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Inside

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Supervisory Insights

Supervisory Insights is published by the Division of Supervision and Consumer Protection of the Federal Deposit Insurance Corporation to promote sound principles and best practices for bank supervision.

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Issue at a Glance

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Letter from the Director

Since the release of the last issue of ***Supervisory Insights***, turmoil in the financial markets and the downturn in the U.S. housing market have continued to significantly challenge the banking industry. The extraordinary events of this past fall, including a series of bank failures and unassisted mergers of large institutions, evidence the pivotal role the FDIC continues to play in maintaining the availability of banking services during a time of tightening liquidity.

On October 14, 2008, in an unprecedented move to address systemic risks arising from a lack of liquidity in the banking sector, the FDIC announced a Temporary Liquidity Guarantee Program (TLGP) aimed at strengthening confidence in the banking system by guaranteeing newly issued senior unsecured debt of banks, thrifts, and certain holding companies, and providing full coverage of non-interest-bearing deposit transaction accounts.[1] In addition, as part of the enactment of the Emergency Economic Stabilization Act of 2008, the basic deposit insurance limit was temporarily increased to $250,000 as a means of further bolstering the public's confidence in the nation's banking sector.[2]

These recent policy initiatives reflect the importance liquidity issues have assumed in the current banking environment. Accordingly, this issue of ***Supervisory Insights*** features "The Changing Liquidity Landscape." The article describes how problems on the asset side of a bank's balance sheet can cascade to a liquidity run and discusses some steps that institutions can take to anticipate and mitigate liquidity risks.

The current financial crisis presents other lessons for bankers and regulators. One such lesson is the importance to bankers, regulators, and customers of fully understanding the risks and pitfalls—both from a safety-and-soundness and consumer protection perspective—of the products banks are marketing to consumers. With the baby boom generation approaching retirement, an example of a consumer financial product that is likely to grow in importance is the reverse mortgage. "Reverse Mortgages: What Consumers and Lenders Should Know" describes the evolution of this product and its increasing attractiveness to borrowers and financial institutions as more individuals reach retirement age. This article identifies risks for consumers and lenders, offers suggestions for mitigating those risks, and discusses key regulatory and supervisory concerns.

At times, bank supervisors are called upon to decide whether a particular banking practice should be considered an unfair or deceptive practice for purposes of the Federal Trade Commission (FTC) Act. "Unfair and Deceptive Acts and Practices: Recent FDIC Experience" describes the factors that supervisors analyze to reach this determination, using examples from a series of recent FDIC examination-consultations. This article shares the methodology used by FDIC staff as they perform the sometimes difficult compliance analyses required under Section 5 of the FTC Act and provides lessons for avoiding potential violations.

This issue's "Accounting News" explains how banks must adopt a new approach to the evaluation of and accounting for mergers and acquisitions under a revised standard issued by the Financial Accounting Standards Board. This article describes the key changes that will affect business combinations occurring in fiscal years beginning on or after December 15, 2008.

[1] Federal Deposit Insurance Corporation, Press Release, PR 100-2008, October 14, 2008, at www.fdic.gov/news/news/press/2008/pr08100.html.

[2] Federal Deposit Insurance Corporation, Press Release, PR 93-2008, October 7, 2008 at www.fdic.gov/news/news/press/2008/pr08093.html.

We encourage our readers to continue to provide feedback on articles and suggest topics for future issues. Your input helps ensure we are writing about topics that are of the greatest interest to our audience. Please e-mail your comments and questions to **SupervisoryJournal@fdic.gov**.

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The Changing Liquidity Landscape

During the past ten years, the nation's community banks have benefited from stable credit markets and relatively easy access to sources of liquidity. However, recent disruptions in the credit and capital markets have increased the challenges of liquidity planning for many institutions. Negative media coverage has heightened concerns among some bank customers about the safety of deposits. Emerging liquidity problems are particularly problematic for FDIC-insured institutions that rely on liability and off-balance sheet liquidity sources. These developments have reinforced the importance of effective bank liquidity management systems[1] and have prompted the Federal Reserve and the FDIC to take steps to ease liquidity pressures on banks.

The Winter 2007 issue of ***Supervisory Insights*** featured "Liquidity Analysis: Decades of Change," an article that highlighted the increased use of wholesale funding, off-balance sheet funding sources, and the importance of effective liquidity management. This article builds on those concepts by highlighting in detail some of the unique features and risks associated with various liquidity sources. The article evaluates how a bank's liquidity position can be adversely affected by deteriorating financial conditions and offers suggestions for developing an effective liquidity contingency plan.

Setting the Stage for a Liquidity Problem

Liquidity problems facing community and regional banks can be attributed to a basic structural change during the past decade. Although asset-based liquidity management continues to be used by many community banks, most institutions have transitioned toward a liability-oriented structure. The desire for earnings and capital growth has encouraged banks to move to an asset structure more heavily weighted in profitable, but less liquid, asset classes (see Chart 1). This includes, for many community institutions, high concentrations in acquisition, development, and construction lending. The combination of a less liquid asset mix and increasing use of liability-based liquidity strategies has increased liquidity risks and required more careful management scrutiny.

Community banks continue to struggle with attracting low-cost, stable deposits to fund growth. Although most institutions try to attract a large dollar volume of retail deposits, the challenges of deposit disintermediation and market competition have forced bankers to identify alternative funding sources. Advances in technology and greater access to liquidity markets have provided institutions with more funding options (see Chart 2).

Examiner observations indicate that many banks have established only rudimentary liquidity policies and contingency funding plans as part of the overall asset/liability management function. Monitoring ratios are often limited to a static analysis that depicts a point-in-time snapshot of the liquidity position. Comprehensive cash flow analyses that identify sources and uses of funds are rare. For example, a recent review of a multibillion dollar institution revealed that the sources-and-uses report tracked wholesale funding sources but did not incorporate retail cash flows. In many cases, contingency planning policies lack procedures based on bank-specific stress events, are not regularly updated to reflect current market conditions, and are not tested to ensure the accuracy of the assumptions.

[1] See the FDIC's supervisory guidance and examination procedures regarding sound liquidity risk management in the *FDIC Risk Management Manual of Examination Policies,* Section 6.1 – Liquidity. The evaluation factors for rating liquidity are described in the Uniform Financial Institutions Rating System.

A Liquidity Crunch

With this as background, we can analyze how the deteriorating financial condition of an institution can cascade into severe liquidity pressures. One or more scenarios can precipitate such problems:

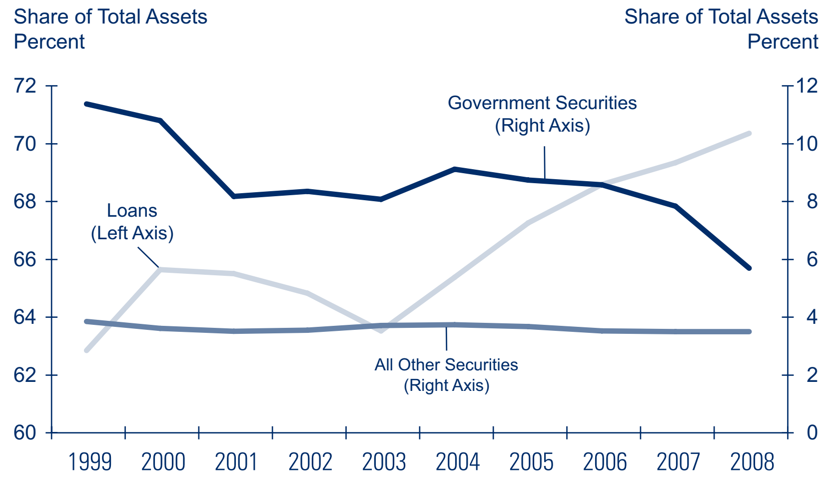
- Home price depreciation affects local markets.
- Speculative residential development projects stall.
- Planned commercial real estate projects fail to materialize.
- A slowing economy reveals fraudulent activities.
- Expansions into new markets or products result in operational losses.
- External events, such as a natural disaster or a systemic liquidity problem, disrupt markets.

Asset quality problems in the loan portfolio are the most common precursor to liquidity issues. Deteriorating asset quality typically depletes earnings and core capital as additional loan loss provisions are required and write-downs to investments and other real estate occur. An increase in nonperforming assets also pressures interest income and cash flow. Finally, overhead expenses begin to rise due to higher legal, operational, administrative, and staffing costs.

As asset quality problems emerge, the level of regulatory oversight can be expected to intensify, and the potential for negative publicity may increase. Financial information on all financial institutions is readily available to the public each quarter. Publicly held financial institutions are required to notify the U.S. Securities and Exchange Commission (SEC) when significant events occur. For other banks, credit-sensitive providers will review significant Call Report amendments. In addition, formal enforcement actions or capital directives are made public. This information increases the likelihood that negative media attention, Internet blogs, or rumors within the community will erode the confidence of bank customers.

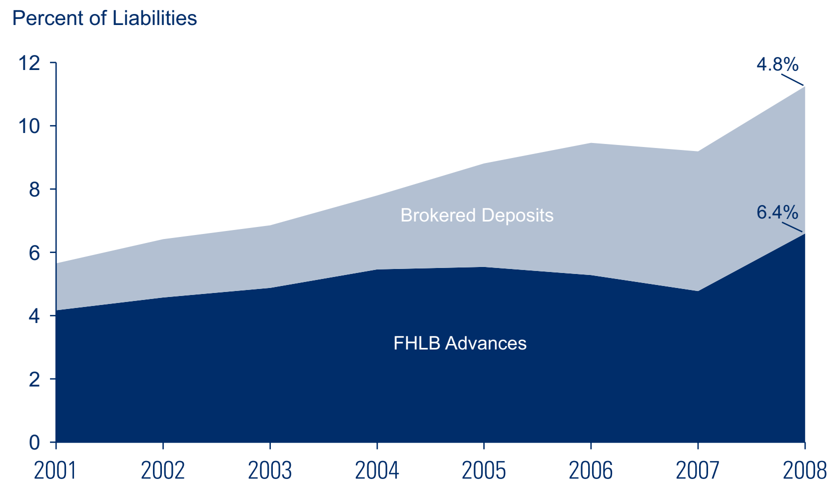
Management often is not prepared to cope with severe liquidity pressures. They likely have little experience dealing with liquidity problems and are focused primarily on resolving asset quality issues. If management has contributed to the asset quality problems or other

Chart 1: The Shift Toward Higher-Yielding Assets Continues Among Community Institutions



Source: Bank and Thrift Call Report data are aggregate as of June 30, 2008, for all insured institutions with assets less than $1 billion. Government securities include treasuries, agencies, and sponsored-agency securities.

Chart 2: Rapid Loan Growth Among Community Institutions Has Prompted an Increase in the Use of Certain Noncore Funding Products



Source: Bank and Thrift Call Report data are aggregate as of June 30, 2008, for all insured institutions with assets less than $1 billion.

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Developments That May Accompany a Liquidity Crunch

When insured institutions encounter financial problems and these problems become known to the public, FDIC personnel tracking liquidity at these institutions have identified certain patterns in deposit and liability funding activity. This activity may vary by institution type. The customer base and business activities at a commercial bank vary from those of a traditional thrift; as a result, differences in funding activity can occur in a troubled institution. Other factors include the level of negative press and whether the institution is publicly or privately held. One pattern that emerges at most troubled institutions is a substantial shifting of deposits among different account types to gain deposit insurance on uninsured funds.

Commercial banks. Distressed commercial institutions generally experience deposit outflows most rapidly in their commercial accounts. These accounts are often higher balance transaction accounts that are the lifeblood of businesses, and these businesses cannot afford to lose uninsured balances or have their accounts tied up in a failed bank resolution. As such, these commercial customers have moved quickly to withdraw funds as negative press circulates. The FDIC's temporary guarantee of non-interest-bearing transaction accounts is expected to substantially reduce incentives for many of these commercial accounts to run off.

The commercial bank also will experience deposit outflows from its retail accounts. Recent experience does indicate that these outflows are frequently offset by funds gathered through above-market deposit rate campaigns. A pattern of early withdrawals does not appear to occur with time deposits. However, when CDs mature, they often leave the bank, and occasional spikes in early withdrawals occur following significant negative press coverage.

Thrifts. Thrifts traditionally hold a smaller volume of business accounts and a higher volume of retail deposits than commercial banks do. As a result, retail deposit outflow relative to total deposits is often higher at distressed thrifts, especially from accounts with uninsured funds. Similar to a commercial bank, thrifts can offset retail deposit outflows by raising interest rates and attracting new funds.

The level of escrow deposits also can significantly affect deposit activity at a distressed thrift, as the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation can, in severe situations, restrict a thrift's ability to hold escrows by either reducing exposure or requiring daily remittance.

operational weaknesses, it is not unusual for senior bank officers to leave as liquidity problems begin to develop. Key operations personnel also may leave the institution as problems emerge. A leadership vacuum can hamper the development and implementation of an effective response to liquidity problems.

A liquidity run on an institution typically is not characterized by Depression era-type lines circling a bank. Examples of activities that suggest a liquidity run could be occurring include:

- Automated teller machines, electronic banking services, and wire transfers are used to rapidly transfer monies out of an institution.
- Public deposits require increased collateral pledges or move to banks that are perceived as safer.
- Time deposit customers are willing to incur early withdrawal fees to access their funds.
- Uninsured depositors withdraw or remove funds to eliminate exposed amounts.

A bank that is experiencing rapid deposit outflows faces an immediate need for liquidity. However, the potentially higher cost of obtaining additional funds may further exacerbate operating losses. If the situation is severe, a liquidity failure may occur, even though the

Time Line of a Liquidity Run

This case study, based on several actual examples, shows how quickly an institution's liquidity situation can deteriorate.

Day 1. A rapidly growing community bank, with $750 million in total assets and several branches, holds a significant concentration in acquisition and development loans. A large local real estate developer, associated with hundreds of loans at the bank, declares bankruptcy. The bank's publicly traded holding company makes a Significant Event filing with the SEC.

Day 2. Local media outlets cover the SEC filing, noting the severe downturn in the area real estate market and the considerable impact on local builders. The holding company stock drops 25 percent, and branch level deposits decline $11 million. Two senior lending officers are placed on administrative leave pending an investigation.

Day 3. Branch level deposits drop another $13 million, and the largest depositor notifies management it intends to withdraw funds. The bank draws $12 million from its borrowing line with the Federal Home Loan Bank (FHLB).

Day 4. Branch level deposits drop another $8 million, and the bank draws $8 million from the FHLB. A correspondent bank requires the bank to pledge securities to a $5 million line that was previously unsecured. The bank reactivates an agreement with an Internet listing service to attract additional deposits. The board of directors engages a consultant to advise on strategic options. A review of borrowing line contracts confirms that all have material change clauses that would allow funded balances to be called.

Day 5. Branch level deposits drop another $14 million, and the bank draws the last $17 million from the FHLB line. A correspondent bank informs the bank that it will no longer process the cash letter. The bank is informed that the Federal Reserve Bank (FRB) will likely impose a zero daylight overdraft. A local newspaper runs a story on high-risk and potentially fraudulent transactions involving real estate investors, brokers, and the bank.

