



BANKING LEGISLATION & POLICY

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HIGHLIGHTS

This issue contains detailed descriptions of [domestic responses to the financial crisis](#), [international responses to the financial crisis](#), and [developments in accounting](#).

In addition, it summarizes [other notable legislative, regulatory, and judicial developments that occurred during the fourth quarter of 2008](#).

DOMESTIC RESPONSES TO THE FINANCIAL CRISIS

As the U.S. economy has slid into a recession, financial and housing markets have been hit especially hard. The regulatory responses to the financial crisis continued to multiply this quarter.

Treasury Uses TARP Funds to Inject Capital into Banks, Auto Industry

The Troubled Asset Relief Program (TARP) was created on October 3 as part of the Emergency Economic Stabilization Act (EESA) of 2008 ([Public Law No. 110-343](#)). TARP, administered by the Department of the Treasury's new Office of Financial Stability, was originally designed to purchase up to \$700 billion in mortgage-related assets from banks in an attempt to inject liquidity into the financial system, relieve banks from impaired mortgage-backed assets, and shore up public confidence in the banking system.¹ Over the

course of the fourth quarter, TARP methods and objectives have been adjusted to account for changing conditions in financial markets, most significantly through the creation of the Capital Purchase Program.

The Treasury has already received \$350 billion to fund TARP acquisitions.² On January 12, the White House requested that Congress release the final \$350 billion of TARP funds to the Treasury, as required by the EESA. Congress had up to 15 days to deny the request. On January 15, the Senate voted down a resolution ([S.J.RES.5](#)) that would have denied the release of the funds, thus ensuring that the full \$700 billion will be made available to the Treasury.

Capital Purchase Program Established

In addition to purchasing mortgage-related assets, the law gives TARP the ability to purchase

¹ For more information on TARP and the Emergency Economic Stabilization Act of 2008, see [Banking Legislation and Policy, Volume 27, Number 3](#).

² On January 5, the Treasury released a [report detailing its TARP distributions](#) through December 31. The *New York Times* keeps an updated [list of approved and pending applicants for TARP funds](#).

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. Before TARP could begin to purchase any mortgage-related assets, the Treasury decided to use this power and inject capital directly into financial institutions.

On October 14, reacting to a recent drastic tightening of credit standards throughout the banking industry, the Treasury announced that TARP would [create the Capital Purchase Program](#) (CPP). The CPP was initially authorized to purchase up to \$250 billion in senior preferred shares from financial institutions that had enrolled in the program.

Publicly held U.S. banks, savings associations, and certain bank and savings and loan holding companies that engage only in financial activities were eligible to enroll by November 14. The minimum subscription amount was 1 percent of the institution's risk-weighted assets, and the maximum was the lesser of \$25 billion or 3 percent of risk-weighted assets.

The senior preferred shares purchased by the Treasury, which are nonvoting, qualify as tier 1 capital and rank senior to common stock. The shares 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 received 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 is 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 agreed to adopt the Treasury's standards for executive compensation and corporate governance for the duration of the

Treasury's investment, as laid out in section 111(b) of the EESA.³

Nine large institutions enrolled almost immediately, splitting the first \$125 billion between them.

SEC, FASB Allow Banks to Treat Warrants as Equity for Accounting Purposes

On October 24, the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) stated in a [letter to the Treasury](#) that warrants for preferred stock issued by firms to the Treasury in exchange for TARP funds could be classified as permanent equity under generally accepted accounting principles. This reading allows a firm to avoid recording a liability for these warrants. However, in order to perform this accounting, the firm must have on hand enough shares to cover a claim for stock if the warrant is ever exercised.

Expansion to Privately Held Banks

On November 17, the Treasury announced that it would increase the number of financial institutions eligible to receive TARP funds, [extending the CPP to firms that are not publicly traded](#). New eligible institutions include U.S. bank holding companies, thrift holding companies, banks, and thrifts that are not publicly traded. However, companies organized as Subchapter S corporations or in mutual form are explicitly excluded from the extension. Firms had until December 8 to submit their applications for enrollment in the program.

Conversions to Bank Holding Companies

In response to troubled credit markets and changes in TARP rules, several companies converted to bank holding companies this quarter. These moves expand their options for raising capital and give them access to TARP funds.

³ For a discussion of these provisions, see [Banking Legislation and Policy, Volume 27, Number 3](#).

On November 10, the Federal Reserve [approved status changes](#) for American Express Co. and American Express Travel Related Services Co. Inc. to become bank holding companies on conversion of American Express Centurion Bank from an industrial loan company to a bank. The companies will also retain American Express Banks FSB, a federal savings bank. The Fed approved the conversion five days after the application was submitted, waiving the typical one-month review because of emergency conditions in financial markets. On December 23, American Express announced that it had entered into an [agreement with the Treasury](#) to receive \$3.39 billion in TARP funds through the CPP.

On December 22, the Federal Reserve [approved the CIT Group's application](#) to become a bank holding company. On December 23, CIT announced that it had entered into an [agreement with the Treasury](#) to receive \$2.33 billion in TARP funds through the CPP.

Automotive Industry Financing Program

The U.S. auto industry has been hit particularly hard by the broad economic downturn. Decreased consumer spending and tightening credit conditions have combined to cause a precipitous drop in auto sales, down nearly 20 percent from 2007. The three largest U.S. auto makers – General Motors Corp., Ford Co., and Chrysler LLC – have had to seek emergency aid from the government as their capital supplies have dwindled.

On December 19, President Bush approved a plan to provide GM and Chrysler with up to a combined \$17.4 billion in TARP funds through a new Automotive Industry Financing Program (AIFP). Ford did not request any emergency funds. Chrysler has [received \\$4 billion in AIFP funds](#). GM is eligible to [receive \\$13.4 billion in AIFP funds](#) distributed in three installments in December, January, and February; \$9.4 billion has already been invested in GM, but distribution of the

February installment of \$4 billion is contingent on Congress approving the release of the final \$350 billion of available TARP funds. The announcement followed the December 11 failure in the Senate of emergency legislation that would have provided a bailout to the companies separate from TARP.

The plan to provide TARP funds to the companies comes with strings attached. The companies are required to use the funds to “become financially viable” by March 31, 2009, or else the loans will be called. A firm will be considered viable if it has a positive net present value and can fully repay the government’s loan. The firms are required to reduce their unsecured debt by two-thirds via a debt for equity exchange and alter their labor contracts to make work rules and wages competitive with those of U.S. plants operated by foreign auto manufacturers.

On December 24, the Federal Reserve [approved GMAC Financial Service's application](#) to become a bank holding company, GMAC LLC. GMAC is the financial affiliate of General Motors Corp. The approval comes with the caveat that GM and Cerberus Capital Management LP, which hold 49 percent and 51 percent of the company, respectively, reduce their stakes in GMAC. On December 29, GMAC announced that it had entered into an [agreement with the Treasury](#) to receive \$5 billion in TARP-AIFP funds. In addition, the Treasury agreed to lend GM \$1 billion in TARP-AIFP funds to allow it to participate in a rights offering by GMAC to support its reorganization.

On January 16, the Treasury announced that it would [loan \\$1.5 billion](#) through the TARP-AIFP to a new special-purpose entity (SPE) created by Chrysler Financial, the lending affiliate of Chrysler LLC. The five-year loan will pay an interest rate of the one-month LIBOR plus 100 basis points for the first year, and then reset to the one-month LIBOR plus 150 basis points for the next four years. The SPE will issue warrants to the Treasury worth 5 percent of the loan. The notes will vest 20 percent

on the closing date and 20 percent every year thereafter. Chrysler Holding will serve as guarantor for the loan, which will be secured by senior secured interest in a pool of new auto loans.

Congress Seeks to Increase Restrictions on Uses of TARP Funds

On October 24, PNC Financial Service Group Inc. announced [plans to buy National City Corp.](#), a financial holding company, for \$5.2 billion worth of PNC stocks (and \$384 million of cash for certain warrant holders), partially funded by capital obtained through the CPP. With this announcement, PNC became the first bank to propose using some of the TARP funds it received for acquiring weaker financial institutions. Other banks subsequently hinted that they too would use TARP funds to acquire smaller banks.

The White House and congressional leaders have complained that the use of TARP funds for such purposes is at odds with the spirit of the EESA. They have stated that if the Treasury is not going to purchase mortgage-related assets directly, then the TARP funds should be used by banks to boost lending and assist distressed mortgage borrowers.

