). The AIA and CIAT also recently agreed to jointly lobby for the inclusion of coverage for nuclear, biological, chemical, or radiological ("NBCR") attacks in the program. The American Council of Life Insurers has lobbied for the inclusion of group life insurance in the program, something which has also received support from the committee.

Barney Frank (D-MA), chairman of the House Financial Services Committee, has pledged to introduce TRIA extension legislation in the coming months. Chris Dodd (D-CT), Frank's counterpart on the Senate committee, has done the same.

## N.D., Iowa, Minn. Support Model Annuity Suitability Regulation

On May 10, 2007, the NASD and state regulators from North Dakota, Iowa and Minnesota announced the signing of a joint statement to support a new rule which would require insurance companies and agencies to recommend only suitable annuity products to their customers. Together, the four parties make up the Annuity Working Group, founded last year to evaluate various regulatory standards. Currently, sales of fixed annuities are regulated by state insurance commissioners, while variable annuity sales are regulated by the Securities and Exchange Commission, NASD, state insurance commissioners, and state securities regulators. Consumers are rarely aware that the annuity products they buy are subject to such a complex regulatory framework.

The Annuity Working Group supports the Suitability in Annuity Transactions Model Regulation, recently approved by the National Association of Insurance Commissioners ("NAIC"). The model regulation, like all insurance regulations, would have to be adopted on a state-by-state basis and would impose a suitability requirement on the purchase or exchange of fixed annuities in those states that do not have such a requirement already. Federal (as well as certain state) securities laws already impose suitability requirements on

broker-dealer and investment adviser sales of variable annuities. The Suitability in Annuity Transactions Model Regulation would, for the first time, impose an express suitability obligation on insurance companies with respect to variable annuities.

It was the general consensus of the more than 20 securities and insurance regulators and industry executives who participated in last May's Annuity Roundtable that investors should have suitability protection, regardless of which regulatory regime covers the particular annuity product they buy. In its statement, the Annuity Working Group notes that the new model regulation represents an important step toward that goal and it urges every state that does not currently have a suitability standard applicable to the sale of annuities to enact the NAIC's model rule.

## OTS Issues Interim Final Rule on Prohibited Service at Savings and Loan Holding Companies

In May 2007, the Office of Thrift Supervision ("OTS") adopted an interim final rule with a request for comment on prohibited services at savings and loan holding companies ("SLHC").

The interim final rule implements section 710(a) of the Financial Services Regulatory Relief Act of 2006, which added section 19(e) to the Federal Deposit Insurance Act ("FDIA").

Section 19(e) prohibits any person who has been convicted of any criminal offense involving dishonesty or a breach of trust, or money laundering or has agreed to enter into a pretrial diversion or similar program in connection with a prosecution for such an offense from certain positions with respect to a SLHC.

The interim final rule provides two exceptions:

- An exemption for certain SLHC employees whose activities and responsibilities are limited solely to agriculture, forestry, retail merchandising, manufacturing, or public utilities operations; and
- A temporary exemption for certain persons who held positions with respect to a SLHC as of the date of enactment of section 19(e) of the FDIA.

The interim final rule was effective on May 8, 2007. Comments must be received by July 9, 2007.

## FinCEN Delays Implementation of Suspicious Activity Report Forms

On April 26, 2007, the Financial Crimes Enforcement Network ("FinCEN") announced the delayed implementation of Suspicious Activity Report ("SAR") forms.

The forms, scheduled to become effective on June 30, 2007, affect depository institutions, casinos and card clubs, insurance companies, and the securities and futures industries. FinCEN will

communicate the new effective and compliance dates for these forms in a future notice.

The announcement does not affect the BSA filing requirements. Financial institutions should continue to use the current SAR forms.

## House Passes Federal Housing Finance Reform Act of 2007

On May 22, 2007, the U.S. House of Representatives passed H.R. 1427, the Federal Housing Finance Reform Act of 2007, which will create a new independent regulator of the following government sponsored enterprises ("GSE") -- Fannie Mae, Freddie Mac and the Federal Home Loan Banks.

H.R. 1427 would overhaul the regulatory oversight of the GSE and create a new, independent regulator with broad powers analogous to current banking regulators. The regulator's primary responsibility will be to ensure the safety and soundness of the institutions. In

addition, the bill creates an off-budget and non-taxpayer financed affordable housing fund, which will dedicate hundreds of millions of dollars for the construction, maintenance and preservation of affordable housing with the first year of the fund to be dedicated to the hurricane stricken areas of the Gulf Coast, and billions of dollars over the next five years for affordable housing nationwide.

