# BANKING LEGISLATION & POLICY

**July – September 2008** **Volume 27, Number 3**


**HIGHLIGHTS**

This issue contains detailed descriptions of responses to liquidity crises at financial institutions, the government takeover of Fannie Mae and Freddie Mac, and a proposed rule to implement Basel II regulations.

In addition, it summarizes other notable legislative, regulatory, and judicial developments that occurred during the third quarter of 2008.

## RESPONSES TO LIQUIDITY CRISES AT FINANCIAL INSTITUTIONS

A number of financial institutions failed this quarter, increasing turmoil in financial markets and resulting in some unprecedented actions by the government and regulatory agencies. New legislation, regulation, and market intervention have targeted commercial banks, thrifts, investment banks, insurance companies, and stock exchanges.

### Actions by the Federal Deposit Insurance Corporation

More than a dozen commercial banks and thrifts have failed so far this year, up from three in 2007. The first notable failure was the thrift IndyMac on July 11, which, with $32 billion in assets and $19.1 billion in insured deposits, represented the second-largest failure of a deposit-taking institution in the history of the United States at the time. The failure of the thrift Washington Mutual (WaMu), with $307 billion in assets, on September 25, easily eclipsed this mark, becoming the largest bank failure in United States history. However, regulators brokered an immediate sale of WaMu to JPMorgan Chase, protecting the deposit insurance fund from any resulting losses. Nearing insolvency, Wachovia, the nation's sixth-largest bank by amount of deposits, agreed to be acquired by Wells Fargo on October 3.

#### *Likely Effects on the Deposit Insurance Fund*

When a federal regulator determines that one of its regulated institutions is in danger of becoming insolvent, the institution may be closed and placed under the control of the Federal Deposit Insurance Corporation (FDIC).[1] The FDIC can then

[1] The Office of Thrift Supervision (OTS) regulates federal savings associations, and the Office of the Comptroller of the Currency (OCC) regulates national banks. State-chartered banks and savings associations and banks that are members of the Federal Reserve System may also have the FDIC appointed as receiver. The FDIC may appoint itself receiver

manage the institution to maximize its value for future sale and maintain its banking services.

In order to prevent runs on banks, the FDIC insures bank deposits up to $100,000 per depositor.[2] Insured deposits include savings and checking accounts, certificates of deposit, certain money market accounts, and outstanding cashier's checks.

Typically, a bank failure ends up costing the FDIC 10 to 20 percent of the value of the bank's assets. The Deposit Insurance Fund (DIF) is maintained by an insurance premium charged on banks' deposits based on the risk profile of the institution. Current annual premiums run between five and seven basis points for well capitalized, low-risk banks. Banks with the riskiest profiles may currently be charged rates as high as 43 basis points. The insurance fund target is 1.25 percent of all insured deposits in the country.

At the time of the IndyMac failure, the reserve ratio stood at 1.19 percent, with a value of approximately $52 billion. The FDIC estimates that closing IndyMac will cost the DIF some $8 billion after liquidating the thrift's remaining assets. Failures at several other institutions have compounded the problem, and the reserve ratio has dipped as low as 1.01 percent this quarter.

If the fund falls below 1.15 percent, the FDIC must enact a restoration plan to replenish the fund. On October 8, the FDIC proposed a plan to replenish the DIF by 2013. For the first quarter of 2009, all rates would rise, and the increase would range from 12 to 50 basis points.

For subsequent quarters, the FDIC proposes a new schedule of rates that initially would range from 10 to 45 basis points. The FDIC also proposes to restructure its risk assessment system at this time to make it more sensitive and accurate. Based on the exact risk profile of an institution as determined by the FDIC, these initial rates would be adjusted and could ultimately range from eight to 77.5 basis points.

***Temporary Liquidity Guarantee Program***

On October 23 the FDIC issued an intermediate rule to implement a new Temporary Liquidity Guarantee Program, designed to strengthen confidence and encourage lending in the banking system (73, *Federal Register*, pp. 64179-91).

The program has two parts. The first part will fully guarantee certain newly issued senior unsecured debt issued before June 30, 2009, in the event that the issuing institution fails or its bank holding company files for bankruptcy. Coverage would be limited to June 30, 2012, even if the maturity of the debt extends beyond that date.

The second part of the program will provide full coverage of non-interest bearing deposit transaction accounts, regardless of dollar amount. These accounts are typically payment-processing accounts used by businesses. This guarantee would expire after December 31, 2009.

The additional coverage provided by the program will be free to all banks for 30 days, after which a depository institution may either opt out of one or both parts of the program, or incur fees for further coverage. The cost to participating institutions would be 75 basis points on all covered new debt issues. A 10 basis point surcharge would be added to an institution's current insurance assessment to continue coverage of deposit transaction accounts.

***FDIC Program to Restructure IndyMac's Mortgage Loans***

IndyMac failed in large part because of rising delinquency and default on subprime and alt-A mortgages in its loan portfolio. Many of these loans were made to borrowers without properly

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for state-chartered institutions. For more information, see the FDIC's description of the process.

[2] Under the Emergency Economic Stabilization Act of 2008 passed on October 3, the amount covered of a bank deposit will temporarily be increased to $250,000 per depositor. For more information on this legislation, see its description in this issue of *Banking Legislation and Policy*.

verifying their income, and a large number have ultimately proven to be unaffordable.

The FDIC has initiated a loan modification program for IndyMac's distressed mortgage borrowers in an effort to ultimately increase the value of the company's mortgage portfolio by providing some relief for these struggling borrowers. The FDIC hopes that this program will serve as a blueprint for other mortgage lenders that are facing rising default rates.

Modifications are available for most borrowers who have a first mortgage owned or securitized and serviced by IndyMac and are seriously delinquent or in default. Modifications will be designed to achieve sustainable payments at a maximum debt-to-income ratio of 38 percent. To achieve this, eligible mortgages will be modified with future interest rates capped at 6.5 percent. If necessary, longer payment periods or deferral or forgiveness of loan principal will be considered. Additionally, all unpaid late fees will be waived.

In the last week of August, the FDIC sent modification offers to 4,000 of the most distressed borrowers, with plans to extend offers to several thousand more. Homeowners may also contact the FDIC directly to initiate the modification process. The modification is not considered complete until the borrower can verify his income and provide the first payment on the new mortgage plan. This workout program will hopefully lead to an increase in the value of IndyMac when it is sold by the FDIC, thus decreasing the final cost to the DIF.

***FDIC Brokers Sales of Commercial Banks***

The FDIC managed to avoid another large payout from the DIF by brokering the sale of WaMu to JPMorgan Chase on September 25. WaMu had approximately $309 billion in assets and $190 billion in deposits when it was shut down by the OTS that day. Had the FDIC needed to cover insured deposits, the DIF would have become underfunded. Instead, JPMorgan Chase paid $1.9 billion for WaMu's assets, deposits, branches, and a large portfolio of mortgage and credit card loans, wiping out value for WaMu's existing shareholders in the process.

In a similar move, the FDIC acted as a facilitator in the attempted sale of Wachovia's banking operations to Citigroup for $2.16 billion in stock and the assumption of Wachovia's senior and subordinated debt, estimated at $53 billion. Though Wachovia, with $812 billion in total assets and $448 billion in deposits, was not insolvent at the time, it had seen its stock price fall rapidly on fears about the health of its $312 billion mortgage portfolio. On October 3, Wachovia announced that it had worked out a new deal, in lieu of the Citibank offer, to be acquired in whole by Wells Fargo for $15 billion in stock with no FDIC assistance needed. The Wells Fargo purchase was approved by the Federal Reserve on October 12.

**Investment Banks Face Challenges**

On September 15, Lehman Brothers, one of the country's oldest and largest investment banks, filed for Chapter 11 bankruptcy. On September 20, a deal was approved for Barclay's to acquire Lehman's investment banking and capital markets operations, as well as its New York office, for $1.35 billion. On September 25, Nomura Holdings of Japan agreed to buy Lehman's European, Middle-Eastern, and Asian operations for a combined total of $425 million.

Also on September 15, facing mounting liquidity problems, Merrill Lynch agreed to sell itself to Bank of America for $50 billion.

On September 22, facing a tight funding market and falling stock prices, the investment banks Goldman Sachs and Morgan Stanley reorganized themselves into bank holding companies. This move will subject them to greater supervision, but it will also ensure access to the Federal Reserve's lending facilities and may expand their abilities to raise retail funding.

Following these reorganizations, both Goldman Sachs and Morgan Stanley subsequently

received large injections of capital from investors. On September 23, Berkshire Hathaway agreed to purchase $5 billion in preferred stock in Goldman Sachs, which will pay a perpetual 10 percent annual dividend, and received in-the-money warrants to purchase up to another $5 billion in common stock at a strike price of $115 per share. On October 6, the Board of Governors of the Federal Reserve approved Mitsubishi UFJ Financial Group's application to purchase from Morgan Stanley $6 billion in preferred stock paying a 10 percent annual dividend, as well as an additional $3 billion in common stock at a strike price of $25.25 per share.

Following these failures, sales, and reorganizations, there are no remaining large, independent American investment banks.