On January 9, House Financial Services Committee Chairman Barney Frank (D.-Mass.) introduced a bill ([H.R. 384](#)) that would place restrictions on the future use of any TARP funds. Under the bill, the Treasury would be required to commit at least \$100 billion of the remaining funds to foreclosure mitigation programs. The bill would also bar the use of TARP funds for the acquisition of healthy financial institutions, expand federal oversight of financial institutions receiving TARP funds, revise the HOPE for Homeowners Act, and make permanent the FDIC's increase in deposit coverage to \$250,000. The bill was passed by the House on January 21 and referred to the Senate Committee on Finance.

Assistance Package for Citigroup

On November 23, the Federal Reserve, FDIC, and Treasury [announced that they would assist Citigroup](#) by agreeing to provide a package of guarantees, liquidity access, and capital to the financial institution. The plan was [finalized](#) on January 16.

Citigroup, one of the nation's top three financial institutions by total assets, with nearly \$200 billion in U.S. deposits and \$2.1 trillion in total assets, had seen the value of its stock plunge more than 50 percent in the previous three trading days, which amounts to a 90 percent drop from its November 2007 value. These losses came as the company reported four consecutive quarters of losses totaling more than \$20 billion.

The government's actions provide a backstop for Citigroup against future losses and inject needed capital into the bank. The Treasury and FDIC will provide protection for an asset pool of approximately \$306 billion in loans and securities backed by residential and commercial real estate and other such assets. Citigroup will be responsible for covering 100 percent of the first \$29 billion in losses from this pool. The government would cover 90 percent of any losses beyond that amount, with the Treasury covering up to the next \$5 billion in losses, and the FDIC up to the next \$10 billion. The Federal Reserve would act as a final backstop and cover any further losses in the form of a nonrecourse loan. These guarantees are effective for 10 years for residential assets and five years for nonresidential assets. In return, the Treasury and FDIC will receive warrants for preferred stock worth \$4 billion and \$3 billion, respectively, with an 8 percent dividend rate.

In addition, the Treasury will invest \$20 billion of TARP funds through a new Targeted Investment Program, established specifically to lend to Citigroup. This injection comes in addition to \$25 billion in TARP-CPP funds that Citigroup has already received.

Restructuring Federal Assistance to AIG

Last quarter, the Federal Reserve created a new lending facility to extend up to \$85 billion in credit to American International Group, Inc. (AIG), the world's largest insurance company. AIG was facing insolvency at the time owing to its large exposure to credit default swaps (CDS) – a kind of credit protection insurance contract that AIG provides to others.⁴ The deal saved AIG, but its terms made the Federal Reserve the de facto majority controller of the company.

On November 19, the Board of Governors of the Federal Reserve and the Department of the Treasury announced a [restructuring of the government's financial support to AIG](#). The new measures are designed to establish a more durable capital structure, reduce capital and liquidity pressures on the firm, and improve its ability to sell off some of its assets in an orderly manner.

On November 25, the Treasury agreed to [purchase \\$40 billion in senior preferred stock](#) from the company using TARP funds through a new [Systemically Significant Failing Institutions Program](#) (SSFIP). The stock pays annual dividends of 10 percent. AIG will use proceeds from the sale to pay down \$40 billion in loans from the Fed. This allows the Fed to reduce the amount available through its facility to \$60 billion.

In addition, the Fed changed the terms of its loans to AIG. The interest rate on withdrawn funds was decreased by 550 basis points to the three-month LIBOR plus 300 basis points. The fee on undrawn funds was decreased from 850 to 75 basis points. The length of the facility was also extended from two to five years.

The Fed also created two new facilities relating to AIG. In the first, the Federal Reserve Bank of New York will lend \$22.5 billion to a new limited liability company (LLC) that will purchase residential mortgage-backed securities from AIG's

U.S. securities lending collateral portfolio. AIG will make a \$1 billion subordinated loan to the LLC and will assume the first \$1 billion in losses on the portfolio. With the creation of the facility, another \$37.8 billion facility that was opened to AIG on October 8 will be repaid and terminated.

In the second new facility, the New York Fed will lend \$30 billion to a new LLC that will purchase multisector collateralized debt obligations (CDOs) on which AIG has written CDS. AIG will make a \$5 billion subordinated loan to the LLC and will shoulder the first \$5 billion in losses. As the CDOs are purchased, the CDS counterparties will work with AIG to unwind the corresponding CDS transactions.

Both facilities' loans will be secured by their assets, which will be repaid with the cash flows from them and from their sale. The New York Fed and AIG will share any residual cash flows after the loans are repaid.

Treasury Extends Temporary Guarantee of Money Market Funds

On November 24, the Treasury announced that it would [extend its temporary guarantee program for money market funds](#) through April 30, 2009, in order to promote continued stability and investor confidence in these funds. The original program was enacted on September 29, 2008, with an original term of three months.⁵ Only money market funds already eligible for the program were able to apply for the extension, and needed to have done so by December 5.

The fee for the extension was based on the fund's net value as of September 19. Funds with a share price between \$0.9975 and \$1 were charged 1.5 basis points per share outstanding. Funds with a share price between \$0.995 and \$0.9975 were charged 2.2 basis points per share. Funds with a share price less than \$0.995 or greater than \$1 were never eligible for the guarantee program.

⁴ For more information on AIG, CDS, and the original terms of the Fed's lending facilities, see [Banking Legislation and Policy, Volume 27, Number 3](#)

⁵ See [Banking Legislation and Policy, Volume 27, Number 3](#) for information about the guarantee program.

Federal Reserve Actions

Money Market Investor Funding Facility Created

On November 24, the Federal Reserve began [operating its new Money Market Investor Funding Facility](#) (MMIFF), which supports a private-sector initiative to provide liquidity to U.S. money market fund investors. Short-term debt markets had been strained prior to the announcement of the facility on October 21. Money market funds and other investors had been increasing their liquidity positions and investing in overnight assets. The goal of the MMIFF and the initiative is to increase confidence among money market funds that they will not sacrifice liquidity by holding slightly longer-term investments.

The Federal Reserve Bank of New York will provide funding through the MMIFF to a series of special purpose vehicles (SPVs) to finance the purchase of certain money market instruments from eligible investors. The MMIFF will provide 90 percent of the purchase price of the instruments to the SPVs. The SPVs will sell asset-backed commercial paper to raise the remainder of their funding. In total, the SPVs will be authorized to purchase up to \$600 billion in eligible assets.

On January 7, the Board of Governors of the Federal Reserve announced [two changes](#) to the MMIFF. First, the set of eligible institutions was expanded beyond just money market mutual funds to include more money market investors, including U.S.-based securities-lending cash-collateral reinvestment funds, portfolios, and accounts, and U.S.-based investment funds that operate similarly to money market funds, such as local government investment pools, common trust funds, and collective investment funds.

Second, the Fed adjusted several of the economic parameters of the MMIFF, including changes to the definition of eligible instrument yield spreads. Eligible instruments include dollar-denominated certificates of deposit, bank notes, and commercial paper from highly rated financial institutions, all with a remaining maturity between

seven and 90 days. Assets must have at least a 60-basis-point spread above the [discount window's primary credit rate](#) at the time of purchase by the SPV and a credit rating of at least A-1/P-1/F1.

Commercial Paper Funding Facility Created

On October 27, the Federal Reserve [launched its new Commercial Paper Funding Facility](#) (CPFF), which provides a liquidity backstop to U.S. issuers of commercial paper, including those with a foreign parent. The facility was announced on October 7 as increasing liquidity pressure on commercial paper investors, particularly on money market mutual funds, reduced demand for commercial paper. This in turn led to decreased volume in commercial paper issuance; high interest rates, especially at longer maturities; and an increasing need for issuers to refinance every day.

The CPFF purchases three-month dollar-denominated commercial paper – both unsecured and asset-backed types – directly from eligible issuers through an SPV, increasing liquidity in the markets. The CPFF also decreases the risk to issuers of being unable to roll over their maturing commercial paper, leaving them incapable of repaying their investors. The increased liquidity and decreased risk that the CPFF provides is intended to unfreeze the commercial paper markets.

Funding for the SPV will come from the CPFF through the Federal Reserve Bank of New York, which will be secured by all assets held by the SPV. The commercial paper purchased must be rated at least A-1/P-1/F1. There is no limit on the total amount of commercial paper that may be purchased, but the purchasing limit for each individual issuer is set at the greatest amount of U.S. dollar-denominated commercial paper the issuer had outstanding between January 1 and August 31, 2008. At the time of its registration to use the CPFF, each issuer must pay a facility fee equal to 10 basis points of this purchase limit.

The price the SPV pays for the paper is the face value, discounted by the then-current three-month overnight index swap (OIS) rate, plus a spread. The spread is 100 basis points for unsecured commercial paper and 300 basis points for asset-backed commercial paper. There is an additional surcharge of 100 basis points per annum for unsecured paper. The discount rates will be announced daily.

