Banking Legislation & Policy

Third Quarter 2009 **Volume 28, Number 3**

HIGHLIGHTS

This issue contains detailed descriptions of:

- The FDIC's Actions to Protect the Deposit Insurance Fund, including:
  - Guidance for Purchasers of Assets or Liabilities of Failed Banks
  - Amendments to the Deposit Insurance Fund Restoration Plan
  - Changes to the Temporary Liquidity Guarantee Program

In addition, it summarizes other notable legislative, regulatory, and judicial developments that occurred during the third quarter of 2009.

FDIC ACTS TO PROTECT THE DEPOSIT INSURANCE FUND

On September 28, the Federal Deposit Insurance Corporation (FDIC) announced that based on the most recently available information on expected failures and loss rates and statistical analyses of trends in CAMELS downgrades, failure rates, and loss rates, the net worth of its Deposit Insurance Fund (DIF) would be negative as of September 30, 2009, and would probably stay negative until 2013. Although the cash balance of the DIF is still positive, containing cash and marketable securities worth about $22 billion, its liabilities due to expected costs of future bank closings has pushed the fund's net worth below zero.

This quarter, the FDIC has undertaken a series of actions that will help it to restore the DIF, sell some of the banks it has acquired, and move toward winding down its Temporary Liquidity Guarantee Program (TLGP).

Background

The DIF's primary goal is to provide deposit insurance – up to $250,000 per depositor[1] – for FDIC member banks. When an FDIC member bank fails or is deemed critically undercapitalized, it is closed by its federal regulator and placed in an FDIC receivership. Once the FDIC has been appointed receiver of a failed bank, it can either attempt to sell the bank's assets and deposits to investors, or it can liquidate the receivership by offering payouts to depositors.

Turbulence in the banking sector over the past year has caused many banks to become distressed, necessitating that they be closed by their regulators and placed in FDIC receivership. Each receivership imposes significant costs on the DIF. In 2008, the FDIC was appointed receiver for 26 failed banks, and so far in 2009,[2] it has been appointed receiver for 98 failed banks.

[1] This limit is a temporary increase that will reset to $100,000 on December 31, 2013.

[2] Total as of October 8, 2009.

The FDIC currently projects total costs to the DIF of $100 billion as a result of bank failures stemming from the crisis and recession; most of these costs will be incurred during 2009 and 2010. More than 400 banks are currently on the FDIC's "problem" list. To ensure that it will be able to continue to protect depositors from losses, the FDIC has a $100 billion line of credit with the Treasury, though it has never been used.

Guidance for Purchasers of Assets or Liabilities of Failed Banks

On August 26, the FDIC issued a final policy statement on qualifications for acquisitions of the assets or liabilities of failed banks ([74, *Federal Register*, pp. 45440-9]). The statement includes minimum capital requirements for buyers, a minimum period of time that buyers must hold the acquisition, and disclosure requirements about ownership and transactions with affiliates. The final statement takes into account comments made on a proposed statement that was released on July 9 ([74, *Federal Register*, pp. 32931-4]). Proceeds from selling these failed banks will be used to replenish the DIF.

The measures do not apply to investors in partnerships with well-established bank holding companies that will have a strong majority interest in the acquired bank, or to investors who hold 5 percent or less of the total voting power of the acquired bank.

The resulting depository institution from the sale must have a ratio of Tier 1 common equity to deposits of at least 10 percent.[3] This ratio must be maintained for at least three years from the time of acquisition, and after this time, the bank must remain "well capitalized" as defined by the FDIC, or else undertake prompt corrective action. The FDIC chose this capital ratio, which is higher than the ratio required for other banks, because of the higher risk profiles of the institutions being acquired, as well as the "higher risk appetite" of private equity investors – some of which are not subject to consolidated supervision – and the general uncertainty surrounding the banking sector.

If any of the investors in the failed institutions jointly own 80 percent or more of two or more banks or thrifts, the stock of the banks or thrifts owned by those investors must be pledged to the FDIC as collateral.[4] If any of the institutions owned by the investors should fail, the pledged equity would be used to cover costs to the DIF from the failure. Also, extensions of credit by the acquired failed bank to the investors or any of their affiliated institutions[5] are prohibited, except for pre-existing extensions of credit.

Potential investors with an ownership structure that is domiciled at least in part in bank secrecy jurisdictions (such as the Cayman Islands) are not eligible to purchase any part of a failed institution, unless the investors are subsidiaries of companies that are subject to consolidated supervision as recognized by the Federal Reserve Board. Investors with complex or opaque ownership structures in which the parties responsible for making decisions are not clearly identified are also ineligible. Potential investors that already own 10 percent or more of the equity of a failed bank are barred from bidding on that bank.