**Federal Reserve Widens Collateral Accepted for Loans to Banks**

In response to liquidity problems at Lehman Brothers, and hoping to avoid further bank failures, on September 14 the Federal Reserve agreed to accept new forms of pledged collateral from banking institutions for access to two of its existing liquidity facilities, the Primary Dealer Credit Facility (PDCF) and the Term Securities Lending Facility (TSLF). The PDCF was established in March 2008 to provide overnight funding to primary dealers. The TSLF offers 28-day loans of Treasury securities to primary dealers; these loans are awarded to the winners of a biweekly auction.[3]

Previously, the PDCF had accepted all investment-grade corporate, municipal, mortgage-backed, and asset-backed securities as collateral for loans. Now, it will accept a wider range of collateral, including all collateral eligible in tri-party repo markets – markets for short-term loans between banks in which a third party holds collateral until the loans are resolved.

The TSLF holds two types of auctions – Schedule 1 and Schedule 2 – which differ in the types of collateral they will accept for loans. The TSLF will now accept a wider range of collateral for Schedule 2 auctions, which already accept broader collateral than Schedule 1 options. Acceptable collateral for Schedule 2 auctions will now include all investment-grade debt securities. Previously, only Treasury securities, government agency securities, and AAA-rated mortgage-backed and asset-backed securities were accepted as collateral. Additionally, the frequency of Schedule 2 auctions relative to Schedule 1 auctions will increase so that Schedule 2 auctions will be held weekly and Schedule 1 auctions will be held biweekly.

**Proposed Decrease in Goodwill Deductions from Tier 1 Capital**

On September 30, the OCC, the Board of Governors of the Federal Reserve, the FDIC, and the OTS issued for comment a proposed rule that would permit banking organizations to reduce the amount of goodwill they must deduct from tier 1 capital calculations by the amount of any deferred tax liability associated with that goodwill (73, *Federal Register*, pp. 56756-63). Comments on the proposed rule were due on October 30, 2008.

Under current rules, a banking organization must deduct the full carrying value of goodwill arising from a taxable business combination from its tier 1 capital calculations.[4] This increases the amount of other capital that the bank must hold in order to meet its reserve capital ratio requirements.

The proposed rule would allow a bank to overlook any deferred tax liability associated with goodwill when calculating its required tier 1 capital. A bank that amortizes its goodwill over several years would therefore be able to decrease its deductions every year by the amount of accumulated taxes on its goodwill, rather than

[3] More information about these facilities can be found at: www.newyorkfed.org/markets/Understanding_Fed_Lending.html and www.ny.frb.org/markets/Forms_of_Fed_Lending.pdf.

[4] Tier 1 capital, or "core capital," consists of common shareholders' equity, most retained earnings, and some perpetual noncumulative preferred stocks.

having to deduct the full carrying value of the goodwill each year.

The proposed change would permit a banking organization to effectively reduce its regulatory capital deduction for goodwill to an amount equal to the maximum losses that could occur as a result of the goodwill becoming completely impaired or disorganized, reducing the amount of other capital that must be held.

**Actions by the Securities and Exchange Commission**

***SEC Limits Short-Selling of Financial Stocks***

In several instances this quarter, the Securities and Exchange Commission (SEC) banned certain practices in short-selling the equity of some financial firms. In an ordinary short sale, the seller borrows a stock for a small fee and sells it, with the understanding that the stock must later be returned to the lender by buying a replacement share in the market, booking as profits the change in the stock price during that time. The more the price drops in the interim, the greater the profit for the short seller. But in a "naked" short sale, the seller does not actually borrow the stock, thus avoiding paying any fees associated with borrowing. Both buyer and seller record the book value of the sale, but the stock is actually purchased only if and when the buyer requires it to be delivered.

As a stock's price falls, profits from short-selling the stock increase. If traders foresee that prices will continue to fall, they may flood the market with short sales of the stock, leading to a cascading effect and driving down the price even further.

The SEC's first ban on naked short-selling, issued July 15 and expiring August 12, listed 19 troubled financial companies that could not be shorted, including the government-sponsored enterprises Fannie Mae and Freddie Mac. Concerned about aggressive naked short-selling of shares of these firms, the SEC banned the practice before prices could fall too far. The moratorium was allowed to expire as volatility in the markets appeared to decrease.

On September 17, the SEC once again acted to curb naked short-selling, this time of all publicly traded stocks. Furthermore, it required that all short-sellers and their broker-dealers deliver the securities they sell no later than the close of business three days after the transaction date. This regulation decreases the appeal of short-selling by limiting the time during which stock prices can fall before they need to be delivered.

On September 18, reacting to extreme losses in stock market values among financial companies, the SEC expanded this order by banning short-selling of any form for 799 specified financial companies. Included in this list were banking institutions such as Bank of America, Goldman Sachs, Morgan Stanley, Merrill Lynch, and Washington Mutual. Also issued that day was an order requiring hedge funds and other large investors to file weekly reports that detail their daily short-selling of certain publicly traded securities. On September 21, the SEC amended the ban to allow securities exchanges (such as the New York Stock Exchange) to add firms to the list of banned short-selling targets. These regulations, originally set to expire October 2, were extended until October 18.

***SEC Ends Voluntary Program for Supervising Capital at Investment Banks***

On September 26, the SEC terminated a regulatory program for supervising liquidity and capital at what used to be the five largest independent investment banks on Wall Street: Goldman Sachs, Merrill Lynch, Morgan Stanley, Lehman Brothers, and Bear Stearns. The program was created in 2004 as a way for the government to consolidate and expand oversight of these banks, dubbed "consolidated supervised entities" (CSEs), which could opt into the program and negate other regulatory rules for their subsidiaries.

The Gramm-Leach-Bliley Act of 1999 (Public Law No. 106-102) allowed investment bank holding companies to opt out of existing regulations. These regulations monitored the investment banks' broker-dealer subsidiaries through the SEC but left many activities at the holding company level or in other subsidiaries largely unregulated. This terminated program acted as an alternative regulatory scheme: By opting out of the existing rules governing broker-dealers, the CSEs necessarily opted into this program, which applied at the holding company level.

The goals of the program were to provide some SEC supervision over the CSEs. Opting into the program removed a leverage ratio cap for broker-dealers but required that the CSEs comply with risk-based capital and liquidity requirements that were similar to those espoused for commercial bank holding companies in the Basel II Accord. This oversight of the CSE holding companies was supposed to allow the SEC to react quickly to any discovered financial weaknesses. Firms were still allowed to use their own value at risk (VaR)[5] models and scenario analysis methods to compute their business risk and capital levels. However, they were required to maintain internal risk controls, calculate capital adequacy consistent with Basel I regulations, allow the SEC to examine their books and records, and make regular reports to the SEC on their financial conditions. The SEC would meet regularly with senior risk managers and financial controllers at the holding company level to review the firms' risk measurement models and governance.

In the wake of the collapse of Bear Stearns in March 2008 and its sale to JPMorgan Chase, the SEC's inspector general began investigating the causes of the collapse and the usefulness of the CSE program. On September 25, a report on the program was issued (SEC Report No. 446-A). It found that Bear Stearns did voluntarily comply with the program's net capital and liquidity requirements but that the requirements themselves were inadequate and poorly enforced.

In the statement about the termination of the CSE program, the SEC chairman announced that the SEC and the Board of Governors of the Federal Reserve would begin working together to regulate organizations like these investment banks that, until now, had not been subject to regulation by either agency. The agencies had released a memorandum of understanding on July 7 that stated their intention to begin this oversight.

Under the memorandum, the Board and the SEC will meet at least quarterly to share information about the financial conditions and liquidity and funding resources of consolidated supervised entities (i.e., investment banks), bank holding companies, and primary dealers. The regulators will also conduct coordinated exams of and visits to the institutions.

**Federal Reserve Creates Lending Facility for AIG**

On September 16, facing the insolvency of American International Group, Inc. (AIG), the world's largest insurance company, the Board of Governors of the Federal Reserve authorized the Federal Reserve Bank of New York to extend up to $85 billion in credit to the company through a new credit facility. This facility was created under section 13(3) of the Federal Reserve Act and allows the Fed to lend to individuals or corporations under unusual and exigent circumstances. The decision came after the Board determined that a disorderly failure of AIG could lead to even greater turbulence in already fragile credit markets and increase borrowing costs for all. The terms of the loan made the federal government a de facto majority controller of the company when AIG began using the facility.

[5] VaR, or value at risk, is a method of calculating the probability of the drop in value of an asset exceeding some specified proportion over a given period of time.

***Problems at AIG***

AIG is a large, multinational corporation with many subsidiaries, including insurance, telecommunications, real estate, and aircraft leasing companies. AIG's insurance subsidiaries are subject to regulation at the state level in the U.S. and are required to hold enough capital to remain solvent.

The damage to AIG that led to this action occurred at the holding company level. AIG has been a major issuer of credit default swaps (CDS) since they were introduced in the mid-1990s. A credit default swap is similar to an insurance contract based on the performance of a credit instrument such as a bond. The buyer of the CDS makes a series of payments to the seller and in exchange receives a payoff if the covered asset goes into default.

In a "naked swap," the purchaser does not actually own the underlying bond. Thus, naked swaps amount to bets by investors against the performance of bond issuers. In recent years, naked swaps have come to dominate the $62 trillion CDS market. By some SEC estimates, they make up about 90 percent of the market, but figures are sketchy because the market is largely unregulated and most trading is done through bilateral trading (i.e., over-the-counter) rather than on an exchange with a central counterparty. AIG's gross exposure to all CDS was more than $500 billion at the time of the Board's action.