As of January 7, the SPV had [net portfolio holdings](#) of \$334.4 billion. The SPV will cease purchasing commercial paper on April 30, 2009, unless the Board extends the facility.

Creation of Term Asset-Backed Securities Loan Facility

On November 25, the Board of Governors of the Federal Reserve [created a new Term Asset-Backed Securities Loan Facility](#) (TALF) that is designed to increase credit availability by facilitating issuance of consumer and small business asset-backed securities (ABS). The facility is expected to commence lending in February 2009, [“contingent on completion of the work necessary to operationalize it.”](#)

Under the TALF, the Federal Reserve Bank of New York is authorized to lend up to \$200 billion on a nonrecourse basis to holders of certain AAA-rated ABS backed by newly originated consumer and small business loans, including student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration. Originators of the credit exposures underlying eligible ABS must have agreed to comply with the executive compensation requirements in section 111(b) of the EESA. The amount of each loan will be equal to the market value of the ABS, less a small profit (“haircut”) that has yet to be determined. The Treasury also pledged \$20 billion of credit protection to the Fed through TARP funds.

Initially, the loans were to have a maturity of one year and would be sold using an auction

format. However, on December 19, the Board released [revised terms and conditions for the TALF](#). Loans will now have a three-year maturity and will be available to all eligible borrowers with suitable collateral. Further changes to the terms of the facility prior to its opening have not been ruled out. The facility will cease making new loans on December 31, 2009, unless the Board agrees to extend the facility.

Federal Reserve to Purchase Mortgage-Related Assets

On November 25, the Federal Reserve announced that it will [initiate a program](#) to purchase both direct obligations of government-sponsored enterprises (GSEs) and mortgage-related assets they have backed. In the first stage of the program, \$100 billion of direct debt obligations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks were purchased through competitive auctions.

In the second stage of the program, the Fed will [purchase up to \\$500 billion in mortgage-backed securities](#) (MBS) from Fannie Mae, Freddie Mac, and Ginnie Mae by the end of the second quarter of 2009. Purchasing is expected to begin in January 2009. The program’s managers will adjust their purchasing prices based on input from investment managers about market conditions and the economic impact of the program.

The combination of these programs is intended to boost liquidity in the MBS market and increase capital at the GSEs, allowing them to increase lending and help support the struggling housing market. It should also help to decrease rate spreads on GSE debt, which will allow them to purchase mortgages from banks at higher prices, bringing down residential mortgage loan rates.

Federal Reserve Pays Interest on Bank Reserves

On October 9, the Federal Reserve amended Regulation D to begin [paying interest on banks’ required and excess reserve balances](#). This

authority was originally enacted in the Financial Services Regulatory Relief Act of 2006 ([Public Law No. 109-351](#)), with an original effective date of October 1, 2011. EESA accelerated the effective date. This action is intended to give the Fed a wider scope for using its other lending programs while maintaining the federal funds rate near its target. Initially, the Fed paid interest on required reserves at a rate equal to the targeted federal funds rate less 10 basis points; interest on excess reserves was paid at the targeted federal funds rate less 75 basis points.

On November 6, the Fed [adjusted its formulas for calculating interest rates](#). Now, the rate on required reserve balances is set at the average targeted federal funds rate over the reserve maintenance period (typically one to two weeks, depending on the size of the institution). The rate on excess reserve balances is equal to the lowest targeted federal funds rate in effect during the period. The Fed judged that this change would help foster trading in the funds market at rates closer to the targeted rate.

FDIC Initiatives

Deposit Insurance Fund Rates Increased

On December 19, the Board of the Federal Deposit Insurance Corporation (FDIC) issued a final rule to uniformly increase assessments for the deposit insurance fund (DIF) by seven basis points for the first quarter of 2009 ([73, Federal Register, pp. 78155-62](#)). This increase implements the first stage of a DIF restoration plan, published by the FDIC on October 16.⁶

Annual rates for institutions deemed sound now range from 12 to 14 basis points. Riskier institutions will pay rates equal to 17, 35, or 50 basis points, depending on their assessed risk categories.

This action comes as the DIF has been depleted this year due to an unusually high

number of bank closures. By law, the FDIC must enact a restoration plan whenever the DIF reserve ratio falls below 1.15 percent. Over the course of 2008, the reserve ratio dropped from 1.19 percent to 0.76 percent.

Mortgage Modification Plan for Distressed Borrowers

On November 14, the FDIC outlined a proposal to [promote affordable loan modifications](#) for distressed homeowners carrying unaffordable mortgages. The FDIC estimates that this program, if broadly enacted, could be applied to roughly 2.2 million troubled loans.

The program would be limited to loans secured by owner-occupied properties that are at least two months delinquent. Through interest rate reduction, extension of term, and principal forbearance, modifications would seek to put borrowers into long-term, low-rate mortgages with debt-to-income ratios as low as 31 percent. Loan servicers would be paid \$1,000 to cover the expense of the modification. Some provisions would also provide for up to 50 percent loss-sharing between the FDIC and the servicers if the mortgage should subsequently re-default. This loss-sharing agreement would not be available if the borrower were to fail to make his first six months of payments, if the modification would not reduce monthly payments by at least 10 percent, or if the loan-to-value ratio were greater than 150 percent.

The FDIC projects the cost for this program to be \$24.4 billion, assuming a conservative 33 percent re-default rate on modified loans. The FDIC cannot enact this program on its own because it lacks funding.

The proposed program is modeled on one the FDIC implemented for customers of IndyMac Bank, which was placed under control of the FDIC when it became insolvent in July. As of mid-December, the FDIC has already modified more than 7,500 IndyMac mortgages.

⁶ See [Banking Legislation and Policy, Volume 27, Number 3](#) for a discussion of the DIF restoration plan.

Final Rule Issued on Temporary Liquidity Guarantee Program

On November 21, the FDIC approved a final rule ([73, Federal Register, pp. 72244-73](#)) on its Temporary Liquidity Guarantee Program (TLGP), revising its October 23 interim rule. The TLGP has two functions. First, it guarantees newly issued senior unsecured debt from banks, thrifts, and certain holding companies. Second, it provides full coverage of non-interest-bearing deposit transaction accounts. The goal of the program is to decrease the cost of bank funding and restore confidence in the banking sector. The interim rule was discussed in [Banking Legislation and Policy, Volume 27, Number 3](#).

There are several changes to the program from the interim rule that incorporate many of the comments the FDIC received. First, the debt guarantee for banks will be triggered by default on payments rather than by bankruptcy. The FDIC will not cover any debt with a maturity of less than 30 days, and the fees charged to banks for the service will be based on the length of maturity. Banks will be charged 50 basis points for debt up to 180 days, 75 basis points for debt from 180 days to a year, and 100 basis points for debt of one year or longer.

The final rule maintains full coverage to participating institutions of customers' non-interest-bearing transaction accounts for an annual fee of 10 basis points. In addition, coverage has been extended to interest on lawyers trust accounts (IOLTAs), and to negotiable order of withdrawal (NOW) accounts with interest rates of less than 0.5 percent. IOLTAs – pooled funds transferred to a lawyer by a third-party on behalf of a client – were included because any interest earned on the accounts is donated to charities. NOW accounts were included because they are technically transaction accounts and earn very little interest.

Banks had until December 5 to opt out of the TLGP coverage. Banks that opted out will not be able to rejoin the program in the future. A list of

banks opting out can be found at the FDIC's [website](#). All guarantees and coverage will expire after June 30, 2012.

Troubled Institutions Must Report on Qualified Financial Contracts

On December 19, the FDIC issued a final rule that requires troubled financial institutions to regularly provide the FDIC with information on qualified financial contracts (QFCs) beginning January 21, 2009 ([73, Federal Register, pp. 78162-73](#)). The goal of the program is to make it easier for the FDIC to unravel these contracts should the institutions fail and be placed in FDIC receivership.

QFCs under the Federal Deposit Insurance Act include securities, commodity and forward contracts, and repurchase and swap agreements. Institutions deemed troubled will have to report to the FDIC on the types of QFCs, counterparties and their affiliates, notional amounts and net positions of the QFCs, purposes of the QFCs, maturity dates, and pledged collateral.

Actions at Government-Sponsored Enterprises Capital Requirements Suspended at GSEs

On October 9, the Federal Housing Finance Agency (FHFA) [announced that it would suspend capital requirements](#) for government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac for as long as the firms remain under the control of the federal government. The FHFA decided that federal conservatorship of the firms decreases their risk of defaulting, freeing them from the need to increase their capital reserves.