Day 6. Branch level deposits drop another $7 million. Another correspondent agrees to take over the cash letter activities, and the bank draws $4 million from this correspondent. Further, the bank obtains $3 million in higher rate CDs through the Internet listing service. The bank's largest depositor has withdrawn the majority of its funds. Another SEC filing details the severity of the loan problems and management's actions to address the issue. Remaining liquidity is estimated at $35 million. A line of credit with the FRB is not pursued as the bank has not identified collateral that is available to pledge. The bank reaches an agreement to obtain substantial deposits, but those funds likely will not be available for two more business days. The potential to sell loans is evaluated, but no loan sales are imminent. Loss on the asset situation is initially estimated at $5–$10 million. The loss will cause the bank's capital level to fall to the point at which a brokered deposit waiver from the FDIC will be required to obtain or renew brokered deposits.

Days 7–9. Over the next three days, branch level deposits drop another $18 million. The bank draws $41 million from the correspondent and obtains $9 million in Internet listing CDs. A full-scope regulatory examination has begun, media coverage continues to scrutinize the asset issue, and the bank has virtually exhausted all credit lines.

Day 10. The bank completes the arrangement with an outside party and receives $99 million in higher cost deposits to avert a liquidity failure.

Thus, as the result of a single (albeit substantial) lending issue, the bank lost $73 million in deposits over ten business days, had a correspondent bank cease its agreement to process the cash letter, and nearly failed, as all ready sources of liquidity were exhausted. Although it survived the short-term liquidity crisis, the bank now faces an extremely narrow net interest margin because of the higher cost deposits.

institution has not breached the capital threshold that triggers a presumption that the regulators will close it.

Strategies for Mitigating Liquidity Risks

Management should be alert to signs of liquidity problems. As these warning signs emerge, management should consider a range of options.

A critical first step in addressing potential liquidity problems is to understand the bank's operations and attempt to retain the current deposit base. Regardless of branch network size, management must have systems in place to solicit feedback from branch managers and monitor branch activity. Management should train branch managers and customer service representatives on how to communicate with depositors, including advising customers on how to properly title deposits and ensuring that they have an accurate understanding of their deposit insurance coverage. In particular, depositors should be made aware of the recent temporary increase in deposit insurance to $250,000 and the potential

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for full coverage of non-interest-bearing transaction accounts.[2]

Branch managers should understand their markets and quickly identify irregular deposit trends. Management should regularly communicate with operations personnel, perform daily cash flow analysis, and consider hiring a public relations firm to handle media inquiries and assist in developing strategies for communicating with depositors and the public.

Correspondent bank relationships likely will change as a bank's financial position deteriorates. Correspondent banks may require collateral to secure lines of credit. Management should review these contracts, as the correspondent bank may have the authority to cancel the line entirely. Even if a correspondent does not cancel the line, at best, these short-term unsecured lines are stop-gap measures because of embedded restrictions on borrowing or on the number of consecutive days a line can be used. A bank's ability to sell federal funds also could be affected, as the correspondent bank or purchasing banks may decide to limit exposures to an institution with known capital problems.

In some cases, correspondent banks will no longer process cash letters. For example, after reviewing an amended Call Report, one bank's main correspondent and clearing agent notified the bank that it would no longer lend to the institution on an unsecured basis. The bank was forced to enter into a repurchase agreement (using remaining unpledged securities) to ensure that the correspondent would continue to provide processing services. Situations like these can result in a scramble for an alternative correspondent banking relationship at the least opportune time.

Federal Reserve Banks can serve as a liquidity option by providing access to the Discount Window.[3] This option also requires collateral documentation. Further, the FRB may move distressed banks from a primary to secondary credit program, which has various restrictions on borrowing from the Discount Window, along with the inability to bid on Term Auction Facility and Treasury Tax and Loan funds. Certain restrictions also can be placed on the bank's correspondent account when using the FRB for check clearing activities. The FRB likely will implement real-time monitoring and may increase the amount of required funds to process cash letter transactions, further constraining the amount of available liquidity.

Banks with high levels of wholesale funding must be aware of potential liquidity problems. The FHLB system is a primary provider of wholesale funding to community banks; these lines generally are secured by blanket liens on certain types of mortgages or mortgage-backed assets. In recent months, the FHLBs have made changes to risk rating programs[4] that could affect an institution's borrowing capacity based on significant financial events, regulatory examination findings, or regulatory enforcement actions. Generally, access to FHLB lines is restricted as a bank's capital position deteriorates, and the bank's deposits at the FHLB might be frozen as a potential offset to these lines. The FHLB also might refuse to renew advances at maturity, accelerate the repayment of advances due to a covenant breach, increase collateral requirements, or reduce funding

[2] Press Release. "FDIC Issues Interim Rule to Implement the Temporary Liquidity Guarantee Program." www.fdic.gov/news/news/press/2008/pr08105.html.

[3] Federal Reserve Financial Services, Account Management Guide, www.frbservices.org. Information also available at www.frbdiscountwindow.org/.

[4] An example of an FHLB credit risk rating system matrix can be found at http://corp.fhlbatl.com/WorkArea/showcontent.aspx?id=1613.

lines.[5] Requirements to pay advances early could seriously constrain cash flow. Additional collateral requirements can limit a bank's ability to sell certain assets. Increased scrutiny and requests for physical custody of loan collateral will require greater management attention. Banks requesting access to the FHLB or increased lending must be prepared to dedicate substantial time and resources to completing applications and providing collateral documentation.

Although brokered deposits can serve as a reliable funding source when a bank is in good financial condition, this source can disappear quickly if the market believes an institution is in trouble and might be at risk of failure. An adverse change in perception may result in a liquidity crisis. Should capital erode, the bank may fall below the Well Capitalized[6] threshold under the Prompt Corrective Action rules.[7] Institutions designated as Adequately Capitalized must then apply to the FDIC for a waiver before they can accept, renew, or roll over any brokered deposit.[8] The FDIC grants waivers on a case-by-case basis, depending on the bank's financial and operational condition. Approval of a waiver in many cases is conditioned on an institution's credible plan to limit growth, reduce its risk exposure, and return to a Well Capitalized position.

The FDIC cannot grant a waiver for a bank that is falling below the Adequately Capitalized level. Banks also are restricted in the deposit rates they may offer. Rates that exceed certain levels are considered a brokered deposit under FDIC Rules and Regulations.[9] As a result, this rate-based restriction could reduce the availability of funding alternatives as a bank's capital condition deteriorates.

Many banks use Internet listing services as alternatives to brokered deposits. These deposits are not considered brokered unless the bank is less than Well Capitalized and the rates offered exceed the guidelines established in the brokered deposit regulations.[10] An institution can obtain Internet deposits relatively quickly; however, recent market events have revealed limitations in this funding source. The number of Internet depositors is relatively small compared with the overall market, and the funds available from this source are limited, as each Internet depositor typically caps the amount placed at any one institution. If Internet deposits are part of an institution's liquidity plan, management should establish agreements with listing services

[5] Kyle L. Hadley and Drew Boecher, "Liquidity Analysis: Decades of Change," S*upervisory Insights* Winter 2007. www.fdic.gov/regulations/examinations/supervisory/insights/siwin07/siwinter07-article1.pdf.

[6] For purposes of these restrictions (established under Section 337.6 of the FDIC Rules and Regulations) the terms "Well Capitalized," "Adequately Capitalized," and "Undercapitalized" shall have the same meaning to each insured depository institution as provided under regulations implementing Section 38 of the Federal Deposit Insurance Act.

[7] Capital categories are defined in the FDIC Rules and Regulations, 12 CFR 325—Capital Maintenance, Subpart B—Prompt Corrective Action. www.fdic.gov/regulations/laws/rules/2000-4400.html.

[8] Institutions that are Adequately Capitalized may apply to the FDIC for a waiver in accordance with FDIC Rules and Regulations, 12 CFR 337—Unsafe and Unsound Banking Practices, Section 337.6—Brokered Deposits. www.fdic.gov/regulations/laws/rules/2000-5900.html.

[9] Banks that are considered Adequately Capitalized under the Prompt Corrective Action (PCA) standard must receive a waiver from the FDIC before they can accept, renew, or roll over any brokered deposit. They also are restricted in the rates they may offer on such deposits. Banks that are less than Well Capitalized under PCA standards may not offer rates of interest "significantly higher" than the prevailing market rate. Refer to FDIC Rules and Regulations, 12 CFR 337—Unsafe and Unsound Banking Practices, Section 337.6. www.fdic.gov/regulations/laws/rules/2000-5900.html.

[10] Refer to FDIC Rules and Regulations, 12 CFR 337—Unsafe and Unsound Banking Practices, Section 337.6. www.fdic.gov/regulations/laws/rules/2000-5900.html.

Liquidity

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and periodically acquire Internet deposits to test the viability of this liquidity source.

Banks facing liquidity problems often consider the benefits of selling assets (securities and loans) to generate additional cash and reduce the overall asset base. However, management should consider the downside risk of this strategy. In the case of the securities portfolio, management may discover that securities listed as available-for-sale may be needed to pledge additional collateral to secure public funds or other borrowing lines. For example, one institution initially was required to pledge collateral for public funds at 25 percent of the average public funds balance. After the examination results required significant Call Report amendments, the public entity increased the collateral requirement to 125 percent of the average balance. With no additional collateral available, the bank was forced to use cash as collateral to retain the deposits. Finally, as recent events have demonstrated, a plan to sell securities as a source of liquidity depends for its effectiveness on the credit quality and marketability of these securities.

Traditionally, loans are not as marketable as securities, and distressed loans are even less marketable. Bids may be severely discounted given the bank's stressed condition, and a deteriorating capital position may prevent the institution from realizing the sale. Finally, due diligence for loan sales requires time and effort. If bank management considers this option, establishing business relationships and completing initial due diligence is important. Asset sales or nonrecourse loan participations may negatively affect interest income, but they can also provide short-term liquidity.

As banks facing liquidity difficulties identify options for improving cash flow, the continued funding of loan commitments and lines of credit may impede effective liquidity management. During the past several months, some financial institutions have reduced or suspended home equity lines of credit and limited funding on other types of off-balance-sheet items to preserve cash. Bank management must consider how funding obligations could affect future liquidity and provide guidance in policies to address this issue.[11]

Developments Supporting Bank Liquidity

In light of recent liquidity events, federal programs have been implemented to bolster consumer confidence in the banking system and the marketplace.

On October 3, 2008, President George W. Bush signed the Emergency Economic Stabilization Act of 2008,[12] which temporarily raises the basic limit on federal deposit insurance coverage from $100,000 to $250,000 per depositor. The legislation did not increase coverage for retirement accounts; this limit remains at $250,000. The legislation provides that the basic deposit insurance limit will return to $100,000 after December 31, 2009.

In addition, on October 14, 2008, the FDIC announced the creation of the Temporary Liquidity Guarantee Program (TLGP)[13] as part of a broader government effort to strengthen confidence and encourage liquidity in the nation's banking system. The TLGP has two components. One guarantees newly issued senior unsecured debt of the participating organizations, within limits,

[11] Financial Institution Letter (FIL-58-2008). "Home Equity Lines of Credit Consumer Protection and Risk Management Considerations When Changing Credit Limits and Suggested Best Practices." www.fdic.gov/news/news/financial/2008/fil08058.html.

[12] H.R. 1424—Emergency Economic Stabilization Act.

[13] Press Release. "FDIC Issues Interim Rule to Implement the Temporary Liquidity Guarantee Program." www.fdic.gov/news/news/press/2008/pr08105.html.

issued between October 14, 2008, and June 30, 2009. The TLGP also provides full coverage for non-interest-bearing transaction deposit accounts, regardless of dollar amount, until December 31, 2009. Institutions may opt out of one or both programs.[14]

Recent Supervisory Guidance

Bank failures that have occurred during the past year, along with media coverage about perceived weaknesses in the financial system, have heightened the public's awareness of the existence of deposit insurance coverage and the need to monitor deposit balances. Community banks that are ***not*** experiencing liquidity pressures are now more aware of the importance of preparing in advance for the possibility of a liquidity run. As a result, the development and implementation of a contingency funding plan (CFP) is critical for all financial institutions.

In August 2008, the FDIC issued *Liquidity Risk Management,* which urges an institution's board of directors to establish a formal CFP policy that adopts quantitative liquidity risk limits and guidelines.[15] This policy should address:

- Discrete or cumulative cash flow mismatches or gaps (sources and uses of funds) over specified future short- and long-term time horizons under both expected and adverse business conditions. Often, these are expressed as cash flow coverage ratios or specific aggregate amounts.
- Target amounts of unpledged liquid asset reserves expressed as aggregate amounts or as ratios.
- Asset concentrations, especially with respect to more complex exposures that are illiquid or difficult to value.
- Funding concentrations that address diversification issues, such as dependency on a few large depositors or sources of borrowed funds.
- Contingent liability metrics, such as amounts of unfunded loan commitments and lines of credit relative to available funding. The potential funding of contingent liabilities, such as credit card lines and commercial back-stop lending agreements, should also be appropriately modeled and compared with policy limits.

Further, the board of directors should use liquidity measurement tools that match their funds management strategies and provide a comprehensive view of an institution's liquidity risk. Risk limits should be approved by an institution's board and be consistent with the measurement tools used. Pro forma cash flows should show the institution's projected sources and uses of funds under various liquidity scenarios, identify potential funding shortfalls or gaps, and include assumptions that consider a wide range of outcomes. The liquidity measurement system also should include scenario analysis to assess the viability of different funding options.

This FDIC guidance further notes that an effective CFP does the following:

- Defines responsibilities and decision-making authority so that all personnel understand their roles during a problem-funding situation.
- Includes an assessment of the possible liquidity events that an institution might encounter.
- Details how management will monitor for liquidity events, typically through stress testing of various scenarios in a pro forma cash flow format.

[14] On November 21, 2008, the FDIC Board approved for *Federal Register* publication the final rule for the TLGP. Changes were made to the interim rule published in the *Federal Register* on October 29, 2008 (73 Fed. Reg. 64179).

[15] Financial Institution Letter (FIL-84-2008). "Liquidity Risk Management." https://www.fdic.gov/news/inactive-financial-institution-letters/2008/fil08084.html.

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- Assesses the potential for triggering restrictions on the bank's access to brokered and high-cost deposits, and the effect on the bank's liability structure.
- Identifies and assesses the adequacy of contingent funding sources. The plan should identify any back-up facilities (lines of credit), the conditions and limitations on their use, and the circumstances in which the institution might use such facilities. Management should understand the various legal, financial, and logistical constraints—such as notice periods, collateral requirements, or net worth covenants—that could affect the institution's ability to use back-up facilities.

The need for an effective CFP is particularly important for banks that rely on brokered deposits. As noted in Chart 2, brokered deposits as a percent of liabilities at FDIC-insured institutions has risen from 1.1 percent as of June 30, 1999, to 4.8 percent at June 30, 2008.[16] Although brokered deposits can be a viable source of funding for certain institutions, management must consider the potential impact on renewing, accepting, or rolling over brokered deposits should capital fall below established limits. The CFP should outline steps for accessing practical and realistic funding alternatives if funding options are reduced.