H.R. 1427 is the product of both bipartisan legislation in the 109th Congress and careful discussions and compromise with the Department of Treasury. The bill also comes after a series of exhaustive deliberations in the House of Representatives under an open rule, a committee process that considered over 30 amendments. There were also extensive legislative hearings on

GSE reforms and proposals, where regulators and expert witnesses testified before both the Financial Services Committee and the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises.

## Chairman Bernanke Discusses the Subprime Mortgage Market

[On May 17, 2007, Chairman Ben S. Bernanke spoke at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition on the subprime mortgage market.](#)

The Chairman discussed some of the recent problems and some of the regulatory responses. He stated that, "...subprime mortgages with adjustable-rate mortgages ("ARMs") ... currently account for about two-thirds of subprime first-lien mortgages or about nine percent of all first-lien mortgages outstanding." The rate of serious delinquencies for these mortgages rose sharply during 2006.

Chairman Bernanke attributes the rise in serious delinquencies to:

- The deceleration in housing prices; and
- The increase in rates for both fixed and adjustable-rate mortgages.

"Subprime borrowers with ARMs, who may have counted on refinancing before their payments rose, may not have had enough home equity to qualify for a new loan given the sluggishness in house prices," stated the Chairman.

Some of the problems can be attributed to mortgage originators, as some lenders loosened their underwriting standards. "These looser standards were likely an important source of the pronounced rise in 'early payment defaults'-- defaults occurring within a few months of origination--among subprime ARMs, especially those originated in 2006," stated Chairman Bernanke.

In discussing the potential regulatory response, the Chairman stated, "...regulators must walk a fine line; we must do what we can

to prevent abuses or bad practices, but at the same time we do not want to curtail responsible subprime lending or close off refinancing options that would be beneficial to borrowers." He suggests the following four tools to "protect consumers and to promote safe and sound underwriting practices":

- Require disclosures by lenders that help consumers make informed decisions;
- Prohibit clearly abusive practices through appropriate rules;
- Offer principles-based guidance combined with supervisory oversight; and
- Take less formal steps, such as working with industry participants to establish and encourage best practices or supporting counseling and financial education for potential borrowers.

"Together with other regulators and the Congress, our success in balancing these objectives will have significant implications for the financial well-being, access to credit, and opportunities for homeownership of many of our fellow citizens."

## Federal Reserve Board Requests Comment on Proposed Amendments to Regulation Z

[On May 23, 2007, the Federal Reserve Board issued for comment proposed amendments to Regulation Z \("Truth in Lending"\).](#)

The amendments are intended to improve the effectiveness of the disclosures related to credit

cards and other revolving credit, ensure the timeliness of those disclosures, and assure that the disclosures are easy for consumers to understand. The amendments apply primarily to open-end credit accounts that are not home-secured such as general purpose credit cards and retail credit cards.

"The goal of the proposed revisions is to make sure that consumers get key information about credit card terms in a clear and conspicuous format and at a time when it would be most useful to them," said Federal Reserve Board Chairman Ben S. Bernanke. "Greater clarity in credit disclosures allows consumers to make more-informed credit decisions and enhances competition among credit card issuers."

The amendments will require format, timing, and content changes to credit card applications and solicitations. Format, timing, and content amendments will also apply to the disclosures that consumers receive throughout the life of an open-end account, including account-opening and periodic statements.

Specific changes would include the following:

- Disclosures accompanying credit card applications and solicitations would highlight fees and the reasons penalty rates

might be applied, such as for paying late. Creditors would be required to summarize key terms at account opening and when terms are changed.

- Periodic statements would break out costs for interest and fees.
- Two alternatives are proposed regarding the "effective" or "historical" annual percentage rate disclosed on periodic statements.
- The proposal would also expand the circumstances under which consumers receive written notice of changes in the terms applicable to their accounts, including requiring an advance notice before a penalty is required, and increase the amount of time these notices must be sent before the change becomes effective.

Comments must be received on or before 120 days after publication in the Federal Register.