The FHFA has classified Fannie Mae and Freddie Mac as undercapitalized using its discretionary authority provided in the Housing and Economic Recovery Act of 2008.⁷ Although both firms met the FHFA and statutory requirements for capital as of June 30, 2008, they

⁷ For more information on the Housing and Economic Recovery Act of 2008, see [Banking Legislation and Policy, Volume 27, Number 2](#).

were deemed to have been undercapitalized because of continued deterioration in their safety and soundness since then.

Proposed Rule to Reduce Capital Requirements for Banks Holding GSE Debt

On October 24, the Office of the Comptroller of the Currency (OCC), the Federal Reserve, the FDIC, and the Office of Thrift Supervision (OTS) issued a joint proposed rule that would reduce the risk weighting for banks to all credit exposures to Fannie Mae and Freddie Mac ([73, Federal Register, pp. 63656-62](#)). The risk weight would be reduced from 20 percent to 10 percent for all credit exposures, such as senior and subordinated debt and counterparty risk credit exposures. It would not apply to stock holdings in the companies. The agencies argue that the credit risk associated with the GSEs has decreased since the government took control of the firms in September, lessening the need to hold capital against their debt. Comments on the proposal were due on November 8.

GSE Efforts to Avoid Foreclosures

Streamlined Modification Program Adopted by GSEs

On December 18, [Fannie Mae](#), [Freddie Mac](#), HOPE Now, and 27 other mortgage servicers adopted a November 11 [FHFA proposal](#) implementing a streamlined modification program (SMP) that will help reduce preventable foreclosures among borrowers most at risk of foreclosure. The FHFA hopes as well that the SMP will become an industry standard used by other servicers.

The SMP will work to reduce total monthly payments, including taxes, insurance, and fees, to an amount equal to 38 percent of household gross monthly income. Changes to mortgage terms can include extending the length of the loan, reducing the interest rate to as low as 3 percent, and forbearing on a portion of the principal that will be repaid via a “balloon payment” when the loan

matures, is paid off, or is refinanced. The principal value of loans will not be written down, but payments may be delayed until the end of the loan period.

The program will be available to borrowers with mortgages on one-unit owner-occupied primary residences owned or insured by Fannie or Freddie that are at least 90 days delinquent. Both conforming conventional and jumbo conforming loans are eligible, but the current mark-to-market loan-to-value ratio must be greater than or equal to 90 percent.

The SMP was inspired in part by the FDIC’s mortgage modification plan, which it has been pioneering with IndyMac customers (see [above](#)).

On November 20, Fannie Mae and Freddie Mac announced that they would [suspend loan foreclosure activities from November 26 to January 9](#) in order to give servicers time to work out loan modifications and to give themselves time to implement the SMP. Foreclosure and eviction proceedings were halted during this time. On January 8, this moratorium was extended through January 31.

Fannie Mae Announces Early Workout, Servicer Flexibility Initiatives

On December 8, Fannie Mae announced a series of [actions designed to avoid foreseeable foreclosures](#). These actions build on the SMP, applying to even more homeowners.

The servicer flexibility initiatives are designed to help borrowers before they become delinquent or default on their mortgages. Under Fannie Mae’s early workout program, borrowers who are current on their loans but for whom default is “reasonably foreseeable” will be able to initiate a mortgage modification program. If the borrower makes all payments on time during a trial period, then the modified terms of the loan will become permanent.

Servicers will also be able to offer borrowers longer-term forbearance and repayment plans. The

maximum period of forbearance (when payments are suspended or reduced) has been increased from six months to 12 months. The maximum length of a repayment plan (when the borrower makes additional payments over a period of time to bring the loan current) has been extended from 18 months to 36 months.

Modifications to HOPE for Homeowners Program

On November 19, the Federal Housing Administration (FHA) announced that the HOPE for Homeowners (H4H) board of directors [approved changes to the program](#) that will relax some of its terms. H4H was established under the Housing and Economic Recovery Act of 2008 ([Public Law No. 110-289](#)), described in detail in [Banking Legislation and Policy, Volume 27, Number 2](#). These changes to the program are designed to make it more attractive to mortgage lenders and borrowers, who have complained that the requirements for the program are too demanding to make it practical.

Originally, lenders had been required to write down the mortgage to 90 percent of its value to obtain an H4H loan. Now, the lenders will only have to write down the mortgage to 96.5 percent of its value.

Another problem with the program has been its requirement that subordinate lien holders relinquish their claims to the loan and receive only a small payment when the property was sold. However, volatility in housing markets and the long time horizon for home sales made this unattractive to the subordinate lien holders. H4H will now offer subordinate lien holders an immediate payment in exchange for releasing their liens.

Finally, the length of the new mortgage may be extended to as long as 40 years, provided that the borrower meets all of the H4H's standard criteria. Previously, only 30-year loans had been available.

The HOPE for Homeowners program began on October 1, 2008, and will end on September 30, 2011.

INTERNATIONAL RESPONSES TO THE FINANCIAL CRISIS

This quarter saw the turbulence in U.S. financial markets, which began in 2007, spread across the globe. In response, many governments and central banks acted aggressively to control the damage caused by this economic downturn. Countries have increased their guarantees of bank deposits in an effort to shore up consumer confidence in the banking system and prevent runs. Nations are also injecting large amounts of capital into banks to ensure that they are solvent and to increase lending.

European Union

Increases in Bank Deposit Guarantees

As the financial crisis began to spread, European governments raised their deposit guarantee limits in order to boost consumer confidence in the banking system. On September 20, Ireland became the first EU country to announce that it would [raise its deposit guarantee limits](#), from €20,000 to €100,000. Ireland announced [further backstops for six large banks](#) on September 30, guaranteeing 100 percent of their deposits and all of their covered bonds, senior debt, and subordinated debt. Over the next two weeks, 19 other EU member nations [increased their deposit guarantees](#). New coverage limits differed in each country, ranging from €50,000 per customer to unlimited guarantees of all deposits.

In order to reduce arbitrage opportunities through deposit guarantees, on October 15 finance ministers of the European Union agreed to immediately [raise the minimum level for bank deposit account guarantees](#) in all EU countries from €20,000 to €50,000. Additionally, the agreement requires that minimum guarantees must be raised

in the next year by each member to at least €100,000.

Enhancing Bank Liquidity United Kingdom

The United Kingdom was one of the first EU nations to act aggressively to support its financial sector, and the measures it has taken have influenced the reactions to this crisis of many other countries, including the United States.

On April 21, 2008, the Bank of England (BOE) launched a [Special Liquidity Scheme](#) (SLS) that allowed banks, for a fee (based on the spread between three-month LIBOR and the three-month general collateral gilt repo rate), to temporarily swap their AAA-rated RMBS and other asset-backed securities with the BOE in exchange for U.K. Treasury bills for up to three years. Just as in the U.S., markets for these securities had disappeared, making it hard for banks to raise funds by selling the securities or pledging them as collateral for loans. The scheme was initially scheduled to end on October 21, but the bank decided to [extend the drawdown period until January 30, 2009](#). At this time, the [SLS had lent £185 billion in U.K. Treasury bills](#) in exchange for £242 billion in RMBS and residential mortgage covered bonds as collaterals. Even though the drawdown period has ended, the scheme will remain in place for the next three years.

Following further tightening of interbank lending markets, on October 3 the BOE [announced that it would widen the collateral](#) it would accept for its weekly three-month sterling repurchase auctions (repos).⁸ Typically, only high-grade government bonds from the United Kingdom, United States, or European Economic Area have

been eligible to be exchanged for cash through these operations. However, the BOE will now accept AAA-rated asset-backed securities backed by student loans, consumer loans, and auto loans; and commercial mortgage-backed securities originated from companies in the U.K., U.S., and European Economic Area (EEA). The bank also announced that in order to further increase liquidity it would increase the funds offered at its October 7 repo auction to £40 billion.

When interbank lending did not pick up as expected following these actions and an [increase in deposit coverage](#) on October 3, the U.K. Treasury announced on October 8 that it would [inject £50 billion into the financial system](#) through the purchase of preferred stock in banks and mortgage lenders. Initially, £25 billion was made available to eight large lenders, and the remaining £25 billion was made available to all lenders. The BOE announced that in conjunction with this move it would increase the amount of funds available through the SLS by £200 billion.

On October 17, the BOE announced that it would further [reform its market operations](#) to induce borrowing by banks. First, it announced that it would make permanent its expansion of accepted collateral for its three-month repo operations.