Like all insurance products, CDS are only valuable if the issuing company can stand behind them. Following the collapse of Lehman Brothers, credit rating agencies downgraded AIG over concerns about the company's possible overexposure to CDS. Had the proportion of margin calls increased, ratings agencies were unsure that AIG would be able to cover them. As a result of this downgrading, AIG's stock price plummeted.

Had AIG been forced to file for bankruptcy, banks and investors that had purchased CDS from AIG would have been forced to recalculate the risk on their CDS-covered investments and write down their values. This could have led to even more panic in the market. The Board, believing that an AIG failure would severely damage markets, created the lending facility so that AIG would have time to raise, by selling subsidiaries and by raising equity, the capital necessary to stand behind its CDS.

***Terms and Conditions of the Lending Facility***

The $85 billion credit facility that the Fed has created for this operation is collateralized by all of AIG's assets, valued at approximately $1.05 trillion. This facility will be monitored by the Federal Reserve Bank of New York and last for 24 months.

The terms of the loan are structured to be unfavorable to AIG, thus encouraging the company to search for other sources of capital. AIG will pay interest on any money it borrows from the Board at a rate equal to the 90-day London interbank offered rate (LIBOR) plus 850 basis points.[6] AIG will also be charged 8.5 percent annual interest on any undrawn funds as a fee for keeping the lending facility open.

In return for the loan, the U.S. government received a 79.9 percent equity interest in AIG and will have the right to veto the payment of dividends to common and preferred shareholders. The loan is expected to be repaid through the sale of AIG's assets and subsidiary companies.

***Second Liquidity Injection***

On October 8, the Board announced that it had authorized the Federal Reserve Bank of New York to make a collateralized loan worth up to $37.8 billion to AIG in exchange for investment-grade, fixed-income securities from AIG's

[6] Since this facility was opened, the 90-day LIBOR has swung from approximately 2.8 percent in mid-September, up to 4.8 percent in mid-October at the height of the financial crisis, and back down to 2.2 percent in mid-November.

regulated U.S. insurance units. The $61 billion[7] that AIG has drawn from the credit facility has been used, in part, to settle transactions with counterparties that had returned these securities to AIG. This new program will allow AIG to replenish liquidity and provide some credit protection to the Fed.

**Guarantee of Money Market Funds by the Treasury**

On September 19, the Treasury announced the creation of a temporary guaranty program for the U.S. money market mutual fund industry. Money market funds are mutual funds that invest in low-risk, short-term assets such as commercial paper and short-term bonds. One goal of these funds is to seek a net asset value (NAV) of no less than $1 per share, meaning that they should never lose money.

On September 17, the Reserve Management Corp.'s Reserve Primary Fund "broke the buck," meaning that its NAV dropped below $1. This happened after a week in which, because of high volatility in the stock market, investors sought to move funds into safer assets such as Treasury bills, driving down the yields of other money market instruments that the money market mutual funds hold.

In response to this occurrence, as well as to NAVs near $1 in some other money market funds, the Treasury received the President's approval to create a $50 billion lending facility to insure money market fund investors against losses. Funding for this program comes from the Exchange Stabilization Fund, which is a little-used Treasury fund established by the Gold Reserve Act of 1934.

Money market funds with NAVs between $0.995 and $1 may sign up for the program by paying a small fee, either $0.01 or $0.015 per share, depending on the exact NAV. The guarantee would then be triggered if the NAV falls below $0.995 and would ensure that investors receive $1 upon withdrawal.

Money market funds had until October 10 to apply for the program. Funds that applied include those of Vanguard, Fidelity, Prudential, T. Rowe Price, and Hartford.

Only shares of funds held by investors on September 19 are protected under this program. To ensure that consumers do not now move their bank deposits to money market funds, any new investments in money market funds will not be covered, nor will any shares sold to another investor. Shares withdrawn from a fund before the guarantee is triggered will also not be covered.

The facility officially opened on September 29. The Treasury has announced that it will be open for only three months, unless the Treasury deems it necessary to renew the program.

**Emergency Economic Stabilization Act of 2008**

On October 3, the President signed into law the Emergency Economic Stabilization Act (EEAS) of 2008 (Public Law No. 110-343). This act authorizes the Treasury to create a Troubled Assets Relief Program (TARP) with the authority to purchase up to $700 billion in mortgage-related assets[8] and equity from financial institutions. In exchange for the mortgage-related assets, the Treasury would receive warrants for equity interests in the firms. The law also contains provisions relating to compensation for executives at financial firms, FDIC deposit insurance, suspension of mark-to-market accounting, and payment of interest on reserves by the Federal Reserve. On October 14, the Treasury announced that TARP would purchase up to $250 billion in equity in financial institutions that choose to enroll in the program.

[7] As of October 3, 2008.

[8] Mortgage-related assets are defined in this context as "residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated on or before March 14, 2008."

***Troubled Assets Relief Program***

The centerpiece of the bill is the creation of a TARP that will purchase troubled mortgage-related assets from banks and other financial institutions. Markets for these assets have dried up over the past several months, and many banks have been hoarding safe assets – cash and Treasury securities – to protect themselves against unrealized losses in their portfolios stemming from these assets.

This hoarding has left financial institutions with unwanted mortgages and securities on their books, and few potential buyers. Furthermore, because the market for these assets have all but disappeared, it has become extremely difficult to accurately gauge their value, which has introduced even more uncertainty into financial markets.

In response to these developments, which have decreased vital access to credit for consumers and businesses, on September 20 the Treasury submitted legislation to Congress that asked for carte-blanche authority to purchase up to $700 billion in mortgage-related assets from struggling financial institutions, thereby freeing up capital and encouraging lending. The enacted legislation is based on the Treasury's original proposal but with more congressional oversight.

TARP will be administered by a new Office of Financial Stability within the Treasury. The $700 billion dollars designated for the program will be made available in increments, with the office immediately receiving $250 billion. Following a report to Congress, which may be submitted at any date, and presidential certification, another $100 billion may be made available to the program. After that, Congress may authorize an additional $350 billion following another presidential request and a 15-day waiting period.

The Treasury will purchase mortgage-related assets at reasonable rates, above the current fire-sale prices, thereby setting meaningful prices for these assets and possibly decreasing uncertainty in the markets over their valuation. Once the assets have been purchased, the Treasury will then be able to work with the FHFA and homeowners to rework the terms of the underlying mortgages, ensuring the continued performance of the assets. Eventually, the Treasury will be able to resell the assets in the markets and buy new ones from banks, never holding more than $700 billion in assets at one time.

Funding for the program will come from the issuing of new debt by the Treasury, with the national debt limit being raised to $11.315 trillion. Any profits resulting from the resale of assets or stocks would be returned to the Treasury's general fund. This program will expire after December 31, 2009, unless extended.

*Purchase of Equity in Financial Institutions*

In addition to purchasing mortgage-related assets, the law also gives TARP the ability to purchase assets that are not related to the mortgage market if the Secretary of the Treasury, in consultation with the Chairman of the Board of Governors of the Federal Reserve, believes that purchasing such assets is necessary to calm turbulent financial markets.

On October 14, reacting to an extreme tightening of lending standards throughout the banking industry, the Treasury announced that TARP would use this power to purchase up to $250 billion in senior preferred shares from enrolling financial institutions. This strategy will hopefully inject ensure the solvency of the banks and thaw frozen credit markets.

U.S.-controlled banks, savings associations, and certain bank and savings and loan holding companies that are engaged only in financial activities may choose to enroll by November 14. The minimum subscription amount is 1 percent of the institution's risk-weighted assets, and the maximum is the lesser of $25 billion or 3 percent of risk-weighted assets.

The senior preferred shares, which are nonvoting, qualify as tier 1 capital and rank senior

to common stock. The shares will pay an annual dividend of 5 percent for the first five years and then reset to a 9 percent rate for subsequent years.

Additionally, the Treasury will receive warrants to purchase common stock in each firm worth 15 percent of the amount of the investment in senior preferred shares. The strike price on the warrants will be equal to the 20-day trailing average market price of the institution's common stock at the time of issuance.

In enrolling in this equity purchasing program, financial institutions must agree to adopt the Treasury's standards for executive compensation and corporate governance as laid out in the EEAS for the duration of the Treasury's investment.[9]

Nine large institutions enrolled almost immediately, and they will split the first $125 billion among themselves, with the other $125 billion remaining to be allocated among other enrolling institutions. The Treasury has indicated that if this equity purchasing program is successful, it could allocate the next $100 billion of TARP's funds to it, bringing the total for bank equity purchases to $350 billion.

*Purchase of Mortgage-Related Assets*

If the full proposed amount of $350 billion is used to purchase equity in banks, a further $350 billion could still potentially be available for TARP to purchase mortgage-related assets from financial institutions. Firms eligible to sell their mortgage-related assets to TARP include any bank, savings association, credit union, security broker or dealer, or insurance company established or regulated under U.S. law with significant operations in the U.S. Excluded are central banks or institutions owned by foreign governments.