Other items management should consider for the CFP include:

- A comprehensive communication strategy for dealing with external inquiries and internal training needs.
- An evaluation of the need for additional liquidity expertise to effectively implement the plan.
- A program to regularly test liquidity sources, including actually borrowing on current lines of credit to ensure that they are valid.
- A review of contracts for provisions that may allow funds providers to limit or cancel access to liquidity lines.
- Continual monitoring of wholesale funding sources to understand any changes in guidelines or collateral requirements.

Conclusion

In the current challenging environment, bank liquidity planning is becoming paramount. Although many banks have traditional contingency credit lines, established liquidity sources can quickly disappear when funding is most needed; in the worst cases, the result may be bank failure. Further, even if an institution can weather a liquidity storm, ineffective funds management decisions could irreparably impair earnings. A comprehensive, well-designed liquidity contingency plan can help bank management effectively navigate a liquidity crisis.

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[16] Bank and Thrift Call Report data for all insured institutions with assets less than $1 billion.

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Reverse Mortgages: What Consumers and Lenders Should Know

The U.S. senior citizen population is growing. Between 1990 and 2000, the number of individuals at least 65 years of age increased from 31.2 million to nearly 35 million. Many more are reaching the minimum social security retirement age; by 2010, more than 50 million people in this country will be at least 62 years old.[1] Life expectancies are lengthening, creating the need for retirement income to last longer than in previous generations. However, according to the U.S. Government Accountability Office, "Efforts to increase personal savings outside pension arrangements seem to have had only marginal success."[2] As a result, older people who need additional funds to cover general living expenses are turning to the reverse mortgage lending market in greater numbers.

Historically, the largest investment of the average American household is its primary residence. A recent study by the American Association of Retired Persons (AARP) indicates that more than 80 percent of households over the age of 62 own their own home, with an estimated value of $4 trillion.[3] Until recently, equity in these homes has not been tapped, but now it represents a likely source of retirement income and an opportunity for significant growth in the reverse mortgage lending industry. This article describes the features of reverse mortgage loan products, identifies key consumer concerns, and provides an overview of potential safety-and-soundness and consumer compliance risks that lenders should be prepared to manage when implementing a reverse mortgage loan program.

What Is a Reverse Mortgage?

Reverse mortgage loans are designed for people ages 62 years and older. This product enables seniors to convert untapped home equity into cash through a lump sum disbursement or through a series of payments from the lender to the borrower, without any periodic repayment of principal or interest. The arrangement is attractive for some seniors who are living on limited, fixed incomes but want to remain in their homes. Repayment is required when there is a "maturity event"—that is, when the borrower dies, sells the house, or no longer occupies it as a principal residence.

Almost all reverse mortgage lending products are nonrecourse loans: Borrowers are not responsible for deficiency balances if the collateral value is less than the outstanding balance when the loan is repaid. This situation, known as *cross-over risk*, occurs when the amount of debt increases beyond (crosses over) the value of the collateral.

Reverse mortgages are fundamentally different from traditional home equity lines of credit (HELOCs), primarily because no periodic payments are required and funds flow from the lender to the borrower. The servicing and management of this loan product also differ from those of a HELOC. (See Table 1 for a comparison of reverse mortgage loan products and HELOCs.)

Evolution of the Reverse Mortgage

Reverse mortgages have been available for more than 20 years, but consumer

[1] U.S. Census Bureau, 2000 Census Population and Projections.

[2] *Retirement Income—Implications of Demographic Trends for Social Security and Pension Reform*, United States General Accounting Office, July 1997, p. 7.

[3] Donald L. Redfoot, Ken Scholen, and S. Kathi Brown, "Reverse Mortgages: Niche Product or Mainstream Solution? Report on the 2006 AARP National Survey of Reverse Mortgage Shoppers" (AARP Public Policy Institute, December 2007).

Table 1

Features of Reverse Mortgage and HELOC Products		
	Reverse Mortgage	**HELOC**
Collateral /security interest	Borrower remains owner of home; lender takes security interest.	Borrower remains owner of home; lender takes security interest.
Flow /access to loan funds	Several options, including periodic payments to borrower and draws on the total available credit.	Borrower draws funds as necessary.
Interest, fees, and charges	All up-front and periodic fees are added to the loan balance. Interest continues to accrue on the outstanding balance until repayment at the end of the loan.	Depending on the program, borrower may pay fees outside closing or by adding them to the unpaid balance. Interest and fees are assessed on outstanding balance until repaid.
Repayment	No periodic payments of principal or interest. One payment is due when borrower dies, sells the house, or no longer occupies it as a primary residence.	Payments vary by program. Generally, HELOCs feature monthly interest-only payments for a set period of time, followed by flexible principal and interest payments until the maturity date.
Maximum loan amount	Some programs allow the maximum loan amount to grow over time (see description later in text of Home Equity Conversion Mortgage).	May vary by program, but most establish the maximum amount based on combined loan-to-value ratio at the time of origination.
Loan suspension	Unused loan proceeds may not be suspended by the lender.	Subject to Regulation Z requirements, unused lines of credit may be suspended in response to delinquent payments or significant decline in collateral value.

demand has been relatively weak because of uncertainty about how this product works. Consumers often ask the following questions:

- Can I retain the title to my house?
- What happens if the loan balance exceeds my home's value?
- Will I be able to bequeath my home to my heirs?

Financial institutions have been slow to enter the reverse mortgage lending market because of the unique servicing and risk management challenges. For example, when the reverse mortgage was first introduced, banks were wary of booking potentially long-term loans that increase over time, do not have a predefined, scheduled repayment stream, and for which there was no established secondary market. Lenders also faced uninsured crossover risk.

However, the market changed in 1988 when the Federal Housing Administration (FHA) launched the Home Equity Conversion Mortgage Insurance Demonstration, a pilot project that eventually was adopted permanently by the U.S. Department of Housing and Urban Development (HUD).[4] The outcome was the Home Equity Conversion Mortgage (HECM), a commercially viable loan product with strong consumer protections. For example, the HECM requires prospective borrowers to complete a pre-loan counseling program that explains

[4] Redfoot, Scholen, and Brown, 2007, p. viii.

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the nature of reverse mortgages, including the risks and costs.[5]

In addition, the HECM is a nonrecourse credit that protects consumers from crossover risk. HECMs carry FHA insurance, which protects lenders from this risk. HECMs have maximum loan amounts based on the location of the collateral (the house). (See Table 2 for details.)

In some cases, individuals with high value homes desire loans that exceed HECM maximums. This demand led to the development of private, proprietary programs through which consumers can obtain alternative loan products if they need access to higher equity amounts. However, crossover risk is a concern with these proprietary programs, as no insurance is available to cover potential collateral deficiencies. Generally, in these

Table 2

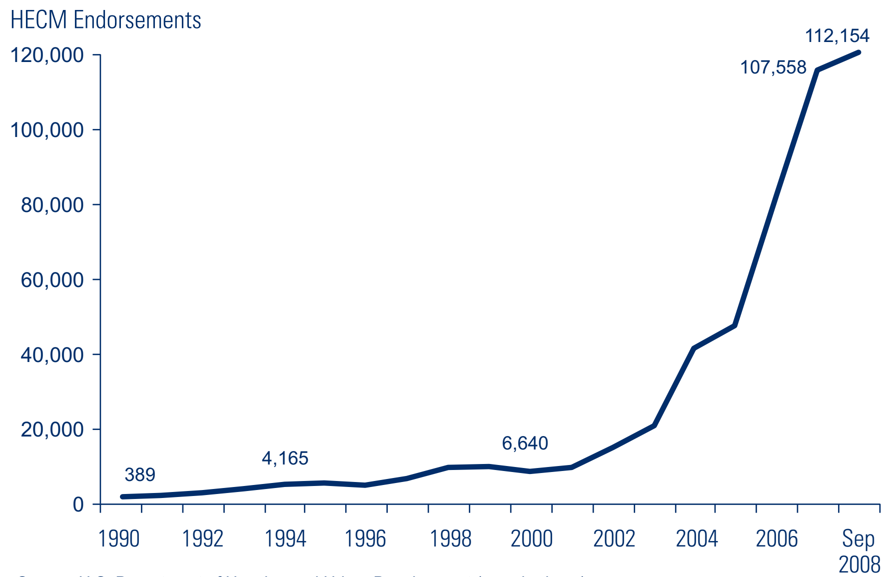
Features of HECMs and Proprietary Programs

	HECM	Proprietary Programs
Who grants the loan?	FHA-approved lenders.	Individual lenders.
What is the maximum loan amount?	Primarily based on the age of the youngest borrower. For all HECMs insured after November 5, 2008, the maximum loan amount is $417,000. The limit is higher in identified high cost areas in Alaska, Hawaii, Guam, and the Virgin Islands. In these areas, loans may exceed the national limit up to 115 percent of the area median price or $625,500, whichever is less.[6]	Lender's discretion. Generally these are jumbo loans designed to fill the market niche for borrowers who want loans above the HECM limit.
How are funds drawn?	Borrowers have five options: 1. Fixed monthly payments 2. Fixed monthly payments for a set period 3. Line of credit, drawn for any amount at any time 4. Combined fixed payments and a line of credit 5. Combined fixed payment term and a line of credit	Lender discretion—programs vary.
Does overall loan cap grow over time?	Yes. HECM allows the loan to grow each year. For example, the unused loan balance is increased by the same rate as the interest charged on the loan. Therefore, for the unused portion of the loan, the total loan amount continues to grow.	No.
What happens if the value of the house becomes less than the amount of the loan?	FHA insures the difference. The borrower (or borrower's heirs) will not be responsible for shortages if the value falls below the outstanding balance. The borrower pays FHA insurance premiums during the term of the loan; these premiums are added to the loan balance.	Anecdotal market data suggest that most current programs are nonrecourse loans. However, programs vary and may be subject to limits under state laws. Lenders bear the risk of collateral shortages.
What are the costs and fees?	Origination fee: maximum of 2 percent of the first $200,000 plus maximum of 1 percent of amounts over $200,000. The overall cap is $6,000. The minimum is $2,500, but lenders may accept a lower origination fee when appropriate. Mortgage insurance (2 percent initial plus .5 percent annually). Monthly servicing fee: $30. Other traditional closing costs (appraisal, title, attorney, taxes, inspections, etc.).	Lender discretion.

[5] HUD partnered with the AARP Foundation's Reverse Mortgage Education Project to develop consumer education materials and train and accredit financial counselors. For additional resources, see www.hecmresources.org/project/proje_project_goals.cfm.

[6] "2009 FHA Maximum Mortgage Limits" (HUD Mortgagee Letter 2008-36, November 7, 2008), https://www.hud.gov/sites/documents/DOC_20412.doc.

Chart 1: HECM Endorsements Have Increased Dramatically Since 2004



Source: U.S. Department of Housing and Urban Development (www.hud.gov).

private programs, greater risk translates into higher costs for consumers—lenders must price products to cover the risk of repayment or loss. (See Table 2 for a comparison of HECMs and proprietary programs.)

The need for higher HECM loan limits was addressed as part of the Housing and Economic Recovery Act of 2008 (HERA), signed into law on July 30, 2008. The HERA effectively raised the maximum HECM loan amount from a range of $200,160–$362,790 to a new nationwide ceiling of $417,000, by tying the limit to the national conforming limits for Freddie Mac. (Higher limits are allowed in certain, designated high cost areas, as noted in Table 2.) Given that the maximum amounts were only recently changed, the impact on the demand for proprietary jumbo loans is not yet known.

In addition to HECMs and proprietary programs, Fannie Mae previously offered the Home Keeper reverse mortgage loan program. This product featured many of the same consumer protections as the HECM, including the counseling requirement, as well as generally higher maximum loan amounts. However, the program did not capture a large segment of the market, and Fannie Mae terminated it in September 2008 subsequent to the new loan limits allowed under the HERA.

Overall, even with the emergence of proprietary programs, more than 90 percent of reverse mortgages are HECMs, and the number of HECMs has increased steadily since 2004. During HUD's 2007 fiscal year, 107,558 HECMs were insured by the FHA, an increase of more than 40 percent over the previous year.[7] As of September 2008, more than 112,000 HECMs had been insured by the FHA during the calendar year (see Chart 1).

Consumer Issues

Reverse mortgages benefit consumers by providing a nontaxable source of funds. This is particularly attractive to seniors who have limited, fixed incomes

[7] National Reverse Mortgage Lenders Association, statistics as of July 2008. See www.nrmlaonline.org/RMS/STATISTICS/DEFAULT.ASPX?article_id=601.

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but high amounts of home equity. These loans can enable some people to continue living in their homes, which may not have been feasible without this additional source of cash. However, this loan product is not for everyone, and potential borrowers should carefully assess the pros and cons before taking on a reverse mortgage.

The report ***Reverse Mortgages: Niche Product or Mainstream Solution?*** published by the AARP Public Policy Institute in late 2007 presents information about consumers who obtained reverse mortgages, as well as those who opted not to pursue them after completing the required pre-loan counseling.[8] Survey respondents cited many reasons for deciding not to pursue a reverse mortgage. The following represent the three most-cited reasons: the high cost (63 percent); respondents found another way to meet financial needs (56 percent); or respondents determined that the loan was not necessary given the individual's financial position (54 percent).[9]

The results of this study highlight key consumer considerations, such as the importance of pre-loan counseling, which may provide information about other programs better suited to a borrower's needs. For example, local lenders and community organizations may offer low-cost home improvement loans for seniors. In some cases, consumers might find they are better off financially if they sell their property rather than refinance an existing loan with a reverse mortgage.

Lenders also face risks associated with the various consumer issues, including those identified in the AARP survey. For example, there is a potential for reputation risk, and perhaps even legal risks that could result from aggressive cross-marketing of other financial products, such as long-term annuities. Some financial service providers encourage reverse mortgage borrowers to draw funds to purchase an annuity or other financial product. Interest begins to accrue immediately on any funds drawn from the reverse mortgage, and borrowers may lose other valuable benefits, such as Medicaid. For example, funds that are drawn and placed in deposit accounts or non-deposit investments would be included in the calculation of the individual's liquid assets for purposes of Medicaid eligibility.

Aggressive cross-selling is considered predatory by many consumer advocates. In fact, the HERA specifically prohibits lenders from conditioning the extension of a HECM loan on a requirement that borrowers purchase insurance, annuities, or other products, except those that are usual and customary in mortgage lending, such as hazard or flood insurance. These prohibitions apply to HECMs but not to products in a proprietary lending program—a fact consumers should consider when choosing a reverse mortgage product.

Another potentially predatory practice is equity-sharing requirements, which are contractual obligations for borrowers to share a portion of any gain—or, in some cases, equity—when the loan is repaid. These provisions mean additional, sometimes substantial, charges that the consumer or the consumer's estate is obligated to pay, thus reducing the consumer's share of his or her home value. Such provisions are prohibited in the HECM program but were a component of early reverse mortgage programs developed in the 1990s. A person who chooses a proprietary program should carefully review contracts for the existence of these provisions.

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[8] Redfoot, Scholen, and Brown, 2007.