## Comptroller of the Currency Discusses 'Stated Income' Subprime Loans

[On May 23, 2007, the Comptroller of the Currency, John C. Dugan said in a speech to the Neighborhood Housing Services of New York that he is "increasingly troubled by the growing use of unverified 'stated income' in subprime lending."](#)

The Comptroller stated, "...nearly 50 percent of all subprime loans last year accepted stated income." In markets where housing prices are rising, the risks of stated income are masked.

"As a result, the rapidly rising housing market of 2003-2005 was the perfect Petri dish to incubate the widespread practice of stated income loans," he said. "At a very fundamental level, it was a bet that the increasing value of a borrower's collateral would offset any inadequacy of the borrower's income."

Mr. Dugan added that now we are seeing the results, in markets where house prices are falling or failing to increase. The consequences have been rising delinquencies and foreclosures.

He does not believe that stated income is the only cause of today's problems. However, he stated, "Apparently verified income is viewed as a critical factor in determining whether a loan can be saved, which of course begs the question: if loan verification is such an important predictor of the borrower's ability to repay in the current environment, why wasn't it equally important when the loan was first made?"

There are instances in which reliance on stated income would be appropriate, he stated, such as a straight refinancing that does not involve a cash take-out and which was underwritten by the same lender.

The Comptroller listed three reasons that the use of stated income should be the exception, not the rule:

- Stated income is too great a temptation for misrepresentation and, in its most extreme form, outright fraud.
- The practice also undermines transparency: "How can lenders seriously talk about debt-to-income ratios, for example, if the denominator of 'income' is really an unknown variable that can be whatever the borrower says it is?" he asked.
- It is not safe and sound underwriting practice to make mortgage loans that substitute future house price appreciation for borrower

income as a key source of repayment, as appears to have been the case in many subprime loans underwritten in the last few years.

The use of stated income has been addressed by the federal banking agencies, he said, "I believe we should, although how we do so and the extent to which we do it are of course decisions that should only be made after careful consideration of the comments we have received."

## Federal Reserve To Hold Hearing On Its Rulemaking Authority Under HOEPA

On May 3, 2007, the Federal Reserve Board ("FRB") announced that it will hold a public hearing under the Home Ownership and Equity Protection Act ("HOEPA") on June 14, to gather information on how it might use its rulemaking authority to curb abusive lending practices in the home mortgage market, including the subprime sector.

"The goal is to find ways to promote sustainable homeownership through responsible lending, informed consumer choice, and effective guidance and regulation," said Federal Reserve Board Governor Randall S. Kroszner, who will chair the hearing. "We want to encourage, not limit, mortgage lending by responsible lenders, so it is crucial that any actions the Board might take are well calibrated and do not have unintended consequences."

The Board held four hearings in the summer of 2006 under HOEPA. Those hearings addressed three topics: (1) predatory lending and the impact of the existing HOEPA rules, and state and local anti-predatory lending laws on the subprime market; (2) nontraditional mortgage products such as interest-only mortgage loans and payment option adjustable rate mortgages, and reverse mortgages; (3) and, how consumers select lenders and mortgage products in the subprime mortgage market.

Based on testimony and public comment from the 2006 hearings, and in response to increased subprime mortgage foreclosures, the

Board plans to hold a fifth hearing that will focus on how it might use its rulemaking authority to address concerns about abusive lending practices in the home mortgage market.

The hearing is scheduled for Thursday, June 14, 2007, at the Federal Reserve Board at 20th and C Streets, N.W., Washington, D.C. The Board is holding the hearing under HOEPA, which was enacted in 1994 in response to reports of predatory home equity lending practices in underserved markets. HOEPA amended the Truth in Lending Act ("TILA") to impose additional disclosure requirements and other limits on certain high-cost, home-secured loans. HOEPA authorizes the Board to issue rules that prohibit certain acts or practices in connection with home mortgage loans. HOEPA also directs the Board to periodically hold public hearings to examine the home equity lending market and the adequacy of existing regulatory and legislative provisions for protecting the interests of consumers, particularly low-income consumers.

## Thrift Industry Performance Solid in First Quarter

The OTS reported on May 23rd that the nation's thrift industry posted solid earnings and profitability in the first quarter of 2007 despite continued weakness in the housing market and a flat-to-inverted yield curve.