In return for purchasing these assets, the Treasury will receive warrants for the purchase of nonvoting common or preferred stock in participating institutions. In this way, the Treasury has a stronger presence in the operation of troubled financial firms and stands to recoup some expenses. A ceiling for purchasing may be applied, such that cumulative purchases from any one firm for the duration of the program may not exceed $100 million.

Determining a fair price for these assets is difficult. Paying too little for them may force institutions to mark down their holdings and possibly face insolvency. However, paying too much may expose the Treasury to excessive downside risk. An exact mechanism for pricing has not been specified, but both a reverse auction system and purchase at hold-to-maturity prices have been suggested. Whatever method is eventually used, the Treasury will have to make the prices public.

Additionally, the Treasury is required to create an insurance fund to guarantee bad assets that were created after March 14, 2008, and are thus ineligible for purchase under the program. The Treasury will be able to establish the criteria for the fund and set premiums for firms that choose to participate at its discretion.

Under the law, the Treasury will have to work to avoid foreclosures on troubled mortgages. Borrowers of troubled mortgages purchased by the Treasury will be encouraged to modify their mortgages under the HOPE for Homeowners Act. The Treasury may also use additional loan guarantees to prevent foreclosures.

*Executive Compensation Provisions*

Part of the law is designed to curb excessive pay for executives of firms taking advantage of the program. This language was included so the legislation would not reward financial firms for taking excessive risks.

Companies that have been taken over by the government, such as AIG, will not be able to offer their executives "golden parachute" severance packages. Any bonuses that are proven in

[9] See the discussion of these provisions below.

retrospect to have been unwarranted given the failure of such firms will have to be returned.

If the Treasury purchases $300 million or more in assets from a company, its executives will be prohibited from receiving any severance pay resulting from the failure of the firm under contracts drawn up following the firm's entrance into the program. Contracts for severance pay that were created prior to the firm's entrance into the program will still be honored.

*FDIC Deposit Insurance*

Under this legislation, the FDIC will temporarily raise the insured amount of every consumer deposit account from $100,000 to $250,000. This grants additional protection to consumers in the event of bank failure and should increase confidence in the banking system. This increase expires on December 31, 2009.

*SEC Can Suspend Mark-to-Market Accounting*

A provision of the bill authorizes the SEC to suspend the application of mark-to-market accounting in Statement 157 of the Financial Accounting Standards Board (FASB). Mark-to-market is a method of assigning value to a financial instrument with an uncertain future value by giving it the value it would currently fetch in the open market. Because markets for many financial instruments have dried up recently, this method of accounting has forced many banks to write down the values of the financial instrument holdings. In response to this, on September 30, the SEC issued guidance on fair value accounting standards that are acceptable under Statement 157.

*Federal Reserve to Pay Interest on Bank Reserves*

The bill authorizes the Federal Reserve to pay interest on commercial banks' reserves. On October 6, the Board announced that it would be implementing this policy, effective October 9. The Board will pay interest on all depository institutions' required and excess reserve balances. The rate paid on required balances will be the targeted federal funds rate less 10 basis points, for a current yield of 0.9 percent. The rate paid on excess balances will be the targeted federal funds rate less 75 basis points, for a current yield of 0.25 percent.[10]

**GOVERNMENT TAKEOVER OF FANNIE MAE AND FREDDIE MAC**

On September 7, the Federal Housing Finance Agency (FHFA) took control of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, placing the two firms in a conservatorship. The takeover came amid worries that the companies had become insolvent, lacking the capital necessary to survive the losses they are expected to face in the coming quarters. The move calmed turbulent housing and financial markets for a time, with mortgage rates falling by about 50 basis points in the days following the action. However, the collapse of Lehman Brothers and the subsequent turbulence in financial markets caused rates to increase again. No timetable currently exists for terminating the conservatorship, and there are lingering concerns about the potential cost to taxpayers.

**Background**

Fannie Mae and Freddie Mac, established by the federal government in 1938 and 1970, respectively, were publicly held corporations that dominated the secondary market for mortgages. Because of an implicit guarantee of their debt by the federal government, the GSEs were able to borrow at advantageous rates and use the money to purchase mortgages from banks, thrifts, and other lenders. The GSEs then kept some of the mortgages for their own portfolios and created mortgage-backed securities (MBS) from others that they sold to institutional investors. Fannie Mae and Freddie Mac guaranteed the performance of the mortgages underlying these MBS, with the result

[10] Rates accurate as of November 18, 2008.

that the securities enjoyed the highest ratings by independent rating agencies. The GSEs also sometimes purchased MBS from other investors for their own portfolios.

By buying mortgages from banks, Fannie Mae and Freddie Mac provided a funding source that allowed banks to continue to make loans. The banks did not need to hold the mortgages on their balance sheets, and the GSEs could get a good price for MBS they issued based on these mortgages and because of their implicit government guarantee.

Combined, these companies own or guarantee approximately 50 percent of the $12 trillion in mortgage debt outstanding in the country.

The two firms are regulated by the FHFA, which sets their minimum retained capital standards.[11] The FHFA also dictates the conforming loan limit – the maximum size of an individual mortgage that the GSEs can purchase. The current conforming loan limit is $625,000 for mortgages on homes located in the most expensive real estate markets around the country.

Another function of the FHFA is to set the minimum capital requirements for Fannie Mae and Freddie Mac – the amount of equity and reserves the firms must hold relative to their asset holdings. Before the takeover, the core capital was required to exceed 2.5 percent of the value of the firms' assets, plus an additional 0.45 percent of the value of the firms' off-balance-sheet obligations (primarily MBS). These requirements are considerably lower than those imposed on banks and thrifts.

The recent dramatic drop in housing prices and rise in mortgage defaults across the country has had a severe deleterious effect on the financial health of the two companies, leaving the GSEs with billions of dollars worth of underperforming MBS on their balance sheets, which have contributed in large part to their combined $14 billion in reported losses over the last year.

**Federal Housing Finance Regulatory Reform Act of 2008**

Ongoing concerns about the financial stability of the GSEs led to a reform in their oversight last quarter. The Federal Housing Finance Regulatory Reform Act of 2008, enacted on July 30, 2008, as part of the Housing and Economic Recovery Act of 2008, included language to update oversight of the companies and allow the Treasury to lend to them directly if necessary.[12] This legislation made explicit what had previously been an implicit guarantee that the United States federal government would back the debt of Fannie Mae and Freddie Mac.

This provision, which never had a chance to be used, allowed the Treasury to loan up to $2.25 billion to each company, as long as the Secretary of the Treasury could certify that it was in the best interests of taxpayers. This amount was a starting point but could be increased by the Treasury if necessary, with no maximum limit as long as the Secretary of the Treasury could justify his actions to Congress.

The law also contains a provision that allows the FHFA to seize control of the GSEs if they are deemed "critically undercapitalized." Within weeks this authority was used to place the firms in a conservatorship, and the Treasury's power to loan to the GSEs was used to enact the specific mechanisms of the seizure.

**Provisions of the Takeover**

The Treasury has announced three separate actions that will help Fannie Mae and Freddie Mac to gain access to the liquidity they need. First, the Treasury has agreed to purchase $5 billion in GSE

[11] The FHFA replaced the Office of Federal Housing Enterprise Oversight (OFHEO) as regulator of the GSEs upon enactment of the Housing and Economic Recovery Act of 2008 (Public Law No. 110-289). For more information on this legislation, see *Banking Legislation and Policy*, Volume 27, Number 2.

[12] For more information on this legislation, see *Banking Legislation and Policy*, Volume 27, Number 2.

mortgage-backed securities in the open market. Demand for MBS has fallen in the last year owing to uncertainty about the value of the mortgages underlying the securities. Because banks and the GSEs have been unable to sell securitized loans, their cost of lending has gone up, leading in part to higher mortgage rates. By purchasing GSE-guaranteed securities, the Treasury hopes to somewhat reactivate the market for MBS.

Second, the Treasury has created the Government Sponsored Enterprise Credit Facility (GSECF) to lend directly to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (FHLBs) as needed. Funding for the facility will come from the government's operating cash, located in an account at the Federal Reserve Bank of New York. Any government borrowing to fund the facility would be limited by the national debt ceiling. The loans will generally be short term, with maturities ranging from one week to one month, depending on the loan requests, though a maturing loan can be replaced with a new one. Interest rates on the loans are expected to run 50 basis points above the London interbank offered rate (LIBOR), though the Treasury reserves the right to change these rates at its discretion.

Finally, the government has become a senior preferred shareholder in Fannie Mae and Freddie Mac, with an initial purchase of $1 billion in senior preferred stock. The Treasury also received a warrant whereby it will purchase common stock in the companies at a nominal price, such that the government will ultimately own a 79.9 percent stake in both companies. The agreement also guarantees that the government will keep the GSEs solvent, making up any difference between liabilities and assets at the GSEs by purchasing additional preferred stock worth up to $99 billion. The Treasury will, in return, receive quarterly coupon payments in cash on its preferred stock worth 10 percent of the purchased amount per year. If a GSE cannot pay this amount in cash, the rate will increase to 12 percent per year until the full dividends have been paid. Dividend payments to all other equity holders will be halted. To offset some of the cost associated with these purchases, beginning March 31, 2010, the GSEs will pay the Treasury a quarterly fee, to be determined in consultation with the Chairman of the Federal Reserve.