[9] Percentages total to more than 100 percent because survey respondents could select more than one reason for not pursuing a reverse mortgage.

Table 3

Safety and Soundness Concerns in Reverse Mortgage Lending	
Issue	**Description**
Property appraisals	Lenders must ensure that property appraisals are conducted in accordance with the requirements of the appraisal regulations in Part 323 of the FDIC Rules and Regulations.
Real estate lending standards	Lenders must comply with Part 365 of the FDIC Rules and Regulations, which requires insured state nonmember banks to adopt and maintain written policies that establish appropriate limits and standards for extensions of credit that are secured by liens on or interests in real estate, or that are made for the purpose of financing permanent improvements to real estate.
Third-party risks	Lenders must manage potential risks associated with third-party involvement. This is particularly relevant to situations in which lenders either conduct wholesale activities or act as brokers or agents themselves. For additional details, refer to "Guidance for Managing Third-Party Risk" (FDIC Financial Institution Letter FIL-44-2008, June 6, 2008), www.fdic.gov/news/news/financial/2008/fil08044.html.
Servicing complexity	Specialized loan servicing functions must be implemented, including processes for disbursing proceeds over extended periods of time and monitoring maturity events that will necessitate repayment.
Securitization and liquidity	Although a secondary market for reverse mortgage lending exists, it is relatively new, and financial institution expertise in this area may be limited.
Collateral	Lenders/servicers must ensure that collateral condition is maintained during the term of the loan.

Regulatory and Supervisory Considerations

Given the downturn in traditional 1–4 family mortgage lending, reverse mortgages may become an attractive product line for some institutions. However, these loans can include complex terms, conditions, and options that could heighten consumer compliance and safety and soundness risks.

Financial institutions participate in the delivery of reverse mortgage loans in a variety of ways. Generally, the lender acts either as a direct lender or a correspondent (or broker) that refers applications to, or participates with, other lenders. Rather than developing the expertise in-house, small community banks might establish referral arrangements with other specialized lenders.

Regardless of the nature or extent of the institution's involvement in offering reverse mortgage products, management should be aware of the safety and soundness and compliance risks associated with this type of lending. Reverse mortgage lending is subject to many of the same underwriting requirements and consumer compliance regulations as traditional mortgage lending. Table 3 gives an overview of key safety-and-soundness issues, and Table 4 summarizes provisions of some of the federal consumer protection laws and regulations that apply to reverse mortgage lending.

In general, the same safety and soundness and consumer compliance regulations and requirements that apply to traditional real estate lending apply to reverse mortgage lending. However, reverse mortgages often present unique challenges and issues for institutions that plan to offer this product line for the first time. For example, management may need to amend operating policies and procedures to appropriately identify and manage the inherent risks, regardless of whether the institution offers reverse

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Table 4

Consumer Protection Laws and Regulations Applicable to Reverse Mortgage Products	
Truth in Lending Act (TILA), 15 U.S.C. 1601 *et seq.* / Regulation Z, 12 CFR 226	• Requires disclosure of overall costs of credit. • Contains provisions for reverse mortgages, because the traditional annual percentage rate and total finance charge will vary depending on how the credit availability is used. • Requires a disclosure of the "total annual cost" using three scenarios.
Real Estate Settlement Procedures Act (RESPA), 12 U.S.C. 2601 *et seq.* / Regulation X, 24 CFR 3500	• Requires disclosure of fees and charges in the real estate settlement process, including fees not considered finance charges under Regulation Z. • Prohibits kickbacks between settlement service providers in these transactions. These provisions are particularly applicable to indirect lending situations in which banks make referrals to other lenders. • Effective October 1, 2008, only FHA-approved mortgagees may participate in and be compensated for the origination of HECMs to be insured by FHA. Loan originations must be performed by FHA-approved entities, including: (1) an FHA-approved loan correspondent and sponsor; (2) an FHA-approved mortgagee through its retail channel; or (3) an FHA-approved mortgagee working with another FHA-approved mortgagee.[10]
Fair Lending (Equal Credit Opportunity Act, 15 U.S.C. 1691 *et seq.* / Regulation B, 12 CFR 202, and Fair Housing Act, 42 U.S.C. 3601 *et seq.*)	• Prohibits discrimination in all aspects of credit transactions on certain prohibited bases.
Flood Insurance—National Flood Insurance Program, 42 U.S.C. 4001 *et seq.*	• Requires lenders to determine whether property is located in a designated flood hazard area prior to making the loan. • Requires borrower notification if property is in a flood zone. • Requires property to be covered by flood insurance during the entire loan term.
Unfair and Deceptive Acts or Practices (UDAP)–Section 5(a) of the Federal Trade Commission (FTC) Act, 15 U.S.C. 45(a)	• Generally prohibits unfair or deceptive acts or practices in all aspects of the transaction. • Provides legal parameters for determining whether a particular act or practice is unfair or deceptive.

mortgages through direct lending or as a correspondent for other institutions.

Conclusion

As the U.S. population continues to age and life expectancies lengthen, more people will be living longer in retirement and undoubtedly will need additional sources of long-term income. This scenario suggests that the demand for reverse mortgages will increase. Potential borrowers should weigh the pros and cons of this loan product for their particular financial situation, and lenders should take steps to ensure they understand how to identify and manage the risks associated with this product.

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[10] "Home Equity Conversion Mortgage (HECM) Program—Requirements on Mortgage Originators" (HUD Mortgage Letter 2008-24, September 16. 2008).

From the Examiner's Desk: Unfair and Deceptive Acts and Practices: Recent FDIC Experience

This regular feature focuses on developments that affect the bank examination function. We welcome ideas for future columns. Readers are encouraged to e-mail suggestions to ***SupervisoryJournal@fdic.gov.***

The Winter 2006 issue of ***Supervisory Insights*** featured an article that serves as a "field guide"[1] to unfair or deceptive acts or practices (UDAPs) under Section 5 of the Federal Trade Commission Act (FTC Act). As noted therein, "UDAPs are not always apparent or easily discovered," making compliance and compliance supervision in this critical area especially challenging.[2] To aid compliance professionals in meeting their UDAP oversight responsibilities, the FDIC's Division of Supervision and Consumer Protection (DSC), during an 18-month period,[3] surveyed UDAP issues identified and analyzed through the FDIC's examination-consultation process.[4]

This article highlights the methodology used by FDIC examiners (and other staff) to analyze the FTC Act (Section 5) UDAP issues surveyed during this period. Each FTC Act violation determination turns

UDAP and Overdraft Protection Practices

The primary focus of this article is on the analytics used in determining an FTC Act violation, rather than on actual practices. However, it is important to note the following about practices observed specific to overdraft protection programs and services. Though the FDIC has previously issued substantial guidance relating to unfair or deceptive overdraft protection practices,[5] the most common FTC Act violations identified by FDIC examiners during this 18-month UDAP survey involved overdraft protection programs and services. The following were typical overdraft protection practices analyzed by examiners and other FDIC staff for compliance with the FTC Act during this period:

- Including the available balance of an overdraft line of credit (ODLOC) when disclosing a deposit account balance, particularly at automated teller machines (ATMs).
- Failing to disclose accessibility of ODLOC via ATMs, point-of-sale (POS) transactions, online banking, or preauthorized transfers.
- Erroneously disclosing inaccessibility of ODLOC via ATMs, POS transactions, online banking, or preauthorized transfers.
- Promoting overdraft protection services without informing the depositor of (or overstating) the maximum dollar amount of protection or without disclosing fees associated with service.
- Using the word "free" (when charges are imposed) and other misleading representations in overdraft protection advertisements.
- Enrolling depositors in overdraft protection programs without their knowledge or consent and, subsequently, approving withdrawals at ATMs that overdraw a depositor's account, resulting in the imposition of fees.

Bank compliance officers should reference FDIC overdraft protection guidance and, along with FDIC examiners, remain vigilant in ensuring overdraft protection programs and services are conducted responsibly and comply with all applicable laws and regulations.

[1] Deirdre Foley and Kara L. Ritchie, "Chasing the Asterisk: A Field Guide to Caveats, Exceptions, Material Misrepresentations, and Other Unfair or Deceptive Acts or Practices" (*Supervisory Insights*, Winter 2006), https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin06/siwinter06-article2.pdf.

[2] Foley and Ritchie, 2006, p. 2.

[3] Survey of FTC Act, Section 5 consultations conducted between January 2007 and July 2008.

[4] To ensure the highest degree of consistency and uniformity throughout the supervisory and enforcement functions of the agency, the FDIC maintains a consultative process applicable to several compliance examination matters, including Section 5 of the FTC Act. Depending on the issue, a "consultation" may be anything from a simple phone conversation or a series of e-mails to formal memoranda among field, regional, and Washington FDIC staff members. These communications are instrumental in maintaining the quality and consistency of compliance, fair lending, and Community Reinvestment Act examination and supervision. Consultations ensure that senior Division of Supervision and Consumer Protection officials are alerted to significant or unusual supervisory issues and that those issues receive appropriate and timely consideration. The examination-consultation process also helps the FDIC develop more responsive and effective compliance policies and regulations. (Examiners see "Division of Supervision and Consumer Protection Memorandum System, Class. No. 6456" (May 7, 2004).)

[5] See FIL-11-2005, "Overdraft Protection Programs Joint Agency Guidance" (February 18, 2005), id. Examiners also see DSC memoranda "Examiner Guidance: Joint Guidance for Overdraft Protection Programs" (April 18, 2005) and "Deceptive Practices: Customer Access to Overdraft Protection" (March 27, 2007).

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on the specific facts and circumstances presented. Thus, while a number of practices are identified and addressed, this article is *not* intended, nor does it attempt, to list a series of citable FTC Act violations.[6] Rather, the goal of this article is to impart, through examples, a better understanding of the approach for determining UDAP violations.

An examiner has discretion to discourage a particular banking practice, regardless of whether that practice is determined to be an FTC Act violation. The FDIC expects all banks to engage in fair and ethical behavior toward consumers and adopt best business practices, including those identified in guidance issued by the FDIC.[7] Failure to do so exposes banks to a variety of risks, even where some practices may not constitute a violation under Section 5 of the FTC Act.

Unfair or Deceptive: A Test for Each

The standards for determining whether an act or practice is unfair or deceptive are independent of each other.[8] Although a specific act or practice may be both unfair and deceptive, an act or practice is prohibited by the FTC Act if it is *either* unfair or deceptive. Whether an act or practice is unfair or deceptive, in each instance, will depend on a careful application of the appropriate standard to the particular facts and circumstances. What follows is a discussion, based on examples from FDIC UDAP examination-consultations (consultations), of analyses performed by FDIC staff (consultants) in determining the existence of a violation of Section 5 of the FTC Act. The representative sets of facts in these particular consultations relate to advertising and credit card lending.

Deceptive Advertising Practices: What Makes an Act or Practice Deceptive?

As stated by the Federal Trade Commission (FTC)[9] and subsequently adopted by the FDIC,[10] a three-part test is used to assess whether a representation, omission, or practice is deceptive under Section 5 of the FTC Act:

1. The representation, omission, or practice *must mislead or be likely to mislead* the consumer;
2. The consumer's interpretation of the representation, omission, or practice must be *reasonable under the circumstances*; and,
3. The misleading representation, omission, or practice *must be material*.

The practices described below are only illustrative of each component of the three-part test for deception. Their inclusion (and any finding that the examined practices satisfy one part of the test) should *not* be interpreted as an ultimate finding that the practices are deceptive in violation of Section 5 of the FTC Act.

Advertising Consultation #1: Mislead or Likely to Mislead

For a representation, omission, or practice to be deceptive under Section 5 of the FTC Act, it must mislead or be likely to mislead a consumer. The facts in Advertising Consultation #1 describe

[6] For a list of some specific citable FTC Act violations, see Regulation AA (12 CFR 227), which specifically prohibits unfair credit contract provisions, unfair or deceptive cosigner practices, and unfair late charges.

[7] For example, see FIL-11-2005, "Overdraft Protection Programs Joint Agency Guidance" (February 18, 2005), www.fdic.gov/news/news/financial/2005/fil1105.html.

[8] FIL-26-2004, "Unfair or Deceptive Acts or Practices by State-Chartered Banks" (March 11, 2004, p. 1), www.fdic.gov/news/news/financial/2004/fil2604a.html.

[9] "FTC Policy Statement on Deception" (October 14, 1983, p. 5), www.ftc.gov/bcp/policystmt/ad-decept.htm.

[10] FIL-26-2004, p. 3; and see Foley and Ritchie, 2006, p. 2.

how a bank used direct marketing to solicit credit card business. To entice potential customers, the bank's credit card solicitations prominently featured a Cash Back Reward program (i.e., use of the credit card would garner cash awards; the greater the card's use, the greater the rewards). In determining whether the bank's solicitation practices were likely to mislead consumers, the consultants reviewed five documents comprising the solicitation (a mailing envelope, a folded brochure, a solicitation letter, an application form, and a summary of terms and conditions) and found the following:

- The phrase "6% Cash Back" appears 13 times in the solicitation materials. Notably, the promise of 6% Cash Back on certain categories of purchases is unqualified, whereas the promise of 2% Cash Back on "all other purchases" is qualified by the words "up to."
- The "6% Cash Back" phrase appears three times in the solicitation letter, in each case not qualified with the phrase "up to."
- None of the instances of the "6% Cash Back" phrase in the solicitation documents are qualified with a phrase such as "up to;" nor is there an asterisk or footnote in proximity to any of the references referring the consumer to additional information. The application and solicitation documents do not indicate any material limitations on the "Cash Back" offer.
- The Solicitation also contains a booklet entitled "Summary of Credit Terms and Conditions." On the fourth page of this document, and in very small font, the program's limitations are listed. The section, entitled "Cash Back Rewards Program Rules," explains the methods of calculating the cash back amount of the reward that the customer actually receives.

In concluding that the bank's credit card solicitation practices were likely to mislead a consumer, the consultants noted that the bank promoted "6% Cash Back" in 13 places throughout the solicitation documents. The consultants further observed that the bank failed to adequately disclose that the actual "Cash Back" reward in a chosen bonus category is tiered, with only 0.5% earned on the first $10,000 in purchases, and with the maximum "6% Cash Back" earned only on "Bonus category qualifying purchases" between $40,001 and $50,000. Additionally, the solicitation failed to disclose (or otherwise qualify), in close proximity to any of the 13 occurrences of the phrase "6% Cash Back," the tiered nature of the "Cash Back" reward structure. Also, the bank's use in its solicitation of the qualifying words "up to" for *non*-bonus category purchases (e.g., "and up to 2% Cash Back on all other purchases") tended to reinforce a message that a tiered structure for bonus category purchases (a category which would seemingly always earn "6% Cash Back") did not exist. In addition, the consultants found that the solicitation was misleading in that no "Cash Back" reward at all is paid unless and until the earned rewards within the year reached $50. Consequently, to receive any bonus, a consumer would have to spend at least $10,000 on purchases ($10,000 x .50% = $50) in their Bonus Category between the time the card is issued and the closing date of his or her twelfth statement. The consultants noted that the bank's repetitive use of the phrase "6% Cash Back," lacking any qualification, falsely suggests that a 6% bonus is immediately available on all bonus category purchases.