Although problem asset levels continued to rise, reflecting the slowing housing sector and other economic conditions, they remain at relatively low levels. The OTS continues to encourage thrifts to work with borrowers to find solutions for loan delinquencies to avoid foreclosures and keep people in their homes. The agency noted that thrifts continue to hold strong capital and increase provisions for loan losses in the current environment. Industry highlights include:

- Net income for the quarter was \$3.6 billion, up 15 percent from \$3.1 billion in the previous quarter but down 14 percent from the near-record \$4.2 billion a year ago.
- Profitability, as measured by return on average assets, was 0.97 percent, up from 0.89 percent in the previous quarter but down from 1.14 percent a year ago.
- The net interest margin (NIM) rose to 2.81 percent of average assets from 2.71 percent in the previous quarter and 2.77 percent a year ago. This improvement was attributable to the upward adjustment of rates on adjustable rate loans.
- The ratio of troubled assets to total assets increased to 0.80 percent from 0.70 percent the prior quarter and from 0.64 percent one year ago. Thrifts added \$1.2 billion to loan loss provisions during the quarter.
- The capital-to-asset ratio was a strong 10.70 percent, compared with the record 10.72 percent in the previous quarter and up from 9.36 percent a year ago.
- Assets were \$1.49 trillion, an increase of 5.6 percent from \$1.41 trillion in the previous quarter but down slightly from nearly \$1.5 trillion a year ago.

The OTS cited several highlights regarding mortgage originations during the quarter:

- The thrift industry originated 23 percent of all 1-4 family mortgages in the U.S.
- Total mortgage originations (including multifamily and nonresidential) were \$168.8 billion, up from \$134.3 billion in the previous quarter and \$164.6 billion a year ago. Refinancing activity accounted for 47 percent of all originations in the quarter, up from 39 percent in the previous quarter and 35 percent a year ago.
- About 4 percent of industry assets are held in subprime loans, with relatively few thrifts engaged in programmatic subprime lending. As a group, these institutions have manageable levels of problem loans, diversified operations and strong capital.

The OTS also reported:

- Of the 838 thrifts regulated by the OTS, there were six problem thrifts (with composite examination ratings of 4 or 5). This is unchanged from the previous quarter. Also for the quarter, there were 62 thrifts with a composite examination rating of 3, which is up 5 from 57 in the prior quarter.
- At the end of the first quarter, the OTS supervised 473 U.S.-domiciled holding company enterprises, with consolidated assets of approximately \$8.0 trillion.

## New York State Banking Department Adopts Guidance on Nontraditional Mortgage Products

On May 25, 2007, the New York State Banking Department announced its adoption of a nationwide set of guidelines for mortgage bankers and brokers who make “nontraditional” or “exotic” mortgage loans. In doing so, it joined 34 other States and the District of Columbia in adopting such guidelines.

The “Guidance on Nontraditional Mortgage Product Risks” is a set of guidelines which were developed in cooperation with the Conference of State Bank Supervisors (“CSBS”) and the American Association of Residential Mortgage Regulators (“AARMR”). The guidelines were designed to protect consumers while offering mortgage providers prudent strategies for managing their loan origination operations.

“New York is proud to stand with its fellow state regulators in supporting a consistent set of regulatory standards for all state-licensed mortgage bankers and brokers,” said Richard H. Neiman, Superintendent of Banks. “While the Banking Department supports the ability of our institutions to innovate mortgage products that address a wide range of consumer needs, it is essential that our lenders take appropriate steps to manage the risks associated with these products. Even more importantly, lending institutions must understand their responsibility to evaluate the capacity of the borrowers to repay the loan.”

Nontraditional mortgage products are those that allow borrowers to defer the payment of principal or interest and include “interest-only” and “payment-option” adjustable-rate mortgages. These products generally allow borrowers to exchange lower payments during an

initial period for higher payments later. While such products have been available to consumers for many years, the number of borrowers offering them and their availability to a broader spectrum of borrowers has recently increased.

In addition to adopting the guidance, the Department also announced its support of both the “Proposed Federal Interagency Statement on Subprime Lending” and the “Federal Interagency Statement on Working with Mortgage Borrowers”. The statements encourage lenders to adopt best practices when lending to subprime borrowers and further encourage them to avoid foreclosure, whenever possible, and work with borrowers who are unable to meet their monthly payment obligations.

In a letter issued to its supervised institutions, the Department reminded mortgage bankers and brokers that it views the CSBS/AARMR guidance as a minimum standard that neither supersedes existing Department laws and regulations nor prevents the Department from issuing additional guidance or regulations when appropriate.