A controversial requirement of the takeover would allow each GSE's retained mortgage and mortgage-backed securities portfolio to expand to up to $850 billion by December 31, 2009; each portfolio is currently valued at just under $800 billion. After this time, the portfolios would be required to shrink by 10 percent per year until they reach a value of $250 billion each. The FHFA believes this can be achieved through a combination of some debt maturing and through the sale of some other assets. This could open up the market for more competition, allow the companies to more closely monitor their assets, and hopefully stave off the need for future intervention.

As part of the takeover, the CEOs of both GSEs are being replaced. They had both been slated to receive large severance packages, together totaling $24 million. Given the state of the companies, this amount was seen as excessive by many lawmakers. In response, on September 14, the FHFA published a rule that allows the director of the FHFA to limit "golden parachute" payments to the executives (73, *Federal Register*, pp. 53356-59).

**Costs of the Takeover**

These actions put a significant amount of taxpayer money at risk, although the exact amount is uncertain. When evaluating the Housing and Economic Recovery Act of 2008 in July, the Congressional Budget Office estimated the expected cost to the Treasury of enacting a conservatorship at $25 billion over fiscal years 2008 and 2009, with a 5 percent chance that costs could run up to $100 billion. The exact cost will depend on whether the housing market stabilizes, the

performance of Fannie Mae's and Freddie Mac's assets, and the duration of the conservatorship.

Although these actions may help to stabilize housing markets and avoid foreclosures, the Treasury's purchase of new shares of common and preferred stock greatly dilutes the value of equity held by other investors. Especially at risk of losses are small banks and thrifts that hold preferred shares of Fannie Mae and Freddie Mac, though the Emergency Economic Stabilization Act contains tax provisions that mitigate some of these losses.

However, if the conservatorship is successful, the Treasury stands to reap some rewards. Restructuring currently unaffordable mortgage loans could increase the value of the GSEs' assets by lowering default rates. This would enable them to repay the loans with interest and pay dividends on the government's equity shares, which may net the Treasury a profit. In the long run, if this rescue plan works, shareholders may even see some value return to their holdings.

**Mortgage Adjustment Programs**

When borrowers default on mortgages held, securitized, or insured by one of the GSEs, that GSE must compensate investors or issuers. Thus, Fannie Mae and Freddie Mac both stand to gain by encouraging mortgage lenders and distressed borrowers to work together on loan modifications, payment plans, and other alternatives to foreclosure. The GSEs are currently considering implementing wide-scale loan modification programs that would be available to borrowers through mass solicitation programs.

Additionally, under the Housing and Economic Recovery Act of 2008, the firms are required to contribute hundreds of millions of dollars to affordable housing and foreclosure prevention funds. One program, the HOPE for Homeowners fund, offers FHA insurance against mortgage default to lenders who rework loans and reduce the principal to 90 percent or less of the home's current market value. This fund is supposed to be financed by Fannie and Freddie. However, if contributing to such a fund would hinder the GSEs from becoming adequately capitalized, the FHFA director has the authority to withdraw the companies' support. In the case of the HOPE program, the burden of providing funding would fall on the Treasury.

**PROPOSED IMPLEMENTATION OF BASEL II REGULATIONS**

On July 29, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve (Board), the Federal Deposit Insurance Corporation (FDIC) and the Office of Thrift Supervision (OTS) issued a joint notice of proposed rulemaking that would provide a framework for banks to implement standardized approaches to the Basel II accord (73, *Federal Register*, pp. 43982-44060). The proposed rule was open for comment until October 27, 2008.

**The Basel Committee**

The Bank for International Settlements, based in Switzerland, established the Basel Committee on Banking Supervision (Basel Committee) in 1974 to facilitate international discussion of banks' capital adequacy and risk management processes with the aim of "improv[ing] the quality of bank supervision worldwide."[13] The Basel Committee formulates guidelines and standards that individual member countries then implement independently based on the characteristics and needs of their own financial systems.

**Basel I**

In 1988, the Basel Committee released the "International Convergence of Capital

[13] Originally composed of central banks from the G-10 nations, member countries today are Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

Measurement and Capital Standards" (Basel I). Under Basel I, banks are required to assign a risk weight to every asset or investment and hold adequate capital to protect themselves from becoming insolvent during poor economic conditions. Banks that hold riskier assets are thus required to hold more capital. The Basel I framework was implemented in the U.S. by 1992 through several general risk-based capital rules, issued by the various regulating agencies.[14]

The Basel I guidelines established two tiers of regulatory capital. Core capital, also called "tier 1" capital, consists of common shareholders' equity, most retained earnings, and some perpetual noncumulative preferred stocks. Supplementary, or "tier 2," capital consists of subordinated debt, limited-life preferred stocks, and loan loss reserves that can total up to 1.25 percent of the risk-weighted assets. Together, these two categories must exceed 8 percent of the institution's total risk-weighted assets.

The first pillar of the Basel II accord, which the proposed rule addresses in the most depth, requires banks to calculate minimum regulatory capital levels based on their exposure to different types of risk. Basel I required that assets be grouped into "buckets" by the type of asset, with each bucket representing a different amount of risk. The face values of the assets in each bucket are then multiplied by a risk-weighting factor, and the resulting values are used to calculate the amount of risk-based capital that banks are required to hold. For example, cash and bonds issued by OECD member governments are in the lowest risk class with a risk weighting factor of zero: Banks do not need to hold any capital against them. However, some high-risk asset-backed securities and commercial loans have a risk-weighting factor of 200 percent: Banks are required to hold twice the amount of capital against these assets that would be required if capital were calculated based solely on the face values.

**Basel II**

In 2004, the Basel Committee released the "International Convergence of Capital Measurement and Capital Standards, A Revised Framework, Comprehensive Version" (Basel II), revising and refining the Basel I accord. Bankers had argued that the existing bucket classifications were too broad and did not accurately assess the risk associated with many types of assets. They also complained that Basel I did not take into account hedging strategies employed by banks, which actually reduce the overall risk in portfolios. Finally, Basel I did not address operational risk – the risk due to fraud, human error, and other such factors.

Basel II updated Basel I to ensure that capital requirements were more sensitive to risk, separate operational risk from credit risk, and align economic and regulatory capital more closely to reduce the opportunities for regulatory arbitrage.[15] The Basel II Accord consists of three pillars: minimum capital requirements for credit risk, market risk, and operational risk based on the degree of risk; supervisory review of institutions' internal risk assessment processes and capital adequacy; and the promotion of market discipline through enhanced public disclosures.

The first pillar requires banks to calculate minimum regulatory capital levels based on their exposure to different types of risk. It retains some of the basic concepts of Basel I: The definitions of regulatory capital are unchanged, and the minimum risk-based regulatory capital ratio remains the same (8 percent total qualifying capital to total risk-weighted assets and 4 percent core capital to total risk-weighted assets). The new rules,

[14] 12 CFR part 3, Appendix A (OCC); 12 CFR parts 208 and 225, Appendix A (Board); 12 CFR part 325, Appendix A (FDIC); and 12 CFR part 567, subpart B (OTS).

[15] In this case, regulatory arbitrage refers to a bank's ability to take advantage of the difference between its economic risk and required regulatory position.

however, alter the calculation of certain aspects of credit risk and now account for operational risk.

**Basel II Advanced Approaches Rule**

Basel II describes three methods each for calculating credit risk and operational risk. On April 1, 2008, an "advanced approaches" risk-based capital framework became effective for some banks (72, *Federal Register*, pp. 69288-445). This approach uses the "advanced internal-ratings method" for calculating credit risk and the "advanced measurement method" for calculating operational risk.[16] American banking organizations with total assets of $250 billion or more or consolidated on-balance-sheet foreign exposure of $10 billion or more (approximately the 10 largest banks in the country) are required to implement these advanced approaches. Other banks may opt in to this framework if they wish.

A statement from the agencies detailing the process for complying with the advanced approach rule was issued on July 8, 2008. It details the terms for enacting the terms of the rule. Banks must make a parallel run, using both the advanced approach and the current general risk-based capital rules for four consecutive quarters before applying the switch to the new capital rules.

**Basel IA NPR**

On December 26, 2006, the agencies issued a notice of proposed rulemaking known as the Basel IA NPR (71, *Federal Register*, pp. 77446-518).[17] This proposed framework for the Basel II standardized approach is now being offered in place of Basel IA.

Like the currently proposed Basel II standardized approach framework, Basel IA was offered as an alternative to the Basel I general risk-based capital rules that banks would be able to opt into. The objective of Basel IA was to refine the risk sensitivity of the risk-based capital requirements without greatly increasing the regulatory burden on banks. It took into account complaints from banks that the Basel I risk-based capital requirements did not accurately rate the riskiness of many assets that were lumped into broad weighting categories and recommended increasing the number of these categories. It also would have redefined how banks actually assess risk for many types of assets, including residential mortgages, retail exposures, and derivative transactions.

After considering comments on Basel IA and the Basel II advanced approaches framework, the agencies decided to withdraw Basel IA and offer the Basel II standardized approaches framework instead, which incorporates many of the concepts that Basel IA embraced but adjusts them to meet Basel II standards.