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Advertising Lesson #1: Representations should be sufficiently qualified within an advertisement or direct solicitation to avoid the likelihood of misleading consumers. Furthermore, the likelihood of a consumer being misled by an advertisement or direct solicitation increases with the repetitiveness of the unqualified representation. In Advertising Consultation #1, the bank repeatedly promoted "6% Cash Back" throughout its solicitation documents when, in practice, due to the "tiered" structure of the Reward Program, the reward earned was far less than the amount stated in the solicitation documents. In fact, as a result of the program's "tiered" structure, the consumer could *never* earn, on overall purchases, the amount of rewards stated in the solicitation. Thus, the consultants concluded that the bank's practice of omitting qualifying information in its credit card solicitation materials concerning its Cash Back Reward program was likely to mislead consumers.

Advertising Consultation #2: Reasonable Interpretation

In determining whether a consumer's interpretation of a representation, omission, or practice is reasonable, the *totality of the circumstances and the net impression* of the solicitation must be evaluated. For instance, in Advertising Consultation #1, the consultants found that, viewed as a whole, the credit card solicitation was likely to mislead a reasonable consumer in that it gives the false impression that a 6% cash bonus is available for all purchases in a chosen bonus category.

In Advertising Consultation #2, a consumer's interpretation of a representation and omission was deemed reasonable given the totality of the circumstances and the net impression made. Here, a consumer complained that she received a direct mail solicitation from a bank offering her zero percent interest for 12 months on balance transfers to a new credit card account (new card). She accepted the offer by applying for the new card and requesting a balance transfer on July 3, 2005. A new card account was opened in her name on July 3, 2005. Her balance transfer ($6,000) was posted to the new card account on July 12, 2005, and appeared on the July 2005 periodic statement, which had a closing date of July 24, 2005. Thereafter, she made at least minimum monthly payments as required. She made no other charges, either purchases or cash advances, on this account. When she received the July 2006 periodic statement (which had a closing date of July 24, 2006), she sent a payment for the outstanding balance before the due date reflected on the statement. This payment was posted to her new card account on the actual due date: August 13, 2006. Nevertheless, the bank assessed finance charges, beginning on July 24, 2006, of $19.89, representing interest at the standard rate for purchases on the average daily balance of the account for the July 24–August 23, 2006, billing cycle.

The bank never disclosed to the consumer the actual date that her 12-month promotional zero percent rate would end. In addition, it was difficult for the consumer to accurately calculate the date, given the conflicting and confusing information contained in the direct mail solicitation for the promotional offer and in the card member agreement sent to her when she accepted the offer.

The bank stated that it does not send cardholders any kind of disclosure advising them when the promotional zero percent interest rate expires, because the bank does not know when the balance transfer will be made, how many transfers will be made, and when each one will be processed. Therefore, the bank left it to the consumer to determine when the 12-month promotional period expires based on when the transfer is transacted on the account. The direct mail solicitation to which the consumer responded contained the following information, which became part of the consumer's agreement with the bank:

> ***AS IF 0% INTEREST WASN'T ENOUGH OF A REWARD***
>
> ***0% APR ON BALANCE TRANSFERS FOR 12 MONTHS.*** *Pay off all your high-rate cards and get the most out of [new card account].*
>
> *No interest for 12 months. No annual fees. Lots and lots of rewards.*
>
> ***IMPORTANT INFORMATION REGARDING YOUR APPLICATION***
>
> - *Balance Transfer APR: 0% during the first twelve months of Cardmembership on balance transfer requests submitted on this application.*
>
> *Information on Balance Transfers. I understand that finance charges will begin to accrue at the time a check is issued to my current credit card institution.*
>
> ***0% APR ON BALANCE TRANSFERS FOR 12 MONTHS.*** *Pay off all your high rate cards and get the most out of [new card account].*
>
> *[Footnote]: Please note this balance transfer rate applies to balance transfer requests submitted with this acceptance certificate. Then, the balance transfers will receive the standard purchase APR unless otherwise notified.*

As stated, for an act or practice to be misleading, the consumer's interpretation of the representation, omission, or practice must be reasonable. In determining whether a consumer's interpretation is reasonable, it is appropriate to look at the entire advertisement, transaction, or course of dealing to determine how a reasonable consumer would respond. In this consultation, it was determined that the consumer's interpretation of the promotional offer and disclosures was reasonable, especially in light of the entire course of dealing between the parties. Here, the consumer received monthly periodic statements showing the remaining balance of the transfer, credit for payments remitted, the new balance, and no finance charges. This was repeated each month for 12 months with no notice from the bank at any time that the new balance on the monthly statement had to be paid by a certain date to avoid finance charges. There was nothing in this course of dealing to warn the consumer that her interpretation of the term of the promotional offer was incorrect (or was not shared by the bank).

Although other interpretations were possible, given the totality of the circumstances and the net impression under the facts in Advertising Consultation #2, the consumer's interpretation of the bank's representation and omission was deemed reasonable.

Although not discussed in Advertising Consultation #2, it must be noted with respect to reasonableness, as the analyses in many of the consultations remind us, where a particular group is being targeted by a bank's representations or marketing practices (for example, the elderly, students, or the financially unsophisticated), the reasonableness of a consumer's interpretation of the representation or practice must be judged from the vantage point of a reasonable member of the targeted group.[11]

Advertising Lesson #2: Diligence must be exercised to ensure that (1) representations made in advertisements are accurate, clear, and sufficiently informative to convey to consumers the message intended and (2) ongoing communications made throughout the account relationship reinforce, not controvert or cloud, the intended advertised message. Here, the consultants concluded the consumer's interpretation of the conflicting representations or repeated omissions, as to when the zero percent promotional interest rate expired, was reasonable given the totality of the circumstances and the net impression.

[11] FIL-26-2004, p. 3; see Foley and Ritchie, 2006, p. 2.

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Advertising Consultation #3: Materiality

To find a representation, omission, or practice deceptive under Section 5 of the FTC Act, the representation, omission, or practice must be *material*. A representation, omission, or practice is material if it is likely to affect a consumer's decision regarding a product or service. Representations about costs are presumed material. Omissions about costs are presumed material when the bank knew or should have known the consumer needed the omitted information to evaluate the cost of a product or service.[12] For instance, in Advertising Consultation #2, the consultants concluded not only that the consumer's interpretation of the bank's representations and omissions was reasonable with respect to when the zero percent introductory interest rate period expired, but that the representations and omissions were material to the consumer's decision regarding when to pay off the outstanding card balance.

In Advertising Consultation #3, the facts present a clear example of materiality within the context of Section 5 of the FTC Act. Here, the bank regularly ran advertisements in local newspapers, on the radio, and through a direct mail campaign that claimed that customers would receive free credit reports. Typically, the language in these advertisements stated: "Call for a **FREE CREDIT REPORT**" or simply **"FREE Credit Report."** The representation of a free credit report was neither qualified nor conditioned in the advertisements. If a consumer asked for a copy of the report, it was provided free to the consumer. However, if that consumer ultimately applied for and was granted credit, the cost of the credit report would be charged to the consumer at closing. Nothing in the bank's records or promotions suggest that consumers were told they would be charged a fee for the "free credit report" if they accepted a loan.

In this instance, the bank's representation that consumers would receive a free credit report is clearly material. The consultants in this case cited several court cases in which the court affirmed the FTC's position that information regarding the price of goods or services is material, because price is likely to affect a consumer's choice of or conduct regarding a product.[13] The consultants also noted the FTC's recognition of the extraordinary drawing power of the use of the word "free" in these situations.

> All advertisements are designed to excite demand for the advertised article and to call attention to the particular product. But when a prospective customer is offered something "free," it is not unreasonable to assume that the conscious or subconscious appeal involved in the offer will influence his judgment; the value of the so-called "free" article will divert the customer from the major inquiry into the quality of the article or of competing articles.[14]

It is important to note that a deceptive representation can be expressed, implied, or caused by a material omission. In Advertising Consultation #3, the bank's omission from its advertisement of a free credit report—and subsequent communications—that the consumer, in fact, would be charged the cost of the credit report if the consumer accepted a loan was material.

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[12] Foley and Ritchie, 2006, p. 4.

[13] See *FTC v. Crescent Publishing Group*, 129 F. Supp. 2d 311, 321 (S.D.N.Y. 2001) quoting *Thompson Medical Co.*, 1984 FTC LEXIS 6, 372.

[14] *Matter of Book-of-the-Month-Club, Inc. et al.*, 1952 FTC LEXIS 5 at *26-27 (1952).

Advertising Lesson #3: Representations that go to the heart of a consumer's decision with respect to a bank product or service must be carefully reviewed and monitored for accuracy and clarity. The FDIC deems representations about costs, benefits, or restrictions on the use or availability of a product or service to be material.[15] In Advertising Consultation #3, the bank advertised free credit reports without qualification or condition. However, in practice, when a consumer applied for and was granted a loan, the bank would charge the cost of the credit report to the consumer at the loan closing.

Unfair Credit Card Lending Practices: What Makes an Act or Practice Unfair?

As stated above, the standards for finding an act or practice deceptive have been established by the FTC and adopted by the FDIC.[16] However, unlike deception, the standards for finding an act or practice *unfair* are codified in Section 5 of the FTC Act.[17] With limited exceptions,[18] whether an act or practice is unfair under Section 5 of the FTC Act must be judged against the three statutory standards. Historically, enforcement actions brought by the FTC and others have focused on deception. However, recent history shows a significant increase in enforcement actions brought under the FTC Act's unfairness standards.

The statutory standards for unfairness are as follows:

1. The act or practice must *cause or be likely to cause substantial injury* to consumers.
2. Consumers must *not reasonably be able to avoid* the injury.
3. The injury must *not be outweighed by countervailing benefits* to consumers or to competition.[19]

In addition to these standards, the FTC Act allows public policy to be considered in determining whether an act or practice is unfair.

The practices described below are illustrative of each component of the three-part test for unfairness. Their inclusion (and any finding that the examined practices satisfy one part of the test) should *not* be interpreted as an ultimate finding that the practices are unfair in violation of Section 5 of the FTC Act.

Credit Card Lending Consultation #1: Cause or Be Likely to Cause Substantial Injury

To find an act or practice unfair, it must *cause or be likely to cause substantial injury* to consumers. Substantial injury usually involves monetary harm.[20] Trivial or merely speculative harms (e.g., the emotional impact of an act or practice) are typically insufficient for a finding of substantial injury. However an act or practice that causes (or is likely to cause) even a small amount of monetary harm to one person may meet the substantial injury standard if the act or practice

[15] FIL-26-2004, p. 3.

[16] "FTC Policy Statement on Deception" 1983, p. 5; see FIL-26-2004, Id., p. 3.

[17] Section 5(n); 15 U.S.C. 45(a).

[18] Regulation AA specifically prohibits certain credit practices, such as the pyramiding of late fees.

[19] Section 5; 15 U.S.C. 45(a).

[20] However, substantial injury may involve other forms of harm. For instance, unwarranted health and safety risks may also support a finding of unfairness. For an example, see *Philip Morris, Inc.,* 82 F.T.C. 16 (1973) (a consent agreement in which respondent had distributed free-sample razor blades in such a way that they could come into the hands of small children). And while emotional harm typically is not sufficient to find substantial injury, under certain circumstances (e.g., emotional harm caused by unfair debt collection practices), such harm could be sufficient to find substantial injury.

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results in (or is likely to result in) harm to a large number of people.

A review of the facts presented in Credit Card Lending Consultation #1 demonstrates how a monetary harm, in the aggregate, was found substantial by consultants even if the harm, on a case-by-case basis, was small. Here, the bank allocated credit card payments (i.e., the required minimum payment) on accounts with multiple-rate tiers in such a way as to credit the balances with lower annual percentage rates (APRs) first. Specifically, for all accounts with multiple-rate tiers (i.e., separate APRs for purchases, cash advances, balance transfers, promotional rates, etc.), the bank applied the consumer's monthly payment exclusively to the lowest rate tier, potentially resulting in the capitalization of interest to the balance with the highest rate. For example, where a customer has both a purchase balance and a balance transfer balance, the lower APRs are typically assigned to balance transfers and the highest assigned to purchase balances. As a result, any payments made by the customer would first be applied exclusively to the balance transfer balance. Unless the payment completely pays off the balance transfer balance, the interest accrued on the purchase balance is capitalized, and the balance increases.

In finding the substantial injury element of the unfairness standard met, the consultants noted how the harm suffered was monetary and concluded that the harm was or could be substantial when multiplied by all cardholders with accounts that had multiple-rate tiers. This standard is met regardless of any actual injury experienced, as long as substantial injury is a *likely result* of the act or practice.

Credit Card Lending Lesson #1: Injury caused to a group of consumers by a bank's practices, in its totality, may be judged substantial by the FDIC; injury of a similar nature limited to only one consumer may not. Therefore, banks should routinely examine their business practices to ensure such practices do not (or are not likely to) substantially injure consumers, either individually or in the aggregate. In Credit Card Lending Consultation #1, the bank allocated credit card payments on accounts with multiple-rate tiers first to balances with lower APRs, potentially resulting in the capitalization of unpaid interest to balances with higher APRs. While the harm (or likely harm) to one cardholder caused by this practice arguably may not have been substantial, when multiplied by all cardholders with rate-tiered accounts, such harm (or its likelihood) was determined to be substantial.

Credit Card Lending Consultation #2: Not Reasonably Avoidable

To find an act or practice unfair, the injury caused by the act or practice must not be reasonably avoidable by consumers. In Credit Card Lending Consultation #2, the bank periodically sent convenience checks to its customers along with their regular credit card statement indicating the offer to use the checks is good until a certain date. The checks are drawn against the customers' credit card accounts and can be used to obtain cash, purchase goods or services, or pay the outstanding balance on another credit account. They are mailed to consumers unsolicited.

Use of the convenience checks is monitored by the bank and can trigger a verification of credit (as disclosed in the card agreement). Their use may represent one factor in the bank's decision to reduce a customer's line of credit. (The account card member agreement discloses the bank's ability to change a customer's line of credit "without notice" and "at any time.") The bank stated that the reasons for reductions of credit limits are obtained from a review of the credit report and a review of its own, internal information.

Here, a customer had his credit limit reduced after using a convenience check but before the check was presented for settlement. The customer first learned of the credit reduction in a letter from the bank dishonoring the check and advising him of the credit reduction. (In many cases, it is the bank's practice to honor the check, but in so doing, triggering unintended overdraft services and costs to the consumer.)

As a result of this practice, the customer's check bounced, causing a variety of harms to the customer. For instance, when the check was declined (because it would have caused the customer's credit limit to be exceeded), the customer still owed the debt that the check was originally written to cover. In addition, the customer may be liable for fees resulting from the check not being honored. For example, the payee may pass on the cost of the bounced check to the consumer and, depending on what the check was for, may assess a late fee against the consumer if the check was used to pay a bill that then became past due. Once the check is written, if there is a decrease in the credit line such that the bank will not cover the check, the harm to the bank's customer is unavoidable.

