CAPITOL ANALYSTS NETWORK, INC.
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BACK TO BASICS FOR BANKING POLICYMAKERS

For investors holding financial institution securities, 2003 is a year to focus on three "old Washington friends" – the Fair Credit Reporting Act, bankruptcy reform, and deposit insurance.

Fairness and Privacy Protection for Consumers

In 1996, Congress updated the Fair Credit Reporting Act (FCRA), preempting state laws and drawing national bright lines to govern lender behavior when corporations collect and distribute consumer data to their affiliates. This federal preemption expires on December 31, 2003.

Despite minor flaws, the U.S. system that collects and disseminates consumer credit information is largely responsible for the widespread availability of consumer credit, from home mortgages to credit cards, at interest rates lower than can be found elsewhere in the world. Having an accurate way to inexpensively evaluate the risks that potential borrowers won't pay you back makes it possible to extend credit widely at low rates. With enough information about past payment, employment, marital status, and length of residence history, it's possible to calculate an accurate "risk probability" for any borrower and therefore a risk premium to charge him.

While consumers naturally want the lowest possible interest rates, they are not fond of learning that the personal information they provide to make this possible can be widely distributed, or abused. However, financial privacy covers more than just the information a consumer provides to apply for credit. Financial firms can share "transactional data," such as type of charges put on a credit card, payment histories, and number of loan applications made – particularly if the two companies, such as a bank and a credit card affiliate, are owned by the same parent. Currently, financial companies must give each customer a statement of their privacy policies, and offer customers the choice to "opt out" and not agree to data sharing. FCRA prevents states from enacting privacy laws that would prevent such sharing.

Lenders fear that Congress won't extend the preemption, and they will have to comply with 50 different sets of state rules, many more restrictive than those set by Congress. This would drive up costs and indirectly lead to larger loan losses. Their fear is unfounded; the preemption will be extended, and new national rules can be expected. The extension will please lenders. However, Senate Banking Committee Chairman Shelby (R-AL) in the past has supported giving consumer the right to "opt in" to affiliate information sharing rather than keeping the current "opt out" system, which allows information sharing unless consumers explicitly order lenders to keep their data private. Approximately 3 percent to 5 percent now

take the trouble to opt out. Under "opt in," no sharing is permitted until consumers provide their consent in writing. The difference is obvious. At a minimum, it will cost banks more to secure the written consent of their customers.

The tactical danger facing lenders is that Shelby's leverage grows with every day. If he waits until the fall before writing a bill and sending it to the Senate floor, the prospect that 50 sets of rules will sprout on January 1 will make banks eager to settle, agreeing to liberal "opt in" rules that raise their costs of collecting consumer information and increase the risks of imprudent credit approvals. This will be a fight worth watching.

Will Congressional Manuvering Abort Bankruptcy Overhaul Again?

In 1998, House Judiciary Subcommittee Chairman George Gekas (R-PA) first broached the idea of amending consumer bankruptcy laws by introducing "The Bankruptcy Reform Act of 1998." Since then, credit card issuers to middle and upper income families, retailers, and auto lenders have lobbied for passage of legislation that would limit the use of bankruptcy as a financial planning tool by high-living borrowers who temporarily overextend themselves, then used the courts to discharge their debts. Under current rules, almost all debtors have ready access to Chapter 7 filings that offer them clean starts regardless of future ability to pay. Under the "needs-based" bankruptcy reform pursued by abused creditors, a bankrupt filer with an income that exceeds the median in his state would have to prove he couldn't pay much in the future to qualify for Chapter 7. Overextended professional yuppies need not apply.

Five years later, to paraphrase Bruce Springstein, "The debtors are still here" while Gekas is "all gone," having left the Congress. Creditors are still here, too, and they start the new Congress with reason for guarded optimism. On March 19, 2003, the House passed "The Bankruptcy Abuse Prevention and Consumer Protection Act of 2003" by an overwhelming vote of 315-113. This Act is virtually the same as legislation that cleared both the House and Senate, with one important exception. It deletes controversial compromise abortion language negotiated by Rep. Hyde (R-IL), a long time pro-life leader, and Sen. Charles Schumer (D-NY), an aggressive pro-choice advocate. In this case, the center could not hold. The abortion compromise inflamed enough pro-life House Republicans that they voted down the bankruptcy reform bill on the House floor with the help of Democrat liberals in the lame duck session held last year.