**Proposed Rule for Basel II Standardized Approaches**

This new rule would implement standardized approaches to credit risk and operational risk calculations. Any banking institution not required to implement the advanced approaches would be able to opt in to the new framework.

***Opting in to the Standardized Framework***

Under the proposal, any bank wishing to opt in to the new standardized framework would need to notify its primary Federal supervisor of its intent at least 60 days before the start of the calendar quarter in which it will begin implementing the new framework. A bank that has opted in to the standardized framework would need to comply with all of the regulations of the framework – it could not pick which rules to adopt and create a hybrid with the existing Basel I framework. Any bank that had opted in to the Basel II standardized framework would be able to return to the Basel I framework as long as it could justify its decision to its regulator and provided notification of its intent

[16] For details of the advanced approaches rule, see *Banking Legislation and Policy*, Volume 26, Number 4.
[17] For more information on Basel IA, see *Banking Legislation and Policy*, Volume 25, Number 4.

at least 60 days before the start of the calendar quarter in which it would opt out.

Except for savings and loan holding companies, which are not subject to risk-based capital rules, if a depository institution opts in to the standardized framework, its parent company and its subsidiary depository institutions (where applicable) would also be required to adopt the standard framework. This would provide a safeguard against regulatory capital arbitrage among affiliated institutions.

The agencies would reserve the right to require a bank to change which framework it used if the regulator determined that one framework was more appropriate given a bank's operating profile. The agencies would also reserve the right for an institution's primary federal supervisor to require that it hold a greater amount of capital than would otherwise be required under the rule if that supervisor determined that the risk-based capital requirements were inadequate for that particular institution because of its activities.

***Risk-Based Capital Requirements***

The minimum risk-based capital ratio requirements of 4 percent of tier 1 capital to total risk-weighted assets and 8 percent of total qualifying capital to total risk-weighted assets would be unchanged under this rule. The definitions of tier 1 and tier 2 capital would also remain largely unchanged. The only adjustment to these calculations would require banks to deduct from tier 1 capital any after-tax gain-on-sale resulting from a securitization.

***Risk-Weighting Assets***

The biggest change to the current general risk-based capital rules under this proposal would refine the methods for risk-weighting assets. Rather than lumping several different types of assets together into "buckets," with a common risk weight for each bucket, the new rules will allow assets to be valued individually. For example, corporate exposures and regulatory retail exposures will now be individually defined and subject to different risk-weighting factors. Within each category, the risk-weighting factor for each individual asset would be based on the asset's credit rating, rather than assigning a common risk weight for the entire category. For example, corporate exposures would have risk-weighting factors ranging from 20 percent for AAA-rated exposures to 150 percent for CCC-rated exposures.[18]

*External and Inferred Ratings*

The current general risk-based capital rules permit the use of external ratings issued by a nationally recognized statistical rating organization (NRSRO) to assign risk weights to recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage-backed securities. A banking organization must use the lowest NRSRO external ratings if multiple ratings of an asset exist. If there is no external rating, the bank must apply a risk weight mandated by the Basel I rules, which often does not reflect the asset's true riskiness.

This proposal would expand the types of assets that are eligible for NRSRO external rating and would require that inferred ratings be used to determine the risk weight for certain assets[19] as well. If multiple external ratings exist for an asset, the bank would still have to assign the lowest one.

The agencies are asking for comments on the advantages and disadvantages of the use of

[18] In credit ratings, AAA is the highest rating an asset can receive, followed by AA and A. BBB is considered the lowest investment-grade rating. Assets rated BB, B, and CCC are considered noninvestment grade (also called "speculative" or "junk").

[19] Any exposure to a sovereign entity, public-sector entity, or corporation that does not have an external rating would need to be assigned an inferred rating by the bank. This rating may be based on the overall rating of the issuer by an NRSRO or may be equal to the rating assigned to a similar asset from the same issuer. If more than one inferred rating is available, the lowest one is applied.

external credit ratings. Specifically, they want to know whether weaknesses in the credit rating process necessitate any changes in the current proposal.

*Risk-Weighting Categories*

The number of risk-weighting categories into which traditional assets may fall is greatly expanded in this proposal. Notable changes are mentioned here.

Exposures to sovereign entities that are members of the OECD, including any department, ministry, or central bank of a country, are considered relatively safe. Risk weights range from 0 percent for AAA-rated exposures to 150 percent for CCC-rated exposures. Exposures to government subdivisions such as states receive slightly higher risk weights, with the safest assets assigned a 20 percent weight and the riskiest still assigned a 150 percent weight.

Exposures to supranational entities such as the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, or many multilateral development banks will automatically receive a zero risk weight.

Currently, exposures to depository institutions, foreign banks, and credit unions are assigned a risk weight of 20 percent if they are from an OECD country and a 100 percent risk weight otherwise. The new rule would eliminate the OECD/non-OECD distinction and instead charge a risk weight one level higher than the risk weight assigned to the institution's sovereign of incorporation.

Under the current risk-based capital rules, most corporate exposures receive a risk weight of 100 percent. This proposal would allow banking organizations to select one of two methods by which to weight corporate exposures. Either all exposures could be risk-weighted at 100 percent, or they could be assigned a weight ranging from 20 to 150 percent based on credit rating. If the banking organization elects to rate individual corporate assets, there are separate schedules for short-term and long-term exposures.

Most residential mortgage exposures, secured by a first lien on a one- to four-family home, are currently risk weighted at either 50 or 100 percent. Junior liens are generally weighted at 100 percent. This proposal would base risk weights on the loan-to-value ratio (LTV) of the asset. The bank would have to calculate separately the values of both the funded and the unfunded portions of the exposure and risk-weight the total of the portions. The funded portion would include the principal amount of the loan, and the unfunded portion would include additional features such as negative amortization or a home equity line of credit (HELOC). Risk weights for first-lien residential mortgage exposures would range from 20 percent for LTVs less than or equal to 60 percent, to a risk weight of 150 percent for LTVs greater than 95 percent. Risk weights for junior liens would range from 75 percent to 150 percent. The proposal also gives detailed instructions for calculating the LTV, which includes a deduction from exposure value for loan-level private mortgage insurance. Because the carrying value of the loan will change over time, LTV, risk weights, and required capital would need to be recalculated every period. However, the value of the property would be set at origination (equal to the lesser of the appraised value or purchase price) and could be adjusted only if the loan was restructured.

Pre-sold construction loans – loans for the construction of one- to four-family residences that have been purchased before the actual construction of the house – and statutory multifamily mortgages would be risk-weighted at 50 percent, in accordance with the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991.

Under current rules, risk weights of loans generally do not change if the loan becomes delinquent, with the exception of residential

mortgage loans that are 90 days or more past due. This proposal would risk-weight most exposures that are 90 days or more past due at 150 percent. The agencies seek comment on this change.

Other types of assets will generally be risk-weighted at their current levels.

*Off-Balance-Sheet Items*

Under the current rules, a banking organization generally determines the risk-based asset amount for an off-balance-sheet exposure by applying a credit conversion factor (CCF) to the asset to obtain an on-balance-sheet equivalent and then multiplying that by a risk-weight factor. CCFs range from 0 percent to 100 percent, depending on the terms of the commitment.

This proposal would keep much of this process and the CCFs intact, with a few changes. All commitments with an original maturity of one year or less that are not unconditionally cancelable would receive a 20 percent CCF rather than the current 0 percent. Otherwise, CCFs would remain unchanged by this rule.

Currently, capital is required against any on-balance-sheet exposures that arise from securities financing transactions, such as repurchase agreements or securities lending transactions. This rule would require banks to hold risk-based capital against the full amount of both the on- and off-balance-sheet portions of any securities financing transactions (i.e., a 100 percent CCF would apply to the off-balance-sheet portions).

*OTC Derivative Contracts*

Under the general risk-based capital rules for over-the-counter (OTC) derivative contracts, a bank must hold risk-based capital for counterparty credit risk. Capital is determined by first computing a credit equivalent amount for a contract and then applying to that amount a risk weight based on the obligor, counterparty, eligible guarantor, or recognized collateral. The credit equivalent is computed using the net of the current exposure (mark-to-market value) and the estimate of the future potential credit exposure (PFE).

The proposed rule would define a derivative contract as a financial contract whose value is derived from the values of one or more underlying assets, reference rates, or indices of asset values or reference rates. An OTC derivative contract would be defined as a contract that is not traded on an exchange that requires the daily receipt of a cash-variation margin.

The proposal would retain the current method for determining the exposure amount for single OTC derivative contracts.

Under this proposal, if a bank were to use a netting treatment for multiple OTC derivative contracts – i.e., a bilateral agreement covering the treatment of multiple contracts in the event of default by the issuer – the derivatives would need to be subject to a master netting agreement. This master netting agreement would need to specify the bank's rights to close out all transactions or to liquidate property or collateral in the event of counterparty insolvency.

This rule would now recognize the use of credit derivatives in hedging strategies. Banks that purchase a credit derivative as a credit risk mitigant for an existing exposure would not have to compute a separate counterparty credit risk capital requirement for the derivative.

Equity derivative contracts, however, would be treated as equity exposures. Thus, they would have to use the risk-weighting schedule for equity exposures in risk-based capital computations.