Credit Card Lending Lesson #2a: Banks should monitor their business practices to reduce the likelihood of harm to consumers, especially harm that consumers cannot reasonably avoid. In Credit Card Lending Consultation #2, customers of the bank were not reasonably able to avoid the harm caused by a bounced check drawn against a credit card account. Here, a check bounced solely because the bank, unbeknownst to the customer, reduced the customer's credit limit after the customer had already issued the check, but before the check was presented for settlement.

Credit Card Lending Lesson #2b: Banks should structure their practices to enable their customers to make informed decisions about the products and services they choose to purchase and use, and to operate under reasonably reliable expectations about any costs/consequences associated with those decisions.

Credit Card Lending Consultation #3: Not Outweighed by Benefits

To find an act or practice unfair, the injury caused by the act or practice must *not be outweighed by countervailing benefits* to consumers or to competition.

In Credit Card Lending Consultation #3, as in Consultation #1, the bank offered a credit card account composed of multiple balances, each of which was subject to a different APR.[21] The bank allocated the required minimum credit card payments to this account in such a way as to credit a payment to the lower-rate balances first, potentially resulting in the capitalization of interest to the balances with the highest rates.

Although the consultants found this practice to be injurious to consumers (i.e., longer amortization periods and, thus, higher costs for the higher rate balances; see Credit Card Consultation #1), and the harm not reasonably avoidable, the consultants determined the injury was, in this instance, outweighed by the benefits in the form of low promotional rates for balance transfers and similar promotional rates (e.g., introductory low rates for new accounts). Determining whether this element of the unfairness test is met (i.e., whether an injury is outweighed by countervailing benefits) turns on the facts of each case; though the consultants in Credit Card Lending Consultation #3 found the injury outweighed by the

[21] The circumstances in Credit Card Lending Consultation #1 are instructive for purposes of demonstrating the third prong of the unfairness standard and, therefore, are revisited and referenced here as Consultation #3.

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benefits, a different finding may result from different facts.[22]

Credit Card Lending Lesson #3: Banks should closely examine, monitor, and test their business practices to confirm the benefits associated with those practices (be they related to a product or service), in their net effect, outweigh any harm resulting from such practices. For instance, while certain payment allocation practices in isolation may appear onerous and unfair, such practices, in their net effect, may benefit consumers and competition (e.g., the availability of low-rate balance transfers or other promotional rates). In addition, practices that do not result in a fair exchange of value between banks and their customers are likely contrary to best—and *sustainable*—business practices, as evidenced by current macroeconomic and financial events.[23]

Credit Card Lending Consultation #4: Contrary to Public Policy

Public policy—as established by statute, regulation, or judicial decisions—may be considered in determining whether an act or practice is unfair under Section 5 of the FTC Act. For example, a credit card lending practice that violates a federal banking regulation may evidence an unfair act or practice. In Credit Card Lending Consultation #4, a bank failed to provide required finance charge disclosures under Regulation Z (Truth in Lending) yet charged finance charges to a consumer's account. The consultants cited the violation of Regulation Z as evidence of an unfair credit card lending practice.

Credit Card Lending Lesson #4: The consequences of noncompliance with consumer protection laws and regulations are not limited to the statutory and regulatory penalties specific to those laws. In Credit Card Lending Consultation #4, a bank's violation of Regulation Z was found to evidence conduct contrary to public policy and, thus, was considered in analyzing unfairness under Section 5 of the FTC Act. Therefore, a comprehensive and effective compliance management program—one that avoids an overly myopic and, thus, constrained approach to compliance—will greatly benefit a bank in general, and in particular with respect to compliance with Section 5 of the FTC Act.

[22] The Federal Reserve Board (FRB) has proposed amendments to Regulation AA which, if adopted, would restrict the allocation of credit card payments in excess of the required minimum payment. The proposal provides that when different annual percentage rates (APRs) apply to different balances on a credit card account (for example, purchases and cash advances), banks would have to allocate payments exceeding the minimum payment using one of three methods or a method equally beneficial to consumers. They could not allocate the entire amount (i.e., the amount in excess of the required minimum payment) to the balance with the lowest rate. Under the proposal, a bank could, for example, split the amount equally between two balances. In addition, to enable consumers to receive the full benefit of discounted promotional rates (for example, on balance transfers) during the promotional period, payments in excess of the minimum would have to be allocated first to balances on which the rate is not discounted.

The FRB has indicated it expects to issue a final rule by the end of 2008. However, as of the date of publication of this article, the FRB has not done so. When issued, the reader is urged to consult amended Regulation AA for UDAP guidance with respect to credit card payment allocation practices as well practices relating to time to make payments, application of an increased annual percentage rate to outstanding balances, fees for exceeding the credit limit caused by credit holds, security deposits and fees for the issuance or availability of credit, and use of unfair balance computation methods (as well as overdraft protection practices). In addition to Regulation AA, Regulation Z (Section 226), implementing the Truth in Lending Act (as recently amended by the Home Ownership and Equity Protection Act Amendments of 2008), proscribes several specific mortgage lending acts and practices as unfair or deceptive, including certain servicing and advertising practices and the coercion of appraisers. In limited circumstances, Regulation Z also prohibits as unfair collateral-based lending, stated-income/asset-based lending, prepayment penalties, and not escrowing for taxes and insurance. All other practices must be judged by applying the FTC Act UDAP standards discussed in this article.

[23] FIL-6-2007, "FDIC Supervisory Policy on Predatory Lending" (January 22, 2007, p. 1), www.fdic.gov/news/news/financial/2007/fil07006.html.

Conclusion

Meeting the standards for deception or unfairness depends on the specific facts and circumstances of each case. Judgment will always be a factor. The FDIC examination-consultation process assists FDIC staff responsible for exercising such judgment. Through the consultation process, not only are concerns relevant to a particular examination appropriately and comprehensively addressed, valuable lessons emerge that can assist in future examinations and serve as the basis for effective supervisory policy.

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Accounting News: Accounting for Business Combinations

*This regular feature focuses on topics of critical importance to bank accounting. Comments on this column and suggestions for future columns can be e-mailed to **SupervisoryJournal@fdic.gov.***

In an effort to improve the accounting for and reporting of mergers and acquisitions, the Financial Accounting Standards Board (FASB) issued a revised standard on the accounting for business combinations in December 2007 that will take effect in 2009. Under the standard's new guidance, key changes have been made to the accounting for business combinations that will require banks to modify their approach to the evaluation of and accounting for mergers and acquisitions. In reviewing applications for mergers and acquisitions that will be consummated after 2008 and post-acquisition bank financial statements, case managers will need to consider the changes the revised standard makes to the scope, terminology, and application of business combination accounting.

Background

Statement of Financial Accounting Standards No. 141 (revised), *Business Combinations* (FAS 141(R)), will replace Statement of Financial Accounting Standards No. 141, *Business Combinations* (FAS 141), and nullify Statement of Financial Accounting Standards No. 147, *Acquisitions of Certain Financial Institutions* (FAS 147), when it becomes effective for business combinations that occur in fiscal years beginning on or after December 15, 2008. The issuance of FAS 141(R) completes the second phase of the FASB's project to revise the accounting for business combinations. Until the first phase ended with the issuance of FAS 141 and Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (FAS 142), in June 2001, business combination accounting was guided by Accounting Principles Board No. 16, *Business Combinations* (APB 16).

Under APB 16, the pooling-of-interests method was used to account for business combinations if 12 conditions were met.[1] Otherwise, the "purchase method" of accounting (renamed the "acquisition method" under FAS 141(R)) was used. This practice changed with the issuance of FAS 141. Under FAS 141, all business combinations, except for combinations between two or more mutual entities (e.g., credit unions and mutual banks), were required to use the acquisition method to account for business combinations.

The culmination of the second phase of the FASB's project to update business combination accounting under FAS 141(R) will significantly affect the way banks and mutual entities account for business combinations occurring after this new standard takes effect. Among the institutions most affected by the changes made to business combination accounting rules are mutual entities, which no longer will be permitted to account for mergers between two or more such entities under the pooling-of-interests method. Thus, the pooling-of-interests method of accounting for business combinations between banks is now fully prohibited. FAS 141(R) also more broadly defines the term "business." As a result, more acquisitions will be treated as business combinations under FAS 141(R) than under FAS 141.

Foremost among the changes to the accounting for business combinations under the acquisition method in FAS 141(R) is the requirement to measure all identifiable assets acquired, all liabilities assumed, and any noncontrolling interests in the acquiree, with limited exceptions, at fair value as of the acquisition date. This change from the cost

[1] The conditions address the attributes of the combining companies, the manner in which the companies' interests are combined, and the absence of planned transactions after the combination.

allocation method applied under FAS 141 prohibits the "carrying over" of the target institution's allowance for loan and lease losses. These and other changes to the accounting for business combinations brought about by FAS 141(R) are summarized below.

At the same time that FAS 141(R) was issued, the FASB also issued Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (FAS 160). FAS 160, which amends Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB 51), also becomes effective for fiscal years beginning on or after December 15, 2008. A noncontrolling interest (previously referred to as a "minority interest") is defined as the portion of the equity in a subsidiary that is held by owners other than the parent company.[2] In a business combination resulting in the acquisition of less than a 100 percent ownership interest in a target entity, the application of FAS 141(R) and FAS 160 will change the way the noncontrolling interest in the target entity is measured at the acquisition date and where this interest is reflected on the balance sheet going forward.

Steps in Accounting for a Business Combination under FAS 141(R)

1. Determine whether the transaction is a business combination, as defined in FAS 141(R), which requires that the assets acquired and liabilities assumed constitute a business.
2. If the transaction is a business combination, account for the combination by applying the acquisition method. (If the transaction is not a business combination, account for it as an asset acquisition.)
3. Identify which of the combining entities is the acquirer.
4. Identify the acquisition date, which is the date the acquirer obtains control of the acquiree.
5. Recognize as of the acquisition date the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree subject to the conditions specified in FAS 141(R).
6. Classify or designate as of the acquisition date the identifiable assets acquired and liabilities assumed as necessary to apply other generally accepted accounting principles subsequent to the acquisition date.
7. Measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values, except as specified in FAS 141(R).
8. Recognize and measure goodwill or a gain from a bargain purchase by comparing (a) the consideration transferred, generally measured at its acquisition-date fair value, plus the fair value of any noncontrolling interest in the acquiree to (b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, measured in accordance with FAS 141(R). If (a) exceeds (b), recognize goodwill as of the acquisition date. If (b) exceeds (a), reassess and review the accounting for the transaction and then recognize any resulting gain in earnings on the acquisition date.

Key Change in the Approach Taken to Measure the Fair Value of the Target Entity as of the "Acquisition Date"

Under FAS 141(R), all identifiable assets acquired, all liabilities assumed, and any noncontrolling interest in the acquiree generally must be measured at *fair value* as of the acquisition date.[3] This measurement framework under FAS 141(R) contrasts sharply with the measurement framework used in current practice under FAS 141. Under FAS 141, the acquirer allocates the cost of the target institution to the identifiable assets acquired and liabilities assumed based in most cases on their *estimated fair values* at the date of the acquisition. Further, under FAS 141, certain assets and liabilities were not recognized (i.e., reflected on the balance sheet) at acquisition and others, such as loans (as discussed in the next section), were recorded at amounts other than fair value.

[2] See paragraph 25 of Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (ARB 51), as amended.

[3] Fair value is defined by Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157), as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." The acquisition date is defined in FAS 141(R) as "the date on which the acquirer obtains control of the acquiree."

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Also, "for convenience," FAS 141 allowed the acquirer to designate an effective date at the end of an accounting period between the initiation date and the consummation date of the business combination as the date as of which to estimate the fair value of the assets acquired and liabilities assumed. FAS 141(R) requires that the acquirer measure the fair value of the assets acquired, liabilities assumed, and any noncontrolling interest in the target institution at the acquisition date. As a result, "convenience date" accounting is eliminated.

FAS 141(R) provides exceptions to its recognition and fair value measurement principles for certain assets acquired and liabilities assumed, which should be accounted for under other applicable generally accepted accounting principles (GAAP). These include deferred tax assets and liabilities that are related to the assets acquired and liabilities assumed in the business combination. These deferred tax items should be accounted for under Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* (FAS 109). Similarly, potential tax effects created by any carryforwards and any tax uncertainties of an acquiree that exist as of the acquisition date or that result from the business combination should be accounted for under FAS 109 and related standards, such as FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*.

Moreover, the acquirer should account for any employee benefit arrangements assumed from the target institution based on other GAAP as it applies to each type of arrangement assumed. For example, certain postretirement benefits assumed in a business combination should be accounted for under Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FAS 106). Another exception to the fair value measurement principle under FAS 141(R) is for acquired assets that are held for sale. The acquirer must measure assets held for sale at their *fair value less cost to sell* in accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (FAS 144). For banks, assets held for sale include other real estate acquired in foreclosure. Other exceptions to the fair value measurement principle under FAS 141(R) include share-based payment awards, reacquired rights, and indemnification assets.

Finally, in a business combination where the acquirer obtains less than a 100 percent ownership interest in the acquiree, which becomes a subsidiary in which there is a noncontrolling interest, the contrast between the measurement of the identifiable assets acquired and liabilities assumed under FAS 141 and FAS 141(R) is particularly striking. Under the new standard, the acquiree's assets and liabilities are recorded at their full fair value, regardless of the percentage of ownership the acquiring company obtains. FAS 141 takes a different approach by requiring the acquiring company to record the identifiable assets acquired and liabilities assumed in the business combination at blended amounts that combine the acquiring company's percentage share of the estimated fair values of these assets and liabilities and the noncontrolling (minority) interest's percentage share of the carrying amounts (book value) of these items on the acquiree's books. An additional consequence of the full fair value approach to measurement under FAS 141(R) is that the amount of goodwill to be recorded in a less than 100 percent acquisition will be larger than it has been under FAS 141, because this previous standard did not recognize "the portion of goodwill related to the noncontrolling interests in subsidiaries that are not wholly owned."[4]

[4] FAS 141(R), paragraph B329.

Accounting for Loans Acquired in a Business Combination under FAS 141(R)

A key change to the accounting for business combinations under FAS 141(R) is the prohibition on the "carrying over" of the target institution's allowance for loan and lease losses. In general, under current practice, the acquiring bank normally records the acquired held-for-investment loan portfolio at the present value of amounts to be received on the loans determined at an appropriate current interest rate less the target institution's allowance for loan and lease losses. This practice of "carrying over" the allowance for loan and lease losses was sanctioned by the staff of the U.S. Securities and Exchange Commission (SEC) in Staff Accounting Bulletin No. 61, which was issued in 1986, and has been accepted by the banking agencies for Call Report purposes.[5]

In contrast, the FASB has now determined that the practice of "carrying over" valuation allowances, such as the allowance for loan and lease losses, is not consistent with the fair value measurement principle in FAS 141(R). In the FASB's view, the uncertainties relating to the expected future cash flows should be reflected in the fair value measurement of the acquired loans, and therefore, they are already reflected in the purchase price of the acquired business. The accounting framework for loans in FAS 141(R) is consistent with the approach taken by the American Institute of Certified Public Accountants for "purchased impaired loans"[6] in Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3), which became effective in 2005.