Institutional investors must fully disclose information about their ownership structures to the FDIC. In addition, they must disclose financial information, such as the size of their capital funds,

[3] The original proposal had suggested a leverage ratio of 15 percent.

[4] In the original proposal, investors that owned 50 percent or more of more than one insured depository institution were required to pledge their interests in those institutions as collateral.

[5] Affiliated institutions are defined as any institution in which an investor owns – directly or indirectly – at least 10 percent of the equity and has maintained such ownership for at least 30 days. The original proposal did not contain the 30-day ownership period requirement.

their diversification, return profiles, marketing documents, and business models.

Once the investors have been cleared to purchase the failed institutions, they are prohibited from selling or transferring the purchased securities for three years following the acquisition, unless the transfer is to an affiliate and is approved by the FDIC beforehand. This provision does not apply to investors that are mutual funds.

These guidelines were effective upon publication.

DIF Restoration Plan Amended

On September 29, the FDIC announced that it would amend its plan to replenish the DIF. Whenever the DIF reserve ratio falls below 1.15 percent, the FDIC is required to implement a restoration plan to bring the ratio back above this level. On October 7, 2008, the FDIC established such a restoration plan that would have increased assessment rates on banks and replenished the DIF within five years. On February 27, 2009, the plan was amended to increase the period of restoration to up to seven years.[6]

The new amendment lengthens the period of restoration to eight years. Assessment rates will stay the same for the remainder of 2009 but will uniformly increase by three basis points, effective January 1, 2011.

Rather than applying a one-time special assessment that had been charged in previous versions of the plan, the FDIC will require banks to prepay their quarterly risk-based assessments for 2010, 2011, and 2012, which are due at the same time as their assessments for the fourth quarter of 2009. This is expected to immediately infuse the DIF with about $45 billion without having to charge banks the additional special assessment.

[6] For more information on the original DIF restoration plan, see *Banking Legislation and Policy*, Volume 27, Number 4. For information on the first amendment to the plan, see *Banking Legislation and Policy*, Volume 28, Number 1.

Newly Insured Banks Face Longer De Novo Period

On August 28, the FDIC announced that it would increase the length of its de novo regulatory period for new state-chartered nonmember institutions. Because of the greater risk they pose to the system, newly insured institutions are subject to more stringent capital and examination requirements than more seasoned banks. Under the new rule, this "de novo" period of more stringent regulation is being extended from three years to seven years. The FDIC has found that institutions insured less than seven years are overrepresented among recent closures and that this rule will help it to keep a closer eye on these banks in the future.

Changes to the Transaction Liquidity Guarantee Program

Transaction Account Guarantee Program Extended

On August 26, the FDIC issued a final rule to extend the Transaction Account Guarantee (TAG) program by six months, until June 30, 2010 (74, *Federal Register*, pp. 45093-45100). The extension was first proposed on June 23, 2009.

The TAG offers banks guarantees of deposit transaction accounts – non-interest-bearing accounts that are typically used by companies to cover payroll and operating expenses. Banks that continue to participate in the TAG program during the extension period will be subject to increased fees. For more information on the origin of the TAG program, which is a part of the Temporary Liquidity Guarantee Program (TLGP), see *Banking Legislation and Policy*, Volume 27, Number 4.

Wind-Down of the Debt Guarantee Program

On September 9, the FDIC issued for comment two possible alternatives for winding down the Debt Guarantee Program (DGP) of the TLGP (74, *Federal Register*, pp. 47489-94). Both alternatives require that the program end on October 31, 2009. While one option would be to simply end the program, the other would be to establish a six-month emergency guarantee facility for institutions already enrolled in the DGP. Under this option, institutions could have access to the emergency facility at a cost of 300 basis points per year.

The TLGP was created in October 2008 to strengthen liquidity in the banking system by guaranteeing newly issued senior unsecured debt of banks, thrifts, and certain holding companies. For banks that participate in the program, assets such as commercial paper, promissory notes, and interbank loans are guaranteed by the FDIC in case of bank failure. All guarantees made by the FDIC under the DGP will expire by December 31, 2012.

Resolution Reform Act of 2009 Introduced in Senate

On July 30, Sens. Bob Corker (R-Tenn.) and Mark Warner (D-Va.) introduced a bill (S. 1540) that would give the FDIC resolution authority for bank holding companies (BHCs). The bill would allow the FDIC to wind down a BHC if the bank it owns fails.

Such expansion of resolution has been advocated by both the FDIC and the Treasury. The FDIC currently has resolution authority for insured depository institutions, but no regulator currently has this authority for BHCs.