The risk weight applied to OTC derivative exposures is currently equal to the risk weight of the counterparty but is capped at 50 percent, even if the counterparty would otherwise receive a higher risk weight. This proposal would eliminate this cap.

*Credit Risk Mitigation*

Banking organizations use a number of techniques to mitigate credit risks, such as securing third-party guarantees or purchasing credit derivatives; these are called credit risk mitigants (CRMs). In doing so, they reduce the overall riskiness of their portfolios. However, the general risk-based capital rules do not recognize these hedging strategies. This proposal would allow banks to reduce their risk-based capital through credit risk mitigation strategies, provided they have in place appropriate operating procedures and can produce documentation of their activities.

The current rules generally recognize third-party guarantees provided by central governments and other safe institutional lenders. This proposal would recognize a wider range of guarantors. Included now would be most financial institutions, provided their activities were permissible for a financial holding company.

To be recognized under this rule, a CRM would have to meet certain eligibility requirements. These requirements specify that the beneficiary must have a direct claim against the provider and it would be legally enforceable in the event of bankruptcy.

The rule proposes a "substitution" approach for calculating the risk-based capital required for a hedging strategy. If the protection amount of the CRM is greater than or equal to the amount of the hedged exposure, a bank could substitute the risk weight associated with the CRM for the risk weight of the hedged exposure. If the protection amount of the CRM is less than the amount of the hedged exposure, the bank would have to treat separately the protected and unprotected portions of that exposure. The risk weight for the protected portions of the exposure would be equal to the risk weight of the CRM. If multiple CRMs cover a single exposure, the bank must disaggregate the exposure into portions covered by each CRM and must calculate risk-based capital separately for each portion.

The protection amount of a CRM would be equal to the notional amount, less any applicable haircuts for maturity mismatch, lack of restructuring coverage, or currency mismatch. The formulas for computing these haircuts are specified in the proposal.

Also specified in the proposal are methods for recognizing the risk-mitigating impact of financial collateral in many transactions.[20] Banks would be able to use a simple approach, collateral haircut approach, or simple VaR[21] approach to calculating the risk-mitigating effects. The methods for calculating these approaches are specified in the proposal and vary by the type of transaction the collateral protects against.

*Risk-Weighted Assets for Securitization Exposures*

The securitization framework in the proposed rule addresses the credit risk of exposures that involve the tranching of the credit risk of one or more underlying financial exposures. All or substantially all of the securitized exposures must be financial exposures, such as loans, commitments, asset- and mortgage-backed securities, and credit derivatives.

Under the proposed rule, a banking organization would have two methods for calculating the amount of a securitization exposure subject to risk-based capital requirements: a ratings-based approach (RBA) and an approach for exposures that do not qualify for the RBA. The amount of an on-balance-sheet securitization would be the bank's carrying value, less any unrealized gains or plus any realized losses if classified as available-for-sale. The amount of an off-balance-sheet securitization exposure would be the notional amount of the exposure.

Generally, an exposure would qualify for the RBA if it has an external rating from an NRSRO or an inferred rating. Using the RBA, the exposure

[20] Financial collateral includes assets such as cash, gold, investment-grade securities, and convertible bonds.
[21] See footnote 5 for a definition of VaR.

amount would be multiplied by a risk weight ranging from 20 to 350 percent.

Generally, under the proposal, a bank would be required to deduct the exposure amount for securities that are not eligible for the RBA from total capital. However, the proposal specifies several methods for calculating risk-based capital requirements for certain specified securities. One notable specification would require a risk weight of no less than 100 percent for interest-only mortgage-backed securities.

*Equity Exposures*

Under the current risk-based capital rules, a bank must deduct a portion of nonfinancial equity investments from tier 1 capital. Under the proposed rule, a bank would use the simple risk-weight approach for equity exposures that are not exposures to an investment fund. Generally, risk weights would range from 0 to 600 percent, depending on the equity exposure. Exposures to investment funds are treated separately and are subject to their own risk-weighting approaches.

The proposal recognizes hedging strategies for equity exposures. Banks may define hedge pairs and risk-weight the total carrying value of the exposures less the covered value of one of the exposures, rather than the entire carrying value of both. The effectiveness of the hedge would need to be documented and is subject to computations contained in the proposal.

*Other Measures*

Other measures, such as unsettled transactions and operational risk, are also specified. Unsettled transactions would be subject to risk weights that increase with the amount of time since the transaction date. Operational risk would be treated using one of two approaches: either the basic indicator approach or the advanced measurement approach, both of which are specified in the proposal.

**Disclosure Requirements**

The proposal also addresses the third pillar of Basel II: market discipline through public disclosure. The proposed disclosure requirements would apply to the top-tier legal entity that is a banking organization within a consolidated banking group. However, every banking organization within the group would have to disclose total and tier 1 capital ratios and their components. The proposal would require that these disclosures be made quarterly. Required components of the disclosure would include capital structure, capital adequacy, credit risk, counterparty credit-risk-related exposures, securitizations, and operational risk. Specifics of what must be disclosed in these and other required sections are available in the rule.

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**Federal Legislation**

*Insurance Information Act Reported to House Committee on Financial Services*

On July 9, the House Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises approved the Insurance Information Act of 2008 (H.R. 5840). The bill would establish within the Department of the Treasury an Office of Insurance Information, which would collect and disseminate public information on all forms of insurance except health insurance. The office would also be charged with determining federal policy with regard to international insurance matters. Its policies would preempt any state laws that contradict the policies of the office, ensuring consistency in dealing with foreign insurance companies, though states may appeal the preemption decision.

*Bill Would Tax Certain State Banks as Limited Liability Companies*
On July 11, Orrin Hatch (R-Utah), a member of the Senate Finance Committee, introduced a bill (S. 3254) that would amend the Internal Revenue Code, allowing certain state-chartered banks to be taxed at the federal level as limited liability corporations, decreasing their federal tax burden. A qualifying bank would need to be insured by the FDIC and organized as a limited liability company under state law. The law would apply to all taxable years after December 31, 2007. The bill was referred to the Senate Committee on Finance.

*SEC Would Define Asset-Backed Securities Eligible for NRSRO Rating*
On July 14, Gary Ackerman (D-N.Y.), a member of the House Financial Services Committee, introduced a bill (H.R. 6482) that would require the Securities and Exchange Commission (SEC) to define a subset of asset-backed securities that are eligible to receive ratings from nationally recognized statistical rating organizations (NRSROs). The bill sets forth the standards of approval for NRSRO asset-backed securities, which are limited to those whose future performance is "reasonably predictable." The bill would also give the SEC the right to strip credit rating agencies of their NRSRO status if they fail to meet certain eligibility requirements. The bill has been referred to the House Committee on Financial Services.

*Proposed Usury Cap on All Consumer Credit Transactions*
On July 17, Sen. Dick Durbin (D-Ill.) introduced the Protecting Consumers from Unreasonable Credit Rates Act of 2008 (S. 3287). The bill would amend the Truth in Lending Act by capping the annual percentage credit rate that may be charged to a borrower at 36 percent. This amount takes into account all interest, fees, and charges. This would apply to all consumer credit transactions, including payday and auto loans. States would be allowed to set their own stricter standards, if desired. The bill has been referred to the Senate Committee on Banking, Housing, and Urban Affairs.

*House Passes Money Service Business Act; Bill Moves to Senate*
On July 22, the House voted to approve the Money Service Business Act of 2008 (H.R. 4049). The bill would revise federal anti-money-laundering programs that target money service businesses (MSBs), such as check cashers and payday lenders. The bill would require MSBs to file a self-certification with their banks detailing their safeguards against money laundering. As long as these certifications are filed, banks will have no obligation to monitor the MSBs' accounts for illegal activity. The bill has been referred to the Senate Committee on Banking, Housing, and Urban Affairs.

*FHA Risk-Based Pricing and Down Payment Assistance Reform Bill Introduced*
On September 16, the House Committee on Financial Services approved a bill (H.R. 6694) that would undo certain provisions of the recently enacted Housing and Economic Recovery Act of 2008 (Public Law No. 110-289), which took effect on October 1. Under the bill, the Federal Housing Administration (FHA) would be allowed to charge risk-based premiums on FHA-insured mortgage loans to borrowers with low credit scores; such risk-based pricing is prohibited under the recent housing reform law. The bill would also allow certain borrowers to accept mortgage down payment assistance from charitable organizations, which was prohibited under the housing reform law.

**State Legislation**

*Five Bills to Protect Mortgage Borrowers in Pennsylvania Enacted*

On July 8, Gov. Edward Rendell (D-Penn.) signed into law five bills intended to protect mortgage borrowers and reform oversight of the mortgage industry in the state. H.B. 2179 sets forth more stringent licensing standards for mortgage brokers and originators by requiring them to complete training, pass a written test on mortgage laws, and pass a background check before a license is granted. S.B. 483 bars lenders from charging prepayment penalties on mortgages worth less than $217,873, adjusted annually for inflation. S.B. 484 allows the state banking department to release to consumers previously confidential information about enforcement actions against mortgage lenders. S.B. 485 establishes the State Board of Certified Real Estate Appraisers, which is charged with setting licensing standards for appraisers, overseeing their operations, and fining them for misconduct. Finally, S.B. 486 requires that foreclosure notices sent to delinquent homeowners also be sent to county and state officials so they can analyze the state's housing market. It also requires that lenders clearly disclose features such as balloon payments, adjustable interest rates, prepayment penalties, and escrow provisions.