The following example shows how the acquired held-for-investment loan portfolio is combined with the acquiring bank's held-for-investment loan portfolio as of the "acquisition date" in accordance with FAS 141(R).[7]

Loan Portfolio of Combined Banks at Acquisition Date

	Target Bank*		Acquiring Bank Carrying Amount	Acquisition Date Combined Banks
	Carrying Amount	Fair Value		
Held-for-Investment Loans	$5,000	$4,920**	$5,000	$9,920
Allowance for Loan and Lease Losses (ALLL)	50		50	50
Held-for-Investment Loans, net	4,950		4,950	9,870
ALLL/Loans	1.00%		1.00%	0.51%

* If Target Bank remains in existence as a separate legal entity after its acquisition and push down accounting is required, Target Bank will report no ALLL on its balance sheet at the acquisition date.
** Fair value of portfolio reflects an $80 discount from its recorded investment.

Accounting for Held-for-Investment Loans Acquired in a Business Combination Subsequent to the "Acquisition Date"

After an acquisition, the held-for-investment loans acquired from the target entity are accounted for like other purchased loans. Thus, the premiums and discounts on the loans that are not "purchased impaired loans" at acquisition will be amortized and accreted, respectively, over the life of the loans as an adjustment of yield in accordance with Statement of Financial Accounting

[5] SEC Staff Accounting Bulletin No. 61, *Adjustments to Allowances for Loan Losses in Connection with Business Combinations*, which has been codified as Topic 2.A.5. in the SEC's Codification of Staff Accounting Bulletins, www.sec.gov/interps/account/sabcodet2.htm#2a5.

[6] Purchased impaired loans are loans that a bank has purchased where there is evidence of deterioration of credit quality since the origination of the loan, and it is probable, at the purchase date, that the bank will be unable to collect all contractually required payments receivable.

[7] This example assumes that the acquiring bank designates all loans in this acquired portfolio as held for investment.

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Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FAS 91). In addition, the acquiring bank should establish loan loss allowances for the acquired held-for-investment loans in periods after the acquisition, but only for losses incurred on these loans due to credit deterioration after acquisition.

However, the guidance contained in SOP 03-3 should continue to be used to account for purchased impaired loans acquired in a business combination. Under SOP 03-3, the yield that may be accreted on a purchased impaired loan, referred to as the "accretable yield," is limited to the excess of the acquiring bank's estimate of the undiscounted principal, interest, and other cash flows expected at acquisition to be collected on the loan over the bank's initial investment in the loan. The excess of the loan's "contractually required payments receivable" over the cash flows expected to be collected on the loan, referred to as the "nonaccretable difference," must not be recognized as an adjustment of yield, a loss accrual, or a loan loss allowance. However, the acquiring bank must determine, as of the acquisition date, whether it is appropriate to recognize the "accretable yield" as income over the life of the purchased impaired loan or whether it should place the loan on nonaccrual status at acquisition and then apply the cost recovery method or cash basis income recognition to the loan. SOP 03-3 also provides guidance on the establishment of post-acquisition loan loss allowances on purchased impaired loans.[8]

Expansion of Scope

Effects of FAS 141(R) on Business Combinations between Two or More Mutual Entities

Among the institutions that will be most affected by the implementation of FAS 141(R) are mutual entities, e.g., mutual banks and credit unions, that engage in business combinations. Because FAS 141 deferred the application of the acquisition method to mergers between two or more mutual entities for future consideration, mutual entities continued to use a method of accounting for such combinations after FAS 141 took effect in 2001 that was substantially similar to the pooling-of-interests method under APB 16. In developing FAS 141(R), the FASB determined that business "combinations between mutual entities are economically similar to combinations between other business entities,"[9] and therefore, the same accounting method should be used to account for business combinations between two or more mutual entities as for combinations between other entities.

In applying the acquisition method to mergers between two or more mutual entities, one of the combining entities must be identified as the acquirer. The acquirer then must determine the fair value of the target entity as a whole. Normally, no consideration is transferred in a combination between mutual entities. Therefore, the fair value of the target entity may be estimated, for example, by using an estimated cash flow model. The resulting fair value is added directly to the acquirer's equity (i.e., the surplus account for a mutual bank), not its retained earnings. Next, the target's assets acquired, including identifiable intangible assets, and liabilities assumed

[8] For further discussion and examples on how to account for and evaluate purchased impaired loans, including the treatment of any "accretable yield" and "nonaccretable differences," refer to "Implications of New Guidance on Accounting for Purchased Impaired Loans," *Supervisory Insights*, Summer 2004.

[9] FAS 141(R), paragraph C34.

Balance Sheet of Combined Mutual Entities at Acquisition Date				
	Target Mutual		Acquiring Mutual	Acquisition Date Combined Mutuals
	Book Value	***Fair Value***	***Book Value***	
	(in millions of dollars)			
Assets	$250	$260*	$1,000	$1,260
Goodwill				8***
Liabilities	225	228	880	1,108
Equity**	25		120	160
Net Assets		32		

* Excluding goodwill.
** Fair value of target mutual as a whole, for example, based on an estimated cash flow Model is $40 million. This amount is recognized as a direct addition to the acquiring mutual's equity.
*** Goodwill is the excess of the fair value of the target mutual as a whole ($40 million) over the fair value of the target's net assets ($32 million).

must be measured at their fair values in accordance with FAS 157. Finally, goodwill is determined based on the amount by which the target's fair value as a whole exceeds the fair value of the target's net assets.

Business Defined

FAS 141(R) broadens the definition of a business. In defining a business, FAS 141 referenced Emerging Issues Task Force Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business* (EITF 98-3), which described "a business as a self-sustaining integrated set of activities and assets conducted and managed to provide a return to investors." Under EITF 98-3, a business consists of inputs, processes applied to inputs, and resulting outputs used to generate revenues.

FAS 141(R) expands the EITF 98-3 definition by removing the requirements that a business have an integrated set of activities and assets that are self-sustaining and that it have outputs. Thus, for instance, many development stage businesses that were excluded from business combination accounting under FAS 141 because they were not self-sustaining and had no outputs may now be considered businesses, depending on the specific facts and circumstances relating to the acquisition under FAS 141(R). Similarly, bank branches, acquisitions of which were commonly accounted for as asset purchases rather than business combinations under FAS 141, may now meet the expanded definition of a business. In such cases, the acquirer would be required to use the acquisition method to account for these transactions under FAS 141(R).

Other Key Changes Made to the Accounting for Business Combinations under FAS 141(R)

The following summarizes other key changes to business combination accounting that will affect the accounting for and evaluation of business combinations by banks and examiners.

Acquisition-related costs—Under FAS 141(R), costs such as legal, accounting, consulting, and investment banking fees must be expensed as incurred. Under FAS 141, these costs were included in the cost of the business combination. Thus, acquisition-related costs were allocated to the amounts assigned to the assets acquired and liabilities assumed, thereby increasing the amount of goodwill recorded under the FAS

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141 framework. Costs to issue debt and equity securities in a business combination are not addressed in either FAS 141 or FAS 141(R), and therefore, the accounting for these costs should follow other GAAP, as appropriate.

Post-acquisition measurement period—During the "measurement period" under FAS 141(R), the acquirer may change provisional amounts initially recorded as of the acquisition date as information necessary to complete the fair value measurements is obtained. The "measurement period" is the period of up to one year after the acquisition date of the business combination. Changes to the provisional amounts may reflect only facts and circumstances that existed as of the acquisition date. Thus, any information that relates to facts and circumstances after the measurement date should be accounted for based on post-acquisition accounting. Under FAS 141(R), changes to the provisional amounts must be reported in the financial statements retrospectively. Under FAS 141, changes made during the "allocation period," which is similar to the "measurement period" under FAS 141(R), were generally accounted for prospectively as information was received. Under both methods, changes in the provisional measurements often affect the amount reported for goodwill.

Preacquisition contingencies—When accounting for preacquisition contingencies under FAS 141(R), the acquirer first must determine whether the preacquisition contingency results from a contractual arrangement or a noncontractual event. Contractual contingencies may result in future assets being acquired (e.g., the funding of unfunded loan commitments) or future liabilities being incurred (e.g., repurchase obligations arising from loans sold in the secondary market) based on the contractual terms entered into by the target institution before being acquired. Under FAS 141(R), all preacquisition contractual contingent assets and liabilities need to be recognized on the balance sheet and measured at their fair value as of the acquisition date.

Noncontractual contingencies that exist as of the acquisition date are recognized and measured at fair value on the acquisition date only *if it is more likely than not,* i.e., a greater than 50 percent likelihood, that the contingency will result in an asset being realized or a liability being incurred in the future. If a noncontractual contingency does not meet the more likely than not criterion, it will not be recognized unless and until it later meets the criteria under other GAAP, such as Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5).

FAS 141 made no distinction between preacquisition contractual and noncontractual contingencies. Instead, FAS 141 required preacquisition contingencies to be recorded on the balance sheet at the acquisition date if one of the following two criteria were met. First, the contingency needed to be recorded if the acquirer could determine the acquisition date fair value of the contingency during the allocation period. If the fair value could not be determined during this period, but before the end of the allocation period it was probable that an asset existed or a liability was incurred, and the amount of the asset or liability could be reasonably estimated, then the asset or liability was recorded in accordance with the guidance set forth in FAS 5.

Equity securities issued—Under FAS 141(R), all equity securities issued to effect a business combination must be measured at fair value as of the acquisition date. This contrasts with FAS 141, under which, if certain criteria were met, the acquirer measured the fair value of marketable equity securities to be issued based on the quoted market prices of these securities over the period shortly before and after the terms of the business combination were agreed upon and announced. Thus, under FAS 141(R), the amount of goodwill to be recognized as of the acquisition date will increase or decrease compared to the amount estimated when the business combination was announced based on the movement of the equity securities' market price in response to such factors as the market's perception of the transaction.

Other differences between FAS 141 and FAS 141(R) include the treatment of contingent consideration granted to the former owners of the target, restructuring costs, in-process research and development activities of the acquiree, and bargain purchases (negative goodwill).

Noncontrolling Interests (FAS 160)

As previously mentioned, a noncontrolling (minority) interest is defined as the portion of the equity in a subsidiary that is held by owners other than the parent company. Under FAS 141(R), when a noncontrolling interest is acquired in a business combination, this interest must be recognized and measured at fair value as of the acquisition date. In addition, ARB 51, as amended by FAS 160, requires the noncontrolling interest to be reported within equity capital in the consolidated balance sheet, but separately from the parent company's equity capital. Under current practice, ARB 51 allows a minority interest to be reported either as a liability or between liabilities and equity capital on the consolidated balance sheet.

Other provisions of FAS 160 include changes in the presentation of the consolidated net income when there is a noncontrolling interest by requiring separate disclosure within the income statement of the amounts of income attributable to the parent and to the noncontrolling interest. It also establishes a single method of accounting for changes in a parent company's ownership interest in a subsidiary that continues to be consolidated. In addition, FAS 160 provides guidance on the accounting for deconsolidation of a subsidiary and establishes new disclosure requirements.

Conclusion

The changes made to the accounting for and reporting of mergers and acquisitions under FAS 141(R) and FAS 160 will change the way in which mergers and acquisitions are accounted for and disclosed. When reviewing applications for mergers and acquisitions occurring after the revised standards take effect, case managers must determine whether the financial information provided by the applicant has been prepared in compliance with the significant changes made by these standards. Foremost among these changes is the requirement to measure all identifiable assets acquired (including loans), liabilities assumed, and any noncontrolling interest in the acquiree at fair value, with limited exceptions. Thus, case managers need to ensure that the acquiring bank follows the guidance for measuring fair value set forth in FAS 157. These and other changes will require banks to modify their approach to assessing the accounting consequences of a potential merger or acquisition when determining how to structure the transaction and deciding whether to proceed with the merger or acquisition.

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Overview of Selected Regulations and Supervisory Guidance

This section provides an overview of recently released regulations and supervisory guidance, arranged in reverse chronological order. Press Release (PR) and Financial Institution Letter (FIL) designations are included so the reader can obtain more information.

ACRONYMS and DEFINITIONS	
FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve Bank
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
NCUA	National Credit Union Administration
Banking agencies	FDIC, FRB, and OCC
Federal bank and thrift regulatory agencies	FDIC, FRB, OCC, and OTS
Federal financial institution regulatory agencies	FDIC, FRB, OCC, OTS, and NCUA

Subject	Summary
Extension of Deadlines and Election Instructions for Temporary Liquidity Guarantee Program (PR-110-2008, November 3, 2008, FIL-125-2008, November 3, 2008)	On October 14, 2008, the FDIC announced the Temporary Liquidity Guarantee Program to strengthen confidence and encourage liquidity in the banking system. All eligible entities are covered under the program unless they opt out of one or both of the components by December 5, 2008 (extended from November 12, 2008); otherwise, fees will apply for future participation. The FDIC provided guidance for election options and reporting requirements. See www.fdic.gov/news/news/financial/2008/fil08125.html.
Additional Seminars for Bank Employees on How to Calculate Deposit Insurance Coverage (FIL-120-2008, November 3, 2008)	The FDIC announced it would host four additional deposit insurance seminars identical to the eight telephone seminars for bankers announced in FIL-85-2008. The free seminars covered the recent insurance coverage rule changes and guided bank employees through the process of determining a customer's deposit insurance coverage. The seminars were conducted on November 14, December 5, 10, and 19, 2008. These seminars were available to employees of all FDIC-insured banks and savings associations. See www.fdic.gov/news/news/financial/2008/fil08120.html.
Proposed Rulemaking on Capital Treatment of Certain Claims on or Guaranteed by Fannie Mae and Freddie Mac (FIL-113-2008, October 31, 2008, *Federal Register*, Vol. 73, No. 208, p. 63656, October 27, 2008)	The Federal bank and thrift regulatory agencies sought comment on a joint notice of proposed rulemaking to permit banks, bank holding companies, and savings associations to assign a 10 percent risk weight to claims on or guaranteed by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. The FDIC accepted comments through November 26, 2008. See www.fdic.gov/news/news/financial/2008/fil08113.html.
Interagency Statement on the Regulatory Capital Impact of Losses on Fannie Mae and Freddie Mac Preferred Stock (PR-108-2008, October 31, 2008, FIL-112-2008, October 29, 2008)	Section 301 of the Emergency Economic Stabilization Act of 2008 (EESA) provides tax relief to banks that have suffered losses on certain holdings of Federal National Mortgage Association and Federal Home Loan Mortgage Corporation perpetual preferred stock by changing the character of these losses from capital to ordinary for federal income tax purposes. The Federal bank and thrift regulatory agencies will allow banks to recognize the effect of this tax change in their third quarter 2008 regulatory capital calculations. See www.fdic.gov/news/news/financial/2008/fil08112.html.