The latest bill deletes the controversial abortion language, which prohibits individuals who are found guilty of damaging abortion clinics from declaring bankruptcy to avoid paying for reparations. Sen. Schumer has threatened to filibuster the 2003 bill on the Senate floor if the Republican majority attempts to pass the bill without his abortion language. However, not all Senate Democrats support a filibuster and Schumer could lose. The Act includes language important to indebted farmers that may sway Senators Dorgan (D-ND), Johnson (D-SD), and Nelson (D-NE) to vote against Schumer in a Senate floor showdown. In addition, Southern Democrats Breaux (D-LA), Landrieu (D-LA), Hollings (D-S.C.), Lincoln (D-AR), and Miller (D-GA) are either pro-life or they may feel that lowering credit card interest rates for 50 million families is more important than punishing further a handful of criminal protestors who will be

jailed anyway. Given the prominence of credit card issuers in Delaware, Senators Biden (D-DE) and Carper (D-DE) may have compelling reasons to vote yea, too. Schumer also may have to think twice. There's a chance that Rudy Guiliani will run against him in 2004. With an election approaching, does it make sense to antagonize New York's biggest banks that are fighting for the bill?

Here is a list of representative organizations that sent a March 18, 2003 letter to the House supporting the Act, signing under the banner of the Coalition for Responsible Bankruptcy Laws:

<u>Prime Credit Card Issuers:</u> America's Community Bankers, American Bankers Association, Bank of America, Bank One, Citigroup, Consumer Bankers Association, Financial Services Roundtable, Household International, Independent Community Bankers of America, J.P. Morgan Chase, MasterCard International, Morgan Stanley, Wachovia.

<u>Auto Lenders:</u> Ford, North American Dealers Association

<u>Retailers:</u> May Department Stores, Saks, Sears, Target, Neiman Marcus

They support the reform bill because it contains the following provisions, aimed at making higher-income bankrupts pay off as much of their debts as possible:

- "Means testing" will apply to individuals with incomes higher than their states' medians. Such individuals, if they can pay $10,000, or 25 percent or more of their unsecured debts, will have to do so over five years.

- A national "homestead exemption" of $125,000 in home equity will limit the ability of millionaire debtors in Texas and Florida from purchasing mansions with cash and getting to keep their castles, free and clear, after filing.

- A $1 million cap on retirement savings is created. Creditors can attach assets above this.

- Only car loans lasting long than 5 years may be "crammed down." A $40,000 Lexus may be worth only $25,000 three years later while the borrower still owes $32,000 on the car. In bankruptcy court now, this loan is crammed down; $25,000 is considered secured while the remaining $7,000 is tossed into the pool with all other unsecured creditors, who usually see only pennies on the dollar.

One group of credit card issuers is *not* supporting the bill: those who market to subprime markets. The Act requires card issuers to expand their disclosures under the Truth in Lending

Act (TILA). In solicitations, lenders must clearly identify a credit card's interest rate after any introductory periods expire, as well as transfer fees. Monthly bills must calculate how long it would take to repay the outstanding credit line balance, if only the minimum payment were made.

Another major company, American Express, is neutral on the bill. Cardholders must pay off balances in full every month. Consequently, bankruptcy losses are lower than for other card issuers, and they have less to gain by tightening bankruptcy rules. Costs associated with the higher TILA reporting requirements offset their gains from reduced bankruptcy losses.