In July, the Treasury issued draft legislation to give itself resolution authority for BHCs and nonbank financial firms. For more information on the Treasury's proposal, see *Banking Legislation and Policy*, Volume 28, Number 2.

The bill was referred to the Committee on Banking, Housing, and Urban Affairs.

Federal Legislation

Proposed Legislation

Derivative Trading Accountability and Disclosure Act

On July 22, Rep. Michael McMahon (D-N.Y.) introduced the Derivative Trading Accountability and Disclosure Act (H.R. 3300), which would make broker-dealers that deal in derivatives subject to reporting requirements and regulatory oversight. The Securities and Exchange Commission would oversee securities-related derivatives, and the Commodities Futures Trading Commission would oversee agriculture-, commodities-, and futures-related derivatives. A new Office of Derivatives Supervision would be responsible for coordinating actions between the agencies and ensuring that they create consistent regulations for similar products. The bill was referred to both the House Financial Services and House Agriculture committees.

Federal Board Certification Act

On August 6, Sens. Olympia Snowe (R-Maine) and Ben Cardin (D-Md.) introduced a bill (S. 1592) to create a Federal Board of Certification that would set standards for and certify mortgage-backed securities. The board would include representatives from the Securities and Exchange Commission, the Comptroller of the Currency, the Department of Housing and Urban Development, the Treasury, and the Federal Reserve. The bill was referred to the Committee on Banking, Housing, and Urban Affairs.

Student Aid and Fiscal Responsibility Act Passed by House

On September 17, the House passed the Student Aid and Fiscal Responsibility Act (H.R. 3221), which would amend the Higher Education Act of 1965 so that the government would directly administer all federal student loan programs, thus eliminating private-sector participation in these programs. In addition, the bill would allocate billions of dollars for Pell Grant scholarships, community colleges, and early education programs. The bill was referred to the Senate Committee on Health, Education, Labor, and Pensions.

Federal Regulation

Board of Governors of the Federal Reserve

Proposed Changes in Disclosure Requirements for Mortgages and HELOCs

On July 23, the Board of Governors of the Federal Reserve announced proposed changes to Regulation Z that would affect disclosure requirements for mortgages (74, *Federal Register*, pp. 43232-425) and home equity lines of credit (HELOCs) (74, *Federal Register*, pp. 43428-613). Under the rule for closed-end mortgages, lenders would need to show how the consumer's interest rates compare with national averages and how an adjustable rate could affect payments, as well as highlight risky features such as negative amortization and improve other disclosures. To prevent mortgage brokers or loan officers from steering consumers into more expensive loans, payments to brokers by originators that are based on the loan's interest rates would be prohibited. Under the rule for HELOCs, consumers would receive a one-page summary of basic information and risks associated with a HELOC and lenders would be prohibited from terminating a HELOC for late payment until the consumer was at least 30 days past due. Comments on the proposed rules are due by December 24, 2009.

TALF Extended

On August 17, the Board of Governors of the Federal Reserve, in conjunction with the Treasury, announced that they had approved a limited extension to the Term Asset-Backed Securities Loan Facility (TALF). Newly issued asset-backed securities and legacy commercial mortgage-backed securities (CMBS) will still be eligible collateral for TALF loans through March 31, 2010. Newly issued CMBS will be considered eligible collateral through June 30, 2010. Previously, the TALF had been set to expire on December 31, 2009. For more information on the creation of the TALF, see *Banking Legislation and Policy*, Volume 27, Number 4.

Enhanced Consumer Protection Role for Nonbank Subsidiaries of Bank Holding Companies

On September 14, the Board of Governors of the Federal Reserve published a letter establishing a consumer compliance supervision policy for nonbank subsidiaries of BHCs and foreign banking organizations. The Fed will develop risk profiles of the institutions and determine their compliance with the consumer protection laws that fall under the Fed's examination and enforcement authority, such as the Truth in Lending Act. The policy was effective upon publication.

Proposed Consumer Credit Card Protections

On September 29, the Board of Governors of the Federal Reserve proposed an amendment to Regulation Z that would implement new rules on credit card disclosures, interest rates, and other consumer credit protection (74, *Federal Register*, pp. 54124-332). These rules were mandated by the Credit Card Accountability Responsibility and Disclosure (Credit CARD) Act of 2009, which was signed into law on May 22, 2009. On September 24, Reps. Carolyn Maloney (D-N.Y.) and Barney Frank (D-Mass.) introduced a bill (H.R. 3639) to move up the effective date for the provisions of the Credit CARD Act to December 1, 2009, from their original effective dates in February and August 2010. For more information on the Credit CARD Act, see *Banking Legislation and Policy*, Volume 28, Number 2.