Second, the BOE [created a permanent discount window facility](#) through which banks could, for a fee, swap eligible collateral for U.K. Treasury securities. There is a wider range of eligible collateral than what is accepted under the SLS, including highly rated sovereign bonds and own-name instruments, and eligible collateral is not limited to assets on balance sheets before a particular date. Certain instruments that are not trading in liquid markets are also eligible, including highly rated mortgage bonds and portfolios of corporate bonds. The original term of the drawings was 30 days. On January 19, the BOE announced that it would also [permit drawings with](#)

⁸ These sterling repurchase operations are one element of the BOE's open market operations, within its larger sterling money market operations framework. These operations "implement the Monetary Policy Committee's interest rate decisions while meeting the liquidity needs [of] the banking system as a whole." See the [Bank of England's Sterling Money Market Operations](#) website for more information.

[364-day maturities](#) for an additional fee of 25 basis points.

Finally, the BOE eliminated its Standing Lending Facility (SLF), into which banks could deposit or withdraw funds in unlimited amounts throughout the day in order to balance their daily cash flows; it also helped the BOE stabilize expectations that overnight market interest rates would be commensurate with target rates. A stigma had become associated with using this facility during the financial crisis, as banks thought using it would project financial weakness. In its place, the BOE [introduced the Operational Standing Facilities \(OSF\)](#), which will mature overnight and have the same goal as the SLF of controlling overnight lending rates. However, banks need only make monthly disclosures of their OSF use.

Bank Recapitalization Plans Offered Throughout EU

Over the quarter, many other EU member states have submitted plans to recapitalize their banks and ensure that there is continued access to liquidity throughout the financial system. The Netherlands, Denmark, France, Belgium, Luxembourg, Germany, Ireland, and others began by offering bailouts to individual banks as they became insolvent or reached the verge of collapse.

Members have been submitting national plans to calm troubled financial markets and recapitalize banks. The European Commission (EC) has been reviewing and approving these plans one by one. The EC is the enforcer of EU rules designed to protect the integrity of the single EU market. On October 13, the EC issued a [guidance](#) (in the form of a communication from the commission) that laid out the groundwork for acceptable plans. The EC is looking for modest proposals that address the nation's specific problems with only as much direct intervention as is necessary. Members have pledged not to go on any wild spending sprees or to offer massive subsidies to troubled businesses. On December 8,

in another [guidance](#), the EC eased some of the requirements for plan approval; some nations had complained that they were too restrictive and that the EC was not granting approvals quickly enough. On December 17, the EC adopted a [temporary framework](#) allowing member states to put a number of temporary aid measures in place to tackle the effects of the credit squeeze on the real economy until December 31, 2010.

At least 14 EU countries have offered schemes to recapitalize banks, and at least 13 have offered state guarantees for interbank lending. On October 10, Denmark became the first EU nation to have a national stabilization plan approved by the European Commission. Plans from Germany, France, Sweden, Portugal, the Netherlands, Spain, Italy, Greece, and Finland have also been approved. Details of the plans are unique to each country, but they are all based on the British model of direct investment in banks in return for equity.

Proposed Rule to Change Capital Requirements for Banks

On October 1, the European Commission proposed an [overhaul of EU capital requirement rules for banks](#). Included in the legislative proposal are rules to help banks manage large exposures, improve the quality of capital, and establish a college of supervisors to oversee cross-border banking groups. The proposal would no longer allow banks to rely on an independent credit rating agency for risk analysis of securities; originators would have to make sufficient information available to banks for them to perform their own risk analysis. In addition, originators of securities would be required to retain at least a 5 percent stake in the assets they sell. A bank would also be prohibited from lending more than 25 percent of its capital to another institution. The proposal now passes to the European Parliament and the Council of Ministers for consideration. The European Council has expressed a strong sense of

urgency, emphasizing that the measures should be adopted by April 2009.

Iceland

Iceland has been one of the countries most severely affected by the financial crisis. This quarter, it saw its banking sector completely collapse. As a result, the government has had to take over all three of the nation's largest banks and assume liabilities to retail depositors, at first only for domestic customers, and later, under pressure from other countries, for foreign depositors.

Over the past few years, many Icelandic banks have been aggressively courting foreign depositors, especially from Britain. The number of their retail depositors outside Iceland was greater than the entire population of Iceland, and at the end of the second quarter of 2008 the banking sector's external debt was nearly six times Iceland's 2007 gross domestic product. The falling value of the Icelandic króna – by more than 35 percent against the euro from January to September – exacerbated problems with the banks' foreign-currency-denominated liabilities.

On September 29, Iceland's government agreed to [acquire a 75 percent share in Glitnir](#) for €600 million. The drop in value of the króna, combined with deteriorating conditions in worldwide financial markets, weakened Glitnir's short-term funding and required a large and immediate infusion of capital. However, before the nationalization plan could be completed, the bank was placed into receivership by the Icelandic Financial Supervisory Authority (FME) on October 8.

On October 6, Iceland's government enacted emergency legislation ([Act No. 125/2008](#)) that would allow the FME to seize any bank it deemed not viable. The legislation also promised that the government would guarantee all domestic retail deposits in any Icelandic banks; that guarantee, however, did not extend to foreign customers. As a result, foreign depositors in

Icelandic banks rushed to withdraw deposits. By October 9, the nation's three largest banks, Kaupthing, Glitnir, and Landsbanki, had all been handed over to receivers appointed by the FME as their capital evaporated. The assets of the three banks were 11 times Iceland's 2007 GDP.

International Responses to Iceland's Crisis

As news of Iceland's crisis spread, foreign customers began withdrawing their deposits, deepening the liquidity problems at the banks. Because the recent Icelandic and British deposit guarantees applied only to domestic depositors and banks, British customers of the Icelandic banks became panicked that their deposits would be used to cover Icelandic depositors and rushed to move them, creating a run on Landsbanki through its U.K. operations. In response, on October 8 the British government [froze all assets of Landsbanki](#) and its subsidiaries, as well as assets of the Central Bank of Iceland, and guaranteed that it would protect all British depositors. At the time of the freeze, some 300,000 British customers had £4 billion worth of deposits in Icesave, Landsbanki's online savings program offered to British customers. Another 22,200 customers had £538 million worth of deposits in Heritable Bank, a U.K. subsidiary of Landsbanki.

On the same day, the U.K. Financial Services Authority (FSA) declared Kaupthing Singer & Friedlander (KSF), the U.K. subsidiary of Kaupthing – Iceland's largest bank – in default on its obligations and [placed KSF under administration](#).

To ensure the stability of the banking system, U.K.'s Financial Services Compensation Scheme (FSCS) and HM Treasury agreed to [pay out approximately £3.6 billion](#) to ING Direct for the Dutch online bank to take over retail deposit accounts of KSF and Heritable banks. Other countries also acted to protect their citizens with deposits in Icelandic banks. On October 8, the Swedish central bank [authorized a loan of up to 5](#)

[billion krónur](#) to Kaupthing's Swedish subsidiary. On October 9, the Swiss Federal Banking Commission announced that it would guarantee domestic deposits up to 30,000 Swiss francs in the Swiss branch of Kaupthing. On October 12, the Norwegian government [took control of Kaupthing's](#) Norwegian branches and operations.

On November 16, Iceland reached deals with British and Dutch authorities to [provide equal deposit guarantees](#) to citizens of other European Economic Area (EEA) countries with accounts in Icelandic banks. The guarantee would be financed by €5 billion of loans from the U.K., the Netherlands, and Germany, because Iceland's Depositors' and Investors' Guarantee Fund's reserve of about €68 million was clearly not sufficient to cover all claims.

With the deposit guarantee dispute resolved, the IMF subsequently [approved a two-year stand-by arrangement of \\$2.1 billion](#) to Iceland on November 19 to help contain the negative impact of the crisis on the economy. The credit facility made \$827 million immediately available to the nation, with the remaining funds to be made available in eight installments of \$155 million, subject to quarterly reviews. The IMF program [was supplemented by \\$2.5 billion of loans jointly provided by Finland, Sweden, Norway, and Denmark](#). Russia, Poland, and the Faroe Islands also [committed loans to Iceland](#).

Russia

In October, the Russian government responded quickly to contain the spread of the financial crisis. On October 6, Russia's stock market had its single worst day ever, closing down nearly 20 percent. This precipitous drop followed a 50 percent loss in value in the markets since June. In response, the Federal Financial Markets Service reviewed its rules and announced on October 7 that it would suspend trading if stock indexes move by more than 5 percent per day. One such suspension occurred on October 10 following more volatility.

On October 10, Russian Prime Minister Vladimir Putin announced plans to purchase up to 175 billion rubles (\$6.7 billion) of stock in domestic companies in order to prop up equity prices.