Subject	Summary
Interim Rule on Deposit Insurance Coverage of Mortgage Servicing Accounts (PR-97-2008, October 10, 2008, FIL-111-2008, October 24, 2008, *Federal Register*, Vol. 73, No. 202, p. 61658, October 17, 2008)	The FDIC Board of Directors adopted an interim rule to simplify the deposit insurance rules for accounts held at FDIC-insured institutions by mortgage servicers. Under the interim rule, the FDIC will be able to make deposit insurance determinations on mortgage servicing accounts—and pay deposit insurance—more quickly. Comments on the interim rule, which took effect on October 10, 2008, are due by December 16, 2008. See www.fdic.gov/news/news/financial/2008/fil08111.html.
Interim Rule on Temporary Liquidity Guarantee Program (PR-105-2008, October 23, 2008, FIL-110-2008, October 23, 2008, *Federal Register*, Vol. 73, No. 210, p. 64179, October 29, 2008)	Following a systemic risk determination pursuant to section 141 of the Federal Deposit Insurance Corporation Improvement Act of 1991, in an effort to avoid or mitigate serious adverse effects on economic conditions and financial stability, the FDIC issued an interim rule establishing the Temporary Liquidity Guarantee Program (TLGP). The FDIC sought comment on all aspects of this interim rule, and comments were due 15 days after the interim rule's publication in the *Federal Register*. Coverage under the TLGP was established by the FDIC as of October 14, 2008. See www.fdic.gov/news/news/financial/2008/fil08110.html.
Applications to the Troubled Asset Relief Program's Capital Purchase Program (PR-103-2008, October 20, 2008, FIL 109-2008, October 20, 2008)	State nonmember institutions were encouraged to participate in the Troubled Asset Relief Program's Capital Purchase Program to strengthen their capital positions and their ability to prudently make credit available in their lending markets. All financial institutions were eligible to apply for a capital injection from the U.S. Department of Treasury. Applications were due by November 14, 2008. See www.fdic.gov/news/news/financial/2008/fil08109.html.
Proposed Rule on Deposit Insurance Assessments (PR-94-2008, October 7, 2008, FIL-106-2008, October 20, 2008, *Federal Register*, Vol. 73, No. 201, p. 61560, October 16, 2008)	The FDIC Board of Directors sought comments on a proposed rule that would amend the system for risk-based assessments and change assessment rates. For the first quarter of 2009 only, the FDIC proposed raising the current rates uniformly by 7 basis points. The FDIC also proposed to establish new initial base assessment rates that will be subject to adjustment as described in the proposed rule effective April 1, 2009. Comments on the proposed rule were due by November 17, 2008. See www.fdic.gov/news/news/financial/2008/fil08106.html.
Examination Procedures on Identity Theft Red Flags, Address Discrepancies, and Change of Address Regulations (FIL-105-2008, October 16, 2008)	The FDIC issued examination procedures on identity theft red flags, address discrepancies, and change of address requests. The regulations and guidelines took effect on January 1, 2008, and compliance was required by November 1, 2008. See www.fdic.gov/news/news/financial/2008/fil08105.html.
Revised Trust Examination Manual (FIL-104-2008, October 16, 2008)	The FDIC updated its Trust Examination Manual and is making it available to the public on its Web site and in CD-ROM format. See www.fdic.gov/news/news/financial/2008/fil08104.html.
Temporary Program to Encourage Liquidity and Confidence in the Banking System (PR-100-2008, October 14, 2008, FIL-103-2008, October 15, 2008)	The FDIC announced the Temporary Liquidity Guarantee Program to strengthen confidence and encourage liquidity in the banking system. The new program will (1) guarantee newly issued senior unsecured debt of eligible institutions, including FDIC-insured banks and thrifts, as well as certain holding companies; and (2) provide full deposit insurance coverage for non-interest-bearing deposit transaction accounts in FDIC-insured institutions, regardless of the dollar amount. See www.fdic.gov/news/news/financial/2008/fil08103.html.

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Subject	Summary
Temporary Increase in Deposit Insurance Coverage (PR-93-2008, October 7, 2008, FIL-102-2008, October 3, 2008)	President George W. Bush signed the Emergency Economic Stabilization Act of 2008, which temporarily raises the basic limit on federal deposit insurance coverage from $100,000 to $250,000 per depositor. The temporary increase in deposit insurance coverage became effective on October 3, 2008. The legislation provides that the basic deposit insurance limit will return to $100,000 after December 31, 2009. See www.fdic.gov/news/news/financial/2008/fil08102.html.
Notice of Proposed Rulemaking on Proposed Deduction of Goodwill Net of Associated Deferred Tax Liability (FIL-100-2008, September 30, 2008, *Federal Register*, Vol. 73, No. 190, p. 56756, September 30, 2008)	The Federal bank and thrift regulatory agencies jointly issued a Notice of Proposed Rulemaking (NPR) seeking comment on whether to allow goodwill, which must be deducted from Tier 1 capital, to be reduced by the amount of any associated deferred tax liability. Comments on the NPR were due by October 30, 2008. See www.fdic.gov/news/news/financial/2008/fil08100.html.
Interim Rule for Changing FDIC Deposit Insurance Rules for Revocable Trust Accounts (PR-86-2008, September 26, 2008, FIL-99-2008, October 8, 2008)	The FDIC adopted an interim regulation simplifying the rules for insuring revocable trust accounts—commonly known as *payable-on-death accounts* and *living trust accounts*. The new rules are easier to understand and apply, and provide at least as much coverage as the former rules for revocable trust accounts. The revised rules became effective September 26, 2008, and apply to all existing and future revocable trust accounts at FDIC-insured institutions. Comments were due 60 days after the regulation's publication in the *Federal Register*. See www.fdic.gov/news/news/financial/2008/fil08099.html.
Proposed Revisions to Reports of Condition and Income (Call Reports) for 2009 (FIL-94-2008, September 23, 2008, *Federal Register*, Vol. 73, No. 185, p. 54807, September 23, 2008)	The Banking agencies requested comment on several proposed revisions to the Call Report. The proposed reporting changes, which have been approved by the Federal Financial Institutions Examination Council, would take effect on a phased-in basis during 2009. Comments were due by November 24, 2008. See www.fdic.gov/news/news/financial/2008/fil08094.html.
Statement on Investments in Fannie Mae and Freddie Mac Equity Securities (PR-78-2008, September 7, 2008, FIL-93-2008, September 18, 2008)	The FDIC issued this Statement to announce it will work with the limited number of institutions that have significant holdings of common or perpetual preferred shares in the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation to develop Capital Restoration Plans pursuant to federal regulations. These equity investments should be reported as available-for-sale equity securities, if not held for trading purposes, and any net unrealized losses should be deducted from regulatory capital. See www.fdic.gov/news/news/financial/2008/fil08093.html.
Telephone Seminar for Bank Officers and Employees of FDIC-Supervised Banks on Current Accounting Issues (FIL-92-2008, September 18, 2008)	The FDIC hosted a telephone seminar on several accounting issues of interest to bankers. The seminar was held on September 24, 2008. Interested parties can download the audio and PowerPoint presentation from the FDIC Web site. See www.fdic.gov/news/news/financial/2008/fil08092.html.

Subject	Summary
Nationwide Seminars for Bank Employees on How to Calculate Deposit Insurance Coverage (FIL-85-2008, August 26, 2008)	The FDIC announced it would host eight identical telephone seminars for bankers on the FDIC's rules for deposit insurance coverage. The seminars guide bank employees through the process of determining a customer's deposit insurance coverage. The seminars were held between September 17 and November 4, 2008, and were available to employees of all FDIC-insured banks and savings associations. See www.fdic.gov/news/news/financial/2008/fil08085.html.
Final Guidance on Liquidity Risk Management (FIL-84-2008, August 26, 2008)	The FDIC issued this guidance to highlight the importance of liquidity risk management at financial institutions. Liquidity risk measurement and management systems should reflect an institution's complexity, risk profile, and scope of operations. Institutions that use wholesale funding, securitizations, brokered deposits, and other high-rate funding strategies should ensure their contingency funding plans address relevant stress events. The requirements governing the acceptance, renewal, or rolling over of brokered deposits are applicable to all insured depository institutions. See www.fdic.gov/news/news/financial/2008/fil08084.html.
Notice of Proposed Rulemaking on Recordkeeping Requirements for Qualified Financial Contracts (FIL-75-2008, August 6, 2008, *Federal Register*, Vol. 73, No. 145, p. 43635, July 28, 2008)	The FDIC issued a Notice of Proposed Rulemaking (NPR) that would establish recordkeeping requirements for qualified financial contracts (QFCs) held by insured depository institutions in a troubled condition. This NPR would implement certain statutory authority for purposes of the FDIC's meeting its statutory obligations regarding the treatment of QFCs in the event of its appointment as receiver of a failed insured depository institution. Comments on the NPR were due by September 26, 2008. See www.fdic.gov/news/news/financial/2008/fil08075.html.
FDIC Policy Statement on Covered Bonds (PR-60-2008, July 15, 2008, FIL-73-2008, August 4, 2008, *Federal Register*, Vol. 73, No. 145, p. 43754, July 28, 2008)	The FDIC issued the final policy statement on the treatment of "covered bonds" if the issuing insured depository institution is placed into FDIC receivership or conservatorship. The policy statement provides regulatory clarity by granting expedited access to covered bond collateral if the issuing institution fails and is placed into conservatorship or receivership and meets certain criteria. The FDIC guidance is intended to reduce market uncertainty on the treatment of covered bonds in a receivership or conservatorship, while allowing prudent development of the U.S. covered bond market. See www.fdic.gov/news/news/financial/2008/fil08073.html.
Final Guidance on Supervisory Review Process of Capital Adequacy (Pillar 2) Related to the Implementation of the Basel II Advanced Capital Framework (PR-59-2008, July 15, 2008, FIL-71-2008, July 31, 2008, *Federal Register*, Vol. 73, No. 148, p. 44620, July 31, 2008)	The Federal bank and thrift regulatory agencies jointly issued final guidance on the Supervisory Review Process of Capital Adequacy (Pillar 2) under the Basel II Advanced Capital Framework. Although this guidance reflects a continuation of the longstanding approach used by the agencies in the supervision of banks, it provides the clarification necessary to support the implementation of the advanced approaches final rule. The final guidance was effective September 2, 2008. See www.fdic.gov/news/news/financial/2008/fil08071.html.
Notice of Proposed Rulemaking on Risk-Based Capital Standards: Standardized Framework (PR-50-2008, June 26, 2008, FIL-69-2008, July 29, 2008, *Federal Register*, Vol. 73, No. 146, p. 43982, July 29, 2008)	The Federal bank and thrift regulatory agencies jointly issued a Notice of Proposed Rulemaking and sought comment on the domestic application of the Basel II standardized framework for all domestic banks, bank holding companies, and savings associations that are not subject to the Basel II advanced approaches rule. Comments were due by October 27, 2008. See www.fdic.gov/news/news/financial/2008/fil08069.html.

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Subject	Summary
Expanded Guidance for Providing Technical Assistance to Minority Depository Institutions (FIL-66-2008, July 17, 2008)	The FDIC issued expanded guidance to continue to pursue strategies to preserve and encourage minority ownership of FDIC-insured financial institutions, including providing technical assistance in operational areas. The expanded guidance provides technical assistance to minority depository institution (MDI) management to enhance ongoing communication with and support of MDIs. See www.fdic.gov/news/news/financial/2008/fil08066.html.
Final Rule on Large-Bank Insurance Determination Modernization (FIL-65-2008, July 17, 2008, *Federal Register*, Vol. 73, No. 138, p. 41180, July 17, 2008)	The FDIC issued a final rule requiring certain large depository institutions to facilitate the process for determining the insurance status of depositors of an insured depository institution in the event of failure. The rule applies only to a "covered institution," defined as any insured depository institution with at least $2 billion in domestic deposits and either (1) more than 250,000 deposit accounts or (2) total assets over $20 billion, regardless of the number of deposit accounts. The rule took effect on August 18, 2008, and allows for an 18-month implementation period. See www.fdic.gov/news/news/financial/2008/fil08065.html.
Interim Rule for Processing Deposit Accounts in the Event of an Insured Depository Institution Failure (FIL-64-2008, July 17, 2008, *Federal Register*, Vol. 73, No. 138, p. 41170, July 17, 2008)	The FDIC issued an interim rule establishing its practices for determining deposit and other liability account balances at a failed insured depository institution. Under the rule, the FDIC will require institutions to prominently disclose to sweep account customers whether the swept funds are deposits and the status of the swept funds if the institution were to fail. The FDIC solicited comment on all aspects of this rule. Comments were due by September 15, 2008. The rule became effective on August 18, 2008; however, the effective date of the sweep account disclosure requirement will be deferred until July 1, 2009, to allow the FDIC to consider specific comments. See www.fdic.gov/news/news/financial/2008/fil08064.html.
Guidance on Other Real Estate (FIL-62-2008, July 1, 2008)	The FDIC provided guidance to remind bank management of the importance of developing and implementing policies and procedures for acquiring, holding, and disposing of other real estate. See www.fdic.gov/news/news/financial/2008/fil08062.html.
Consumer Protection and Risk Management Considerations When Changing Credit Limits and Suggested Best Practices (FIL-58-2008, June 26, 2008)	The FDIC issued supervisory guidance to remind FDIC-supervised financial institutions that if, for risk management purposes, they decide to reduce or suspend home equity lines of credit, certain legal requirements designed to protect consumers must be followed. In addition, the FDIC urged institutions to work with borrowers to minimize hardships that may result from such reductions or suspensions. See www.fdic.gov/news/news/financial/2008/fil08058.html.
Portfolio of Deposit Insurance Coverage Resources for Bankers (FIL-47-2008, June 16, 2008)	To commemorate its 75th anniversary, the FDIC mailed to each FDIC-insured institution a Portfolio of Deposit Insurance Coverage Resources for Bankers—a compilation of the FDIC's latest deposit insurance educational tools. The FDIC asked banks to use the resources provided in the Portfolio to raise awareness about deposit insurance coverage among their employees and customers. See www.fdic.gov/news/news/financial/2008/fil08047.html.
Guidance for Managing Third-Party Risk (FIL-44-2008, June 6, 2008)	The FDIC issued guidance describing potential risks arising from third-party relationships and outlining risk management principles that may be tailored to suit the complexity and risk potential of a financial institution's significant third-party relationships. See www.fdic.gov/news/news/financial/2008/fil08044.html.

Subject	Summary
Final Illustrations of Consumer Information for Hybrid Adjustable-Rate Mortgage Products (PR-35-2008, May 22, 2008, FIL-40-2008, May 29, 2008)	The Federal financial institution regulatory agencies published Illustrations of Consumer Information for Hybrid Adjustable-Rate Mortgage Products, which are intended to assist institutions as they implement the Consumer Protection Principles portion of the Interagency Statement on Subprime Mortgage Lending. The illustrations give examples of the types of consumer information that the agencies recommend institutions provide. The illustrations are not intended as model forms, and institutions will not be required to use them. See www.fdic.gov/news/news/financial/2008/fil08040.html.
Provisions for Independent Testing for BSA/AML Compliance (FIL-38-2008, May 16, 2008)	The FDIC reemphasized the importance of an effective independent review for Bank Secrecy Act/Anti-Money Laundering (BSA/AML) compliance. The independent test of the BSA/AML Compliance Program can improve the efficiency and reduce the burden of the examination process. See www.fdic.gov/news/news/financial/2008/fil08038.html.

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