Department of Justice

Settlement with Swiss Government to Release Names of U.S. Account Holders in UBS

On August 12, the Department of Justice (DoJ) announced that it had reached an agreement with Switzerland under which the Swiss bank UBS would release the names of 4,450 U.S. citizens with UBS accounts to the Internal Revenue Service (IRS). The DoJ charges that these accounts have been used by U.S. citizens to hide assets from the IRS. The settlement includes the DoJ dropping its John Doe summonses against UBS and a new treaty between the U.S. and Switzerland. The total value of the accounts was once as high as $18 billion, but the current value is uncertain.

Department of the Treasury

Additional Incentive Payments for Home Affordable Modification Program

On July 31, the Treasury released new Home Price Decline Protection Initiatives for its Home Affordable Modification program, a part of the Making Home Affordable program. The new initiative increases the incentive payments to servicers who initiate mortgage modifications in the markets hardest hit by falling home prices. These incentive payments will be based on average home prices and average decline in home prices in the areas and will accrue for up to 24 months if the modification is successful. For more information on the Home Affordable Modification program, see *Banking Legislation and* Policy, Volume 28, Number 1.

Federal Housing Finance Agency

Loan-to-Value Limit Increased for Home Affordable Refinance Program

On July 1, the Federal Housing Finance Agency expanded the Home Affordable Refinance program by increasing the loan-to-value limit for eligible mortgages from 105 percent to 125 percent of the home's value. The program, initiated in March as part of the Treasury's Making Home Affordable program, is designed to help "underwater" mortgage borrowers – those whose loan amount exceeds the current value of their home – by allowing them to refinance their loans at lower interest rates. For more information on the program, see *Banking Legislation and Policy*, Volume 28, Number 1.

Federal Trade Commission

Proposed Rule to Amend Telemarketing Sales Rule to Address Debt Relief Services

On July 30, the Federal Trade Commission issued a proposed rule that would protect consumers from misleading or fraudulent debt relief services that are sold through telemarketing (74, *Federal Register*, pp. 41988-42024). The rule would amend the Telemarketing Sales Rule to expand the definition of "debt relief service," require new disclosures and prohibit misrepresentations about rates of success, and prohibit debt relief services from requesting or receiving payment until the services have been performed and documented to the consumer. Comments on the proposed rule were due on October 9, 2009.

Judicial Rulings

Circuit Court Rulings

Advisory Firm Not Liable for Recommending Ponzi Scheme

On July 14, the U.S. Court of Appeals for the Second Circuit affirmed a lower court's dismissal of a securities fraud case against a financial adviser that had recommended investing in a fund that turned out to be part of a Ponzi scheme (*South Cherry Street LLC v. Hennessee Group LLC*, 2nd Cir., No. 07-3658, 7/14/09). The court found that a breach of contract claim against the adviser was void because of the nature of its oral contract with the investor and dismissed a charge of securities fraud because the adviser did not act with "either fraudulent intent or conscious recklessness" when it recommended the fund.

Constitutionality of the Unlawful Internet Gambling Enforcement Act
On September 1, the U.S. Court of Appeals for the Third Circuit affirmed a lower court's dismissal of a suit in which the plaintiff had argued that the Unlawful Internet Gambling Enforcement Act was unconstitutional (*Interactive Media Entertainment and Gaming Association Inc., v. Attorney General of the United States*, 3rd Cir., No. 08-1981, 9/1/09). The law, passed in 2006, prohibits online gambling businesses from processing payments for illegal Internet gambling transactions, where the legality of an Internet gambling transaction is dictated by state laws. The court found that the act was not unconstitutionally vague because a person of "ordinary intelligence" could understand the implications of the law; if the state gambling laws that are required to be enforced by the bill are vague, the problem lies with the state laws. The court also found that the act did not violate an individual's First Amendment privacy rights.

Tax Court Rulings
Credit Card Interchange Fees Ruled to Be a Form of Interest for Tax Purposes
On September 21, the United States Tax Court ruled that the interchange fees that credit card issuers charge merchants for each purchase made by a cardholder should be considered a form of interest for tax purposes (*Capital One Financial Corp. v. Commissioner of Internal Revenue*, T.C., No. 19519-05, 133 T.C. No. 8, 9/21/09). The Internal Revenue Service had argued that the interchange fee was payment by merchants for a service, but the court ruled that the fee was more economically equivalent to interest because it is income that compensates the issuers for the cost of lending money to the cardholders.

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