## President To Nominate Two Bankers To Federal Reserve Board

On May 15, 2007, the White House announced that President Bush intends to nominate two financial service company executives, Larry Klane and Elizabeth Duke, to fill vacancies on the Federal Reserve Board.

In a statement, the White House also said the President would nominate current Federal Reserve Governor Randall Kroszner to

serve a full 14-year term once the partial term he is serving expires next January.

Mr. Klane is president for global financial services at Capital One Financial Corp. Ms. Duke is chief operating officer of TowneBank in Portsmouth, Virginia.

The Senate must confirm the nominations. If approved, Mr. Klane and Ms. Duke will fill Fed seats left open by the departures of Governors Susan Bies and Mark Olson.

Mr. Klane joined Capital One in 2000 after working as a managing director at Deutsche Bank/Bankers Trust. Capital One, headquartered in McLean, Virginia, is the largest independent MasterCard and Visa credit card issuer. Ms. Duke was president and chief executive of Bank of Tidewater in Virginia Beach for more than a decade when the bank was bought in 2001. She was chairman of the American Bankers Association in 2004-2005.

Ms. Duke worked for Wachovia before joining TowneBank, which has \$1.5 billion in assets, in 2005. She has also worked in an executive post at SouthTrust Bank.

Mr. Kroszner, an international finance expert who took office on March 1, 2006, was previously a professor at the University of Chicago. He had served on President Bush's Council of Economic Advisers from 2001 to 2003.

## 2007 Money Laundering Strategy

On May 3, 2007, the Departments of Treasury, Justice and Homeland Security issued the 2007 National Money Laundering Strategy ("2007 Strategy"). The 2007 Strategy is a direct response to the first U.S. government-wide money laundering threat assessment released in December 2005. In addition to following this new methodology, the 2007 Strategy for the first time focuses exclusively on money laundering. Previous U.S. money laundering strategies presented a combined program against both money laundering and terrorist financing. While money launderers and terrorist financiers may use the same financial channels and employ similar techniques, there are differences in their operations and in the Government's strategies against them.

The 2007 Strategy identifies areas in which the U.S. government will work to revise, enhance, or renew efforts to enforce existing Federal laws and regulations; study areas in which new guidance

may be appropriate; and work with State supervisory and law enforcement authorities to improve financial transparency in State-regulated financial sectors.

Although conceived to be the foundation for the 2007 Strategy, the U.S. Money Laundering Threat Assessment is much more than that. It not only assesses the progress the United States has made in combating money laundering and highlights areas that require further attention, but also provides lawmakers, regulators, examiners, law enforcement, and industry with a cautionary explanation of how major money laundering methods operate.

## NASD Issues Guidance on Trade Reporting of Foreign Securities

On May 21, 2007, the NASD issued in Notice to Members ("NtM") 07-25 guidance on the trade reporting obligations for transactions in foreign securities and American Depositary Receipts ("ADR").

### Foreign Equity Securities

NASD Rule 6620 states that NASD members generally are required to report transactions in OTC Equity Securities to NASD's OTC Reporting Facility. OTC Equity Securities, as defined by Rule 6610, is any non-exchange-listed security and certain exchange-listed securities that do not otherwise qualify for real-time trade reporting.

Due to the broadness of this definition the NASD filed with the SEC to issue guidance for immediate effectiveness that the transaction reporting requirements of Rule 6620 do not apply to transactions in foreign equity securities if:

- The transaction is executed on and reported to a foreign securities exchange; or

- The transaction is executed over the counter in a foreign country and is reported to the regulator of securities markets for that country.

### ADR/Ordinary Swap Transactions

In ADR swap transactions, a firm matches holders of ADRs with holders of foreign ordinary equity security in the same company. To

effect the "swap," a firm typically will execute the equivalent of two cross transactions in the two securities between the holders. Since the two are separate securities and separate transactions, they must be reported separately to NASD.

## FinCEN Releases the May 2007 Issue of *The SAR Activity Review*

The FinCEN released the May 2007 Issue of *The SAR Activity Review -- Trends, Tips & Issues*.

- Debt elimination schemes; and
- The broad value and utility of BSA data.

This issue's topics include:

- Perspectives on the BSA as it affects the insurance industry - including an analytical review and industry viewpoint;

## Additional Information

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