Beltway Insiders May Not Like a Deposit Insurance Bump, But It Wins Votes Elsewhere

Congress last raised federal deposit insurance limits in 1980, when it doubled coverage from $50,000 per account to $100,000. Community bank advocates have been fighting for a bump in coverage since the late 1990s, facing opposition from prominent policymakers like Federal Reserve Chairman Alan Greenspan. However, every year they gain ground. This year, they may prevail. House Republicans are half way home toward their goal of subsidizing small community banks at the expense of large, publicly traded financial institutions. On April 2, 2003, the House passed HR 522, the Federal Deposit Insurance Reform Act of 2003, by a margin of 411 to 11. According to the Congressional Budget Office, HR 522 will cause deposit insurance premium payments to be $3.5 billion higher over the next ten years – a cost shared by all insured institutions, for coverage that disproportionately benefits smaller banks.

One major provision of HR 522 raises the amount of insurance protection a saver can enjoy from a federally insured depository institution. The bill increases deposit insurance coverage from $100,000 to $130,000 per account, with inflation adjustments for the future. This is the primary legislative goal of small community banks who complain that their best customers are fleeing to money center banks who offer them higher yielding, albeit uninsured, money market accounts. Community bankers claim that boosting the insured limit will convince their largest depositors to keep their funds at home, helping the development of small towns and rural communities. Small towns and rural communities vote Republican, by large margins. On election night, they were the "most red"part of the "red states." Consequently, many Republicans see raising the insured individual deposit limit as a way to skin city slickers, a.k.a. Democrats. For the same reason, they want to double the insurance limits on employee retirement accounts to $260,000 and raise insured limits on municipal deposits.

Separately, HR 522 also grants greater flexibility to the FDIC in collecting premiums from insured institutions. The current rules have allowed well run banks and savings associations to be free from paying FDIC deposit insurance premiums for years. A strong economy has kept the reserves inside the Bank Insurance Fund (BIF) or the Savings Association Insurance Fund (SAIF) above a statutory ratio of 1.25 percent of insured deposits. In the past two years, a growing number of bank failures are causing BIF and SAIF ratios to drift down. The BIF is approaching its 1.25 trigger point, making an FDIC premium call increasingly likely. History has shown that the FDIC is forced to make premiums calls at the very time when bank

earnings are shrinking. HR 522 allows the FDIC to "manage" the trigger ratio between 1.4 and 1.15. It can set the ratio higher in a strong economy to boost premiums when institution earnings are at their highs and so build up reserves, then allow reserves to draw down when the economy is in a downturn.

A landslide House vote does not guarantee that President Bush will sign a deposit insurance reform bill soon. The White House has spoken against boosting the limit to $130,000, stating that it needlessly expands federal guarantees without any material benefit to the public. The Senate may also slow the bill down. Says Senate Banking Committee Chairman Shelby, "If you're a conservative and if you're thinking about the taxpayers, not about the lobbying groups that want something, you've got to ask at whose expense do they want to do this? Not at their own. The deposit insurance fund is not that strong." Despite this statement, Shelby has identified deposit insurance reform as a "big item" for his committee, and held a hearing about the issue on February 26. At the hearing, Shelby ended his opening statement on a optimistic note, observing, "Working together, I think we can seize this opportunity and move forward common-sense reforms – reforms which protect depositors and taxpayers and ultimately make a good system better." This sounds like a key official who is willing to deal, making a law increasingly likely. It can't hurt that the House leader on HR 522 is Spencer Bachus (R-AL). He'll be negotiating with his own state Senator, Richard Shelby (R-AL) when the House and Senate meet in conference to iron out differences. In evaluating the significance of Administration opposition to a deposit insurance hike passed by Congress, it's worth recalling that George Bush has yet to veto his first bill. There's always a first time for everything. But would this become the first time? Probably not.

Implementing the New, Updating the Old

Last year, the House Financial Services Committee and Senate Banking Committee used their time to pass the Sarbanes-Oxley Act, mandating sweeping reforms in corporate accountability. Overseeing the implementation of this new law, which passed in the wake of the Enron and WorldCom corporate governance scandals, will occupy both Committees in 2003. This year banking issues won't make it to the front page of the *New York Times* very often. Still, renewal of the Federal Credit Reporting Act, updating consumer bankruptcy laws, and boosting deposit insurance will impact the bottom line. Look for them on the business page.

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