On October 10, parliament passed amendments to federal laws that will allow the Bank of Russia (Russia's central bank) to grant uncollateralized subordinated loans of up to 500 billion rubles to state-owned Sberbank. The amendments also allow the National Wealth Fund (one of Russia's sovereign wealth funds) to deposit up to 450 billion rubles in the state development bank Vnesheconombank, permitting the latter to use these funds to make 10-year uncollateralized subordinated loans to state-owned VTB bank (up to 200 billion rubles), state-owned Rosselkhozbank (up to 25 billion rubles), other banks with a long-term international credit rating not lower than B-/B3 or a national credit rating not lower than BBB-/Baa3 (up to 225 billion rubles), and foreign currency loans (up to \$50 billion) to Russian companies and banks of strategic importance to the Russian economy. The legislation is effective through December 31, 2009.

Russia has also increased its deposit coverage from 400,000 rubles (at 100 percent coverage for the first 100,000 rubles, and 90 percent coverage for the rest) to 700,000 rubles (at 100 percent coverage) per account, retroactively effective to all banks that failed after October 1. Additional legislation passed on October 23 grants the Deposit Insurance Agency financial assistance worth 200 billion rubles and increased power to lend to and acquire troubled institutions. The legislation is effective through December 31, 2011.

Japan

Japan's first move to combat the financial crisis has been to increase liquidity in the markets to drive down the costs of lending. In October alone, the Bank of Japan (BOJ) injected more than ¥30 trillion (roughly \$300 billion) into its banking system through open market operations in an

attempt to hit its overnight call rate target of 0.5 percent. Rates persistently stayed above the target despite the BOJ's moves. The target rate was eventually lowered, first to 0.3 percent on October 31, and then to 0.1 percent on December 19.

On October 27, the Japanese government outlined an emergency market stabilization program that includes government and central bank stock purchases, a ban on short selling, and reduction of stock dividend taxes. The government expects to spend ¥10 trillion of taxpayer money under a new law to inject capital directly into financial institutions, in a move mirroring those in the U.S. and Europe.

On October 28, the Ministry of Finance banned short sales of stocks. This move echoes moves by the Securities and Exchange Commission last quarter to limit short selling in U.S. markets.⁹

Chiang Mai Initiative

On October 27, an informal meeting of the 10-member Association of Southeast Asian Nations, plus Japan, China, and Korea (ASEAN Plus 3) resulted in an agreement between the nations to expand existing currency swap agreements (known as the Chiang Mai Initiative) to guard against financial runs in the region. This agreement builds on an October 22 decision by Japan, China, and Korea to increase their monitoring of financial institutions and enhance disclosure and risk management guidelines.

International Move to Increase Short-Term Dollar Liquidity

On October 13, the Federal Reserve, the Bank of England, the European Central Bank, the Swiss National Bank, and the Bank of Japan jointly announced an [initiative to improve liquidity](#) in short-term U.S. dollar funding markets. The foreign banks will be conducting tenders of U.S. dollar funding at seven-day, 28-day, and 84-day

maturities at fixed interest rates. There is no limit on the amount of currency that counterparties may borrow, as long as they can pledge appropriate collateral. In order to facilitate this action, the Fed increased the size of its temporary swap facilities with the other central banks. These swap lines will remain open at their increased size through April 30, 2009.

G-20 Nations Agree in Principle to Financial Reform

Leaders from G-20 economies met in Washington in mid-November and agreed in principle to broad reforms that can help stabilize financial markets. Included in their goals were strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets, reinforcing international cooperation, and reforming international financial institutions. Finance members of each nation were charged with implementing recovery plans in their home countries that would be consistent with these goals. They will meet again in April to continue discussions on solving the financial crisis.

DEVELOPMENTS IN ACCOUNTING

Determining the Fair Value of a Financial Asset in an Inactive Market

On October 10 the Financial Accounting Standards Board (FASB) issued a staff position ([FSP FAS 157-3](#)) clarifying the application of FASB Statement No. 157, "Fair Value Measurements." The staff position amends Statement 157 by adding an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. This latest guidance is effective upon issuance and should be applied to third-quarter reports.

Background

According to Statement 157, issued in September 2006, the fair value estimate is intended to convey to investors the value of an asset or

⁹ For information on the SEC's bans, see [Banking Legislation and Policy, Volume 27, Number 3](#).

liability at the measurement date rather than the potential value of the asset or liability at some future date.

A fair value hierarchy is used to prioritize the inputs that should be used to develop the fair value estimate. The first level of the hierarchy estimates the current exchange price for an asset or liability using quoted prices in active markets for identical assets or liabilities. When quoted prices in active markets for identical assets or liabilities are not available, second level estimates may be used, including valuation techniques such as pricing models that incorporate a combination of other inputs, e.g., quoted prices in markets for comparable assets or liabilities. If these are not available, the final level estimates allow evaluators to use unobservable inputs, including the reporting entity's own analysis of the underlying economic data that market participants would factor into the pricing of the asset or liability.

Based on feedback from various constituents, the FASB staff found that the fair value measurement framework outlined in Statement 157 improved the quality and transparency of financial information. Despite the overall positive feedback, certain constituents felt that Statement 157 did not provide sufficient guidance on how to determine the fair value of a financial asset when the market for that asset is inactive. Specifically, application issues arose concerning how the reporting entity's own assumptions should be considered when measuring fair value in the absence of relevant observable inputs. Another issue involved the consideration of available observable inputs in an inactive market in measuring fair value. Last among the issues was how to use market quotes when assessing the relevance of observable and unobservable inputs available to measure fair value.

FASB and SEC Joint Press Release

Prior to the issuance of the formal staff position, the Securities and Exchange Commission (SEC) and the FASB staff issued a [press release](#) on September 30. The press release was intended to provide immediate clarification on fair value measurement questions that preparers, auditors, and investors had cited as most urgent in the current environment. The clarifications set forth were based on the fair value measurement guidance in Statement 157.

First, the release clarified that management's internal assumptions, such as expected cash flows, including risk adjustments, can be used to measure fair value when relevant market evidence does not exist. Based on Statement 157, expected cash flows from an asset can be considered in measuring fair value. In fact, the use of unobservable inputs might be more appropriate than the use of observable inputs in some cases. Such a situation might exist when significant adjustments are required for available observable inputs, making it appropriate to use an estimate based primarily on unobservable inputs.

Second, broker quotes may be an input when measuring fair value, but they are not necessarily determinative in the absence of an active market for the security. Since a broker quote should reflect market information from actual transactions, an entity should place less weight on quotes as an input to fair value when such quotes do not reflect the result of market transactions. In addition, the type of quote, such as an indicative price versus a binding offer, should be considered when weighing the input.

Third, the press release addresses the question of using disorderly transactions to measure fair value. Because the concept of fair value measurement assumes an orderly transaction between market participants, the outcome of a disorderly transaction is not conclusive when measuring fair value. Specifically, an orderly transaction involves market participants that are

willing to transact and allows for adequate exposure to the market before the measurement date. In contrast, a disorderly transaction, such as a fire sale or forced liquidation transaction, involves market participants that are compelled to transact and allows for little or no exposure to the market before the measurement date. The fact that a transaction is distressed should be considered when weighing it as an input in the fair value estimate. Since it is not appropriate to conclude that all market activity represents disorderly transactions even in a dislocated market, significant judgment is required to determine whether an individual transaction is disorderly or not.

Finally, the release asserts that transactions in an inactive market, such as one with a small number of bidding parties, *can* affect fair value measurements. However, such inputs would likely not be determinative of fair value and may need adjustment if the transaction price does not reflect current prices for the same or similar assets. *If available*, a quoted price in an *active* market for the identical asset is required to be used as an input. Judgment is required in determining whether a market for an asset is active.

FASB states that FSP FAS 157-3 is consistent with this press release. However, the American Bankers Association (ABA) disagreed in a [letter](#) to Chairman Christopher Cox of the SEC claiming that the staff position basically ignores the intent of the press release. Specifically, the ABA contends that the FSP is circular by requiring that liquidity risk, from the buyer's perspective, be included in management's cash flow calculation. In requiring such adjustment for the purchase of an asset that is difficult to sell under current market conditions, the guidance comes back full circle to distressed sale values. The ABA then argues that the accounting guidance in the FSP is both too narrow and too complex to be used by either large or small banks

SEC Releases Study on Fair Value Accounting's Impact on the Financial Crisis

On December 30, the SEC [released a study](#), produced in conjunction with the Treasury and Federal Reserve, in which it evaluates the effects of mark-to-market and fair value accounting on the financial crisis. The study concluded that fair value standards had no "meaningful role" in the U.S. bank failures over the past year, and that they do not need to be suspended or eliminated, despite statements to the contrary by banking industry interest groups. The study also makes several recommendations for how to improve the application of fair value standards. The study was commissioned in the Emergency Economic Stabilization Act of 2008 ([Public Law No. 110-343](#)).