*New Jersey Law to Help Mortgage Borrowers Facing Interest Rate Hikes*

On September 15, Gov. Jon Corzine (D-N.J.) signed into law a bill (A. 2780) that would require mortgage lenders to offer a three-year extension of a low introductory mortgage rate for any borrower facing foreclosure following an interest rate hike. Borrowers will have to continue to make monthly payments and pay the lender any deferred interest because of the extension at the time the property is sold or refinanced. Creditors must also provide written notices to borrowers 60 days and 30 days before an introductory rate resets to a variable rate.

**Federal Regulation**

***Board of Governors of the Federal Reserve***

*Final Rule Amending Regulation Z Issued*

On July 30, the Board of Governors of the Federal Reserve published a final rule intended to improve the regulation of residential mortgage loans by amending portions of Regulation Z, which implements the Truth in Lending Act and the Home Ownership and Equity Protection Act (73, *Federal Register*, pp. 44522-614). For details of the rule, see *Banking Legislation and Policy*, Volume 27, Number 1. Elements of the proposal relating to "yield-spread premiums" were withdrawn from the final rule. The rule will take effect on October 1, 2009.

***Department of Education***

*Plan to Purchase Student Loans from Lenders*

On July 1, the Department of Education released the terms, conditions, and pricing under which it will purchase student loans from lenders in order to ensure the availability of these loans for the upcoming school year (73, *Federal Register*, pp. 37422-51). Lenders who enter into a master agreement with the department will have the opportunity to sell their loans or participation interests in the loans through the Loan Purchase Commitment Program and the Loan Participation Purchase Program.

***Federal Deposit Insurance Corporation***

*Treatment of Covered Bonds in a Conservatorship*

On July 28, the Federal Deposit Insurance Corporation released a final statement describing how investors can access the collateral behind covered bonds if the issuing bank is taken over by the FDIC (*73, Federal Register,* pp. 43754-59). Covered bonds are similar to mortgage-backed securities, except that the mortgages being used as collateral stay on the issuing bank's balance sheet. These bonds are widely used in Europe but have only recently been issued in the United States. The rule applies to covered bond issuances capped at 4 percent of the issuing bank's liabilities.

*Proposal to Expand Record Keeping on Derivatives*

On July 28, the Federal Deposit Insurance Corporation issued for comment a proposed rule that would require troubled banking institutions to establish new record-keeping systems for derivative contracts (*73, Federal Register,* pp. 43635-43). In the event of an FDIC takeover of a failed institution, this record keeping would smooth the FDIC's transition into receivership and speed up analysis of the failed bank's financial and legal obligations. Comments were due on September 26.

***Federal Trade Commission***

*Bear Stearns Settles with FTC over Unlawful Mortgage, Debt Collection Practices*

On September 9, the Federal Trade Commission (FTC) announced that it had reached a settlement with Bear Stearns and a subsidiary, EMC Mortgage Corporation, in which the companies will pay $28 million to settle claims of unlawful mortgage servicing and debt collection practices (*Federal Trade Commission v. EMC Mortgage Corporation,* E.D. Texas, No. 4:08-cv-338, 9/9/08). The FTC complained that the companies violated the FTC act by, among other things, misrepresenting the amounts owed by customers and charging unauthorized fees.

***Office of Thrift Supervision***

*Guidance Issued for Suspending a Home Equity Line of Credit*

On August 26, the Office of Thrift Supervision issued guidance for financial institutions when terminating, reducing, or suspending a home equity line of credit (HELOC), a revolving credit line in which a borrower's home serves as collateral. Regulation Z, which implements the Truth in Lending Act, allows such action under certain circumstances, including if the borrower commits fraud or fails to meet repayment terms or if the value of the property "declines significantly" below the appraised value.

***Securities and Exchange Commission***

*Settlements with Banks over Auction Rate Securities Practices*

Over the course of the quarter, the Securities and Exchange Commission, in conjunction with New York state's attorney general, reached settlements with several banks, including Citigroup, UBS, Morgan Stanley, JPMorgan Chase, Wachovia, Bank of America, and Credit Suisse, following investigations into alleged fraud on the part of the banks regarding their marketing of auction-rate securities since 2007. Even though the markets for such securities had begun to dry up because of the national credit crunch, the banks allegedly continued marketing the securities to investors as being highly liquid, constituting fraud. The settlements will require the banks to redeem securities at par to their investors and pay penalties to the government. Investigations into similar practices at Goldman Sachs, Fidelity, and Merrill Lynch are ongoing.

**Judicial Rulings**

***Circuit Court Rulings***

*Auto Lenders Protected on Rollover Financing for Trade-Ins in Case of Bankruptcy*

On August 6, the U.S. Court of Appeals for the Eleventh Circuit ruled that the bankruptcy code protects auto lenders that finance amounts still owed on trade-in vehicles (*Graupner v. Nuvell Credit Corporation (In re: Stephen Michael Graupner)*, 11th Cir., No. 07-13657, 8/6/08). The defendant traded in a vehicle on which he still owed payments for a new vehicle and had the amount remaining on the loan for the old car rolled into the loan for the new car. When he later filed for bankruptcy, he argued that the portion of the loan from his old car should be treated differently from the rest of the loan. The court disagreed, saying that the rollover financing was part of a larger transaction, and that the borrower cannot isolate the rollover amount in an attempt to reduce the amount owed in bankruptcy.

*Investment Bank Had No Obligation to Advise Investors on Hedging Strategies*

On August 19, the U.S. Court of Appeals for the Seventh Circuit ruled that an investment bank had no fiduciary obligation to advise the shareholders of one company in a merger deal on how to hedge their losses in the event that the shares they were to receive from the transaction lost value (*Joyce v. Morgan Stanley*, 7th Cir., No. 07-1992, 8/19/08). The court ruled that Morgan Stanley would have been obliged to provide such advice only if it had accepted an extra-contractual duty, but that the evidence clearly showed Morgan Stanley had neither offered nor accepted such a duty.

*OTS Regulation Preempts Ohio Mortgage Law*

On August 22, the U.S. Court of Appeals for the Sixth Circuit ruled that State Farm Bank FSB, a federally chartered mortgage unit of State Farm Mutual Automobile Insurance Co., could offer mortgages through insurance agents in Ohio without being subject to the Ohio Mortgage Broker Act, because that law is preempted by an Office of Thrift Supervision rule (*State Farm Bank FSB v. Reardon*, 6th Cir., No. 07-4260, 8/22/08). This extends the preemption decision from *Watters v. Wachovia Bank N.A.*, 127 S. Ct. 1559 (2007), which established that it is the banking activity being regulated rather than the entity being regulated that matters for preemption purposes. This decision rules that for purposes of regulation and preemption, it does not matter if the activity is performed by a subsidiary of a banking institution or the bank itself.

*Credit Card Customer Waived Right to Class Action Under Contract*

On September 9, the U.S. Court of Appeals for the Eighth Circuit ruled that a credit card customer will have to arbitrate her complaints against American Express on an individual basis (*Pleasants v. American Express Co.*, 8th Cir., No. 07-3235, 9/9/08). The court ruled that the clause in her contract requiring disputes to be worked out in arbitration was not unconscionable, because in this case the recovery of attorney's fees, costs, and statutory damages would likely exceed the cost of pursuing the claim. Therefore, a class action suit to split costs was unnecessary.

*Assignees Can Enforce Arbitration Clauses Even If Debts Are Extinguished*

On September 23, the U.S. Court of Appeals for the Eighth Circuit ruled that an assignee of a contract with an arbitration clause can force a debt dispute to be resolved in arbitration, even if that debt was satisfied before the contract was assigned (*Koch v. Compucredit Corporation*, 8th Cir., No. 07-1948, 9/23/08). The plaintiff had settled a credit card account that was subsequently bought by the defendant, who tried to force arbitration on

the amount still owed. The court ruled that because the contract steered both parties to arbitration, both were obligated to follow that contract regardless of the previous settlement.

*Class Action Mortgage Rescissions Barred Under TILA*
On September 24, the U.S. Court of Appeals for the Seventh Circuit ruled that class suits for mortgage rescission are barred under the Truth in Lending Act (TILA) (*Andrews v. Chevy Chase Bank*, 7th Cir., No. 07-1326, 9/24/08). The court ruled that the TILA makes no mention of rescission – in which the lender returns all interest and fees to the borrower – as eligible for class suits. Furthermore, because every claim for rescission is such a highly individualized proceeding, it makes no sense to allow class suits, since each plaintiff would need individual attention anyway.

***District Court Rulings***
*Court Faults NCUA over Membership Decision*
On July 21, the U.S. District Court for the Middle District of Pennsylvania overturned an approval by the National Credit Union Administration (NCUA) for Members First Credit Union to extend its credit-union charter to cover six counties in south-central Pennsylvania (*American Bankers Association v. National Credit Union Administration*, M.D. Pa., No. 1:05-CV-2247, 7/21/08). The judge agreed with the American Bankers Association's argument that the new geographical area does not meet the necessary qualification for a credit union of a "well-defined community," and that the NCUA willfully ignored evidence against the expansion in granting its approval.

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