Disclosures by Public Entities about Transfers of Financial Assets and Interests in Variable Interest Entities

On December 11, 2008, FASB issued a staff position ([FSP FAS 140-4 and FIN 46\(R\)-8](#)) amending Statement 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," and Interpretation 46(R), "Consolidation of Variable Interest Entities." Under the amendment to Statement 140, public entities are required to provide additional disclosures about transfers of financial assets. The amendment to Interpretation 46(R) requires public enterprises, including sponsors that have a variable interest in a variable interest entity (VIE), to provide additional disclosures about their involvement with VIEs.¹⁰

The new disclosure requirements apply only to public entities that are subject to the existing disclosure requirements of Statement 140

¹⁰ "A [variable interest entity](#) is a corporation, partnership, trust, or any other legal structure used for financial purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities."

and Interpretation 46(R), respectively.¹¹ The existing disclosure requirements for nonpublic entities are not changed under the staff position.

A public entity must describe the nature of any restrictions on assets, such as carrying amounts, reported in a statement of financial position that relate to transferred financial assets, including transfers to VIEs. It must also disclose how continued involvement with the transferred assets, including through a VIE, affects its financial position, financial performance, and cash flows.

The amendment to Statement 140 also calls for a public entity to explain its continuing involvement in financial assets that it has transferred in a securitization or asset-backed financing arrangement. In addition, any involvement that requires the transferor to provide additional cash flows or other assets to any party related to the transfer must be disclosed.

The amendment to Interpretation 46(R) requires a public entity to provide users of a financial statement with an understanding of the significant judgments and assumptions made in determining whether it must consolidate a VIE and if it must disclose information about its involvement with a VIE. The new disclosures' intent is that the public entity will help financial statement users understand the nature of, and changes in, the risks connected to its involvement with a VIE.

In addition, the amendment to Interpretation 46(R) requires a public entity that is either a nontransferor sponsor or servicer of a

qualifying special purpose entity (QSPE)¹² in which it holds a significant interest to disclose information that provides financial statement users with an understanding of the nature of its involvement with the QSPE.¹³ The affected enterprise must disclose the nature, purpose, size, and activities of the QSPE as well as how the entity is financed. In addition, such an enterprise must disclose the carrying amount and classification of its assets and liabilities resulting from its involvement with the QSPE, the maximum exposure to loss from its involvement with the QSPE, the terms of arrangements that could require it to provide financial support (such as a liquidity arrangement or an obligation to purchase assets), and any financial or other support provided to the QSPE during the periods presented that was not contractually required.

The staff position is effective for the first interim or annual reporting period ending after December 15, 2008, and each interim or annual period thereafter. Furthermore, FASB encourages an entity to disclose comparative information in periods earlier than the effective date for disclosures that were not previously required for public entities by Statement 140 and Interpretation 46(R). Such comparative disclosures are required for periods following the effective date.

SEC Ruling on Perpetual Preferred Shares

On October 14, the SEC announced in a [letter to FASB](#) that banks may temporarily treat perpetual preferred shares (PPS) more like debt securities when assessing them for impairments. An impairment of a security is defined as a decline in fair value below the amortized cost basis. The SEC decided that because PPS are "hybrid" in

¹¹ The definitions of public and nonpublic entities come from FASB statement No. 132 (revised 2003), "Employers' Disclosures about Pensions and Other Postretirement Benefits." Public entities are those (a) whose debt or securities trade in a public or over-the-counter market, (b) who act as a conduit bond obligor for publicly traded conduit debt securities, (c) who make a filing with a regulatory agency before issuing any debt or securities in a public market, or (d) are controlled by an entity covered in (a), (b), or (c). The definition is reprinted in this staff position.

¹² A [qualifying special purpose entity](#) is an off-balance-sheet structure that is often used by companies to securitize financial assets.

¹³ A nontransferor sponsor or servicer is a public entity that holds an interest in a QSPE, but did not actually transfer any of its financial assets to the QSPE.

nature, with the characteristics of both equity and debt, they present a particular challenge to banks.

Under the decision, companies can use an anticipated recovery period in testing for impairment that is more typical of that used for debt securities, which is longer than that commonly used for equity securities. An impairment may be determined to be temporary or “other than temporary” during such a recovery period.

The use of an impairment model similar to that used for a debt security does include a stipulation. The reporting company must neither have evidence of deteriorating asset performance, i.e., from a decline in the cash flows, nor of a downgrade in a security’s rating to below investment grade. Furthermore, investors should be able to understand the information considered by companies in determining that the impairment is not other than temporary.

In the event of an other than temporary impairment, the affected company must report a loss and use mark-to-market accounting for the written-down assets in accordance with FASB Statement No. 115, “Accounting for Certain Investments in Debt and Equity Securities.”

This guidance is effective for any filings made on or after October 15.

Proposed Staff Positions

Guidance to Achieve Consistent Definition of Temporary Impairment

On January 12, FASB issued a staff position targeted to achieve a consistent model to decide if impairment of available-for-sale or held-to-maturity debt securities is other than temporary. Currently, the U.S. GAAP has two different models for determining whether the impairment of a debt security is other than temporary. The first model applies to debt securities within the scope of [EITF Issue No. 99-20](#), which include *beneficial interests* in securitized financial assets with contractual cash flows such as loans, receivables, debt securities, and guaranteed lease residuals. The other model

addresses those debt securities not within the scope of EITF Issue No. 99-20. Such securities would need to apply FASB Statement No. 115.

EITF Issue No. 99-20 requires the use of market participant assumptions about future cash flows, and some constituents commented that in a dislocated market this can automatically result in an other-than-temporary impairment when the fair value is less than the cost basis. The proposed guidance amends EITF Issue No. 99-20 to align its impairment model with the Statement 115 impairment model, which does not require exclusive reliance on market participant assumptions about future cash flows and permits the use of reasonable management judgment of the probability that the holder will be unable to collect all amounts due.

After an unusually short 11-day comment period, on January 7 FASB decided by a vote of 3-2 to approve and issue the final staff guidance ([FSP EITF 99-20-1](#)). Two FASB members, Thomas Linsmeier and Marc Siegel, dissented in the vote. The staff position’s effective date for interim and annual reporting companies is for the applicable period ending after December 15, 2008.

Expanded Disclosure Requirements for Fair Value of Financial Instruments

On December 24, FASB proposed guidance ([FSP FAS 107-a](#)) to amend Statement 107, “Disclosures about Fair Value of Financial Instruments,” by expanding disclosure requirements for financial instruments at fair value. Developed jointly with the International Accounting Standards Board (IASB), the proposal specifically comes in response to complaints, mainly from financial institutions, that current accounting rules on fair value and impairment offer inadequate options for financial assets that have cash flow but have declined in market value. The IASB issued its own [proposal](#) on the issue on December 23 for entities using international reporting standards.

The proposal only offers a change in disclosures and not changes to recognition through earnings as also requested by financial institutions. An entity would be required, under the proposed amendments, to disclose information that allows users of its financial statements to understand the various attributes used to measure held-to-maturity debt securities, available-for-sale securities, as well as loans and long-term receivables, except such assets measured at fair value with changes in fair value recognized through earnings. An entity would be required to give a comparison of such attributes in a tabular

format under three column headings: as reported in the statement of financial position, at fair value, and at the incurred loss amount. In addition, an entity shall provide qualitative disclosures on its accounting policy for each type of financial asset in the table, the methodology used to estimate the key inputs used to measure the incurred loss amount, and, to the extent known, a description of the factors causing the differences in measurements for each financial asset presented in the table.

FASB is seeking comment on these proposed changes, which would be effective for 2008 year-end reporting by January 15.

Federal Regulation

Board of Governors of the Federal Reserve

Final Rule to Block Unlawful Internet Gambling

On November 12, the Board of Governors of the Federal Reserve and the Department of the Treasury issued a [joint rule](#) implementing the Unlawful Internet Gambling Enforcement Act of 2006. The rule requires financial firms to implement policies that are reasonably designed to prevent payments to businesses engaged in unlawful online gaming. The rules apply to designated payment systems that can facilitate illegal transactions, such as credit card payments.

Proposed Changes to Regulation Z Implementing the Mortgage Disclosure Improvement Act

On December 9, the Board of Governors of the Federal Reserve issued a proposed rule that would amend Regulation Z (Truth in Lending) to implement the Mortgage Disclosure Improvement Act of 2008 (MDIA) ([73, Federal Register, pp. 74989-99](#)), an amendment to the Truth in Lending Act (TILA). The proposed rule would require lenders to provide good faith estimates of mortgage loan costs within three days of receiving a consumer's application for a mortgage loan and before the customer was charged any fees, except a reasonable fee for checking the consumer's credit history. These estimates are currently required for loans secured by a principal dwelling; the proposal would expand this requirement to other mortgages, such as those for second homes. In addition, lenders would need to wait seven business days after providing estimates before they could close on the loan. Lenders would also need to submit a revised estimate and wait an additional three business days before closing the loan if the annual percentage rate charged changed during this period. Consumers would be allowed to expedite the process in the case of a financial emergency such as foreclosure. The proposal was open for comments until January 23.

Final Rules to Protect Credit Card Users

On December 18, the Board of Governors of the Federal Reserve issued a number of final rules in conjunction with the Office of Thrift Supervision and the National Credit Union Administration that will better protect credit card users by prohibiting certain unfair or deceptive practices and improve disclosure requirements. The [amendment to Regulation AA](#) requires banks to give consumers adequate time to make payments, allocate payments first to balances with the highest annual percentage rates, limit increases in interest rates,

eliminate “two-cycle” billing, and limit financing of fees on subprime credit cards. The [amendment to Regulation Z](#) includes new rules on disclosures in applications and solicitations, and in account-opening and periodic statements, giving consumers advance notice prior to increases in interest rates and additional protections. All rules take effect on July 1, 2010. The initial proposals for these rules were discussed in [Banking Legislation and Policy, Volume 27, Number 2](#).

Proposed Rules Affecting Overdraft Services

On December 18, the Board of Governors of the Federal Reserve introduced two rules to protect consumers using overdraft services from banks. The final [amendment to Regulation DD](#) requires institutions to disclose aggregate overdraft fees on periodic statements and to provide balance information that does not include funds available to cover overdrafts when the customer accesses this information through an automated system. This rule is effective as of January 1, 2010. The [proposed amendment to Regulation E](#) would prohibit banks from charging overdraft fees when an account is overdrawn because of a hold placed on funds following a debit transaction in excess of the actual transaction amount, and seeks comment on whether the default should be for the consumer to opt in or opt out. This proposal replaces previously proposed amendments under Regulations AA and DD addressing overdraft services.

Department of Education

Department Will Purchase Student Loans from Lenders

On November 20, the Department of Education announced that it would [purchase up to \\$6.5 billion in student loans](#) from lenders until a new commercial paper conduit facility, announced on November 8, is opened in 2009 (no later than February 28). The department will purchase up to \$500 million in Federal Family Education Loan Program (FFELP) loans for the 2007-08 academic year each week beginning in December. The department hopes these actions will continue to ensure that students have access to loans for this school year.

Department of Housing and Urban Development

Mortgage Lenders Must Give Customers Good-Faith Estimate of Closing Costs

On November 14, the Department of Housing and Urban Development issued a rule amending the Real Estate Settlement and Procedures Act, which requires mortgage lenders and brokers to provide potential borrowers with a good-faith estimate that details closing costs and loan conditions ([73, Federal Register, pp. 68204-88](#)). A standardized good-faith form, reproduced in the *Federal Register* notice, must be presented to the customer at the time an estimate is provided. In addition to loan details and closing costs, borrowers must be informed of yield spread premiums that lenders use to compensate mortgage brokers.

Federal Deposit Insurance Corporation

FDIC Settles Deceptive Credit Card Case with CompuCredit

On December 19, the Federal Deposit Insurance Corporation (FDIC) reached a [settlement](#) with CompuCredit Corporation, Atlanta, which had been charged with violating the Federal Trade Commission Act by deceptively marketing subprime credit cards with three FDIC-supervised banks. CompuCredit had marketed subprime credit cards to consumers with low credit scores but failed to adequately disclose significant up-front fees. Furthermore, CompuCredit misrepresented the available credit; cards were advertised as having a \$300 limit, but consumers were immediately charged fees of up to \$185, leaving as little as \$115 in available credit. As part of the settlement, CompuCredit will provide \$114 million in restitution to customers

Internal Revenue Service

Banks Get Beneficial Treatment of Deductions for Losses Following Ownership Change

On October 20, the Internal Revenue Service published a notice that gives banks beneficial treatment of deductions for losses or bad debts following an ownership change under tax code Section 382(h) ([Notice 2008-83, Internal Revenue Bulletin 2008-42, p. 905](#)). As long as financial institutions properly allow deductions for those items, including deductions for an addition to a reserve for bad debts, the deductions will not be treated as built-in losses for tax purposes. This effectively reduces the tax burden on banks that acquire troubled institutions.

Office of the Comptroller of the Currency

Creation of a National Bank "Shelf Charter"

On November 21, the Office of the Comptroller of the Currency (OCC) [evaluated the first of a new type of national bank "shelf charter,"](#) granting preliminary approval to establish the Ford Group Bank, National Association. The new method involves granting preliminary approval to a group of investors for a national bank charter, which remains inactive until the investors are in a position to acquire a troubled or failing depository institution. Any bid from an investor group must still be approved by the FDIC but this puts the investors in a position to move quickly into the bidding process and expands the pool of potential bidders.

Joint Release

Goodwill Deduction Rule Finalized

On December 29, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision released a final rule allowing banks, thrifts, and their holding companies 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, 79602-8](#)). An interim rule for this decision released last quarter was described in [Banking Legislation and Policy, Volume 27, Number 3](#). There were no significant changes between the interim rule and its final version.

Judicial Rulings

Circuit Court Rulings

Finance Charge Is Not Interest Under TILA

On December 24, the U.S. Court of Appeals for the Ninth Circuit ruled that a flat finance charge does not qualify as interest under 15 U.S.C. §1615 of the Truth in Lending Act (TILA) ([Davis v. Pacific Capital Bank N.A., 9th Cir., No. 07-56236, 12/24/08](#)). The plaintiff argued that because she had made early repayment on a refund anticipation loan, a portion of the finance charge should have been returned under §1615 as unearned interest. However, the court found that §1615 intentionally excluded finance charges that do not vary with the term of the loan from the definition of interest, ruling that the bank therefore did not have to return any part of the finance charge.

District Court Rulings

ARS Fraud Case Against UBS Dismissed

On December 19, the U.S. District Court for the Southern District of New York dismissed a suit against UBS Financial Services Inc. by investors who claimed that UBS had misled them in purchasing auction rate

securities (ARS) (*Kassover v. UBS AG*, S.D.N.Y., 08 CV 02753, 12/19/08). UBS marketed the ARS to investors, despite knowing that markets for the ARS were drying up because of the deepening credit freeze. When the investors were unable to sell the ARS without taking a steep discount, they sued UBS under the 1940 Investment Advisers Act. The court dismissed the suit because plaintiffs were unable to prove that UBS acted as an investment adviser as defined by the act. The plaintiffs had 30 days to amend their complaint.

Supreme Court Arguments

Jurisdiction of Federal Courts to Compel Arbitration

On October 6, the U.S. Supreme Court heard oral arguments in a case that could define when federal courts have jurisdiction to compel arbitration between credit card users and issuers (*Vaden v. Discover Bank*, U.S., No. 07-773, argued 10/6/08). Discover has argued that the case belongs in federal court because Section 4 of the Federal Arbitration Act requires federal judges to look through the nuances of a case and determine if a federal question of law is at issue; the court worries that this could give federal judges too much power to decide when to remove a case from a state court.

Settlements

Bank of America Settles Countrywide Predatory Lending Cases with State AGs

On October 6, Bank of America reached a [settlement](#) with attorneys general in 11 states over allegations of unfair or deceptive mortgage practices by Countrywide Financial Corp., its recently acquired subsidiary. Countrywide will initiate a [homeownership retention program](#) that could help as many as 400,000 customers keep their homes by adjusting mortgage agreements, including reductions in principal and interest rate. The program will also create a foreclosure relief fund to assist distressed borrowers. Overall, this program could cost Countrywide as much as \$8.4 billion. The settlement also includes pledges by Countrywide to cease offering subprime and low documentation mortgages, as well as nontraditional products such as payment-option ARMs.

Bank of America, Royal Bank of Canada Reach Settlements in Auction Rate Securities Cases

On October 8, the Securities and Exchange Commission, in association with the New York State Attorney General and the North American Securities Administrators Association, reached settlement agreements with [Bank of America Corp.](#) and [Royal Bank of Canada](#) following investigations into fraud on the parts of the banks regarding their marketing of auction rate securities since 2007. Even though the markets for such securities had begun to dry up due to the national credit crunch, the banks 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. Citigroup, UBS, Morgan Stanley, JPMorgan Chase, Wachovia, and Credit Suisse settled similar cases last quarter. On November 20, the Washington State Securities Division [alleged](#) that Wells Fargo had made similar misrepresentations and will be facing an investigation.

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