



Supervisory Insights

Devoted to Advancing the Practice of Bank Supervision

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Supervision

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Supervisory Insights

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2008 was a year of crisis for the U.S. financial services industry. In 2008 and shortly thereafter, more than \$13 trillion in temporary loans, liability and asset guarantees, and other government programs supporting financial institutions were put in place or announced, and policymakers focused attention on potential improvements to financial regulation. This article presents a chronology of the more significant events and developments affecting financial institutions during 2008 and concludes with a discussion of areas of supervisory focus going forward.

Remote Deposit Capture: A Primer 19

Remote Deposit Capture (RDC) technology is helping to improve the efficiency of how banks process check deposits. RDC allows financial institution customers to "deposit" checks electronically at remote locations, usually in the customers' offices, for virtually instant credit to their accounts. This article discusses the development and recent growth in the use of RDC, identifies risks to financial institutions that offer this service, and highlights appropriate risk management strategies.

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From the Examiner's Desk: Changes to Regulation Z Afford Increased Consumer Protections 25

Recent amendments to Regulation Z extend specific protections to consumers of a newly created category of mortgage loans called "higher-priced" home mortgages and enhance protections for consumers of "high-cost" and other mortgages. This article examines each of the four significant amendments to Regulation Z and offers suggestions for compliance professionals responsible for ensuring compliance with these critical regulatory changes.

Regulatory and Supervisory Roundup 42

This feature provides an overview of recently released regulations and supervisory guidance.

Letter from the Director

The U.S. economy and financial services industry have continued to experience unprecedented challenges during the first half of 2009. Soon after taking office, President Obama signed into law the American Recovery and Reinvestment Act of 2009, a sweeping piece of legislation designed to stimulate an economy buffeted by rising unemployment, tightening credit and liquidity, and declining real estate values.

In addition, in February 2009, the FDIC, along with the other federal financial regulatory agencies, announced the Financial Stability Plan, designed to restore confidence in U.S. financial institutions and stimulate the critical flow of credit to households and businesses. The plan includes a new Capital Assistance Program to help banks absorb potential future losses and support lending to creditworthy borrowers, and extends the FDIC's Temporary Liquidity Guarantee Program through October 2009. The plan also establishes a Public-Private Investment Program to facilitate the removal of up to \$1 trillion of problem assets from financial institution balance sheets and includes provisions designed to bolster the securitized credit markets that in recent years have supported a substantial portion of lending to consumers and small businesses.

This issue of *Supervisory Insights* provides a chronology of selected major events and developments that occurred in the financial services industry during a tumultuous 2008. Although the long-term effects are unclear, certain points of emphasis for bank supervisors are emerging, and "A Year in Bank Supervision: 2008 and a Few of Its Lessons" offers observations on areas of current and future supervisory attention.

A troubling result of the current serious problems in the nation's mortgage industry is the steadily increasing number of home foreclosures. To address concerns about possible preda-

tory lending practices, amendments to Regulation Z (Truth-in-Lending) and the Home Ownership and Equity Protection Act will take effect later this year. The article "Changes to Regulation Z Afford Increased Consumer Protections" previews the new requirements and looks at the practical implications for examiners and bankers.

Banks continue to look for ways to improve efficiency and attract customers, and this is especially important during the current economic downturn. More and more banks are offering Remote Deposit Capture (RDC) as an alternative to processing check deposits, and RDC appears to be a particularly attractive product for small- and medium-size business customers. Although RDC offers substantial benefits, including cost savings, this technology is not without risks. "Remote Deposit Capture: A Primer" describes the growing popularity of the product, identifies the risks, and provides an overview of risk mitigation techniques.

We hope our readers find the articles in this issue of *Supervisory Insights* timely and informative. If you have questions or comments about any of these articles, or if you have suggestions for other topics you would like to see considered for upcoming issues, please e-mail your feedback to SupervisoryJournal@fdic.gov.

Sandra L. Thompson
Director
Division of Supervision and
Consumer Protection

A Year in Bank Supervision: 2008 and a Few of Its Lessons

In the annals of bank supervision, 2008 will be remembered as a year in which some old assumptions were shattered and some old truths relearned. Significant risks emerged in financial products and activities long assumed safe. Risks were correlated internationally and across sectors to a degree no one anticipated. Complex financial engineering tools to measure and disperse risk that many had assumed would act as stabilizers in times of stress, appeared instead to be sources of financial opacity that heightened the risk of contagion. And some of the old banking basics—prudent loan underwriting, strong capital and liquidity, and the fair treatment of customers—re-emerged as likely cornerstones of a more stable financial system in the future.

One indicator of the gravity of recent developments is this: in 2008, U.S. financial regulatory agencies extended \$6.8 trillion in temporary loans, liability guarantees and asset guarantees in support of financial services. By the end of the first quarter of 2009, the maximum capacity of new government financial support programs in place, or announced, exceeded \$13 trillion (see Table 1). The need for emergency government assistance of such magnitude has triggered wide-ranging reassessments of financial sector regulation.

This article provides a selective chronology of events affecting banks in 2008.¹ The crisis has highlighted the importance of a number of areas for current and future supervisory attention, and the article concludes with observations on a few of these issues. While it is too early to draw conclusions about how the events of 2008 may change the way federal banking agencies do business, there appears to be a consensus on at least one central

lesson. The role of financial regulation and supervision going forward will be more important, not less, than it has been in the past.

The Prelude to the Events of 2008

The factors precipitating the financial turmoil of 2008 have been the subject of extensive public discussion and debate. The fallout from weak underwriting standards prevailing during a multi-year economic expansion first became evident in subprime mortgages, with Alt-A mortgages soon to follow. Lax underwriting practices fueled a rapid increase in housing prices, which subsequently adjusted sharply downward across many parts of the country.

With these adverse developments in the housing market, values of complex structured financial products backed by subprime and Alt-A mortgages declined precipitously, and wide swaths of rated mortgage-backed securitizations were downgraded. Other structured products, such as pooled Trust Preferred Securities, also were heavily downgraded. Collateral damage was a loss of marketplace confidence in rating methodologies. As weaknesses in the housing finance market intensified and began to surface in other credit sectors, securities that had been purchased based on an external rating suffered severe declines in value and liquidity.

Excessive reliance on financial leverage compounded problems for individual firms and the financial system as a whole. Thin capital cushions may have made some firms unable to sell assets at a loss and diminished the balance sheet capacity of potential buyers. Financial firms

¹ Sources of information for the majority of events and developments described in the chronology are press releases from the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the U.S. Department of the Treasury, and the U.S. Securities and Exchange Commission.

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Table 1

Government Support for Financial Assets and Liabilities Announced in 2008 and Soon Thereafter (\$ in billions)

Important note: Amounts are gross loans, asset and liability guarantees and asset purchases, do not represent net cost to taxpayers, do not reflect contributions of private capital expected to accompany some programs, and are announced maximum program limits so that actual support may fall well short of these levels.

	Year-end 2007	Year-end 2008	Subsequent or Announced Capacity If Different
Treasury Programs			
TARP investments ¹	\$0	\$300	\$700
Funding GSE conservatorships ²	\$0	\$200	\$400
Guarantee money funds ³	\$0	\$3,200	
Federal Reserve Programs			
Term Auction Facility (TAF) ⁴	\$40	\$450	\$900
Primary Credit ⁵	\$6	\$94	
Commercial Paper Funding Facility (CPFF) ⁶	\$0	\$334	\$1,800
Primary Dealer Credit Facility (PDCF) ⁵	\$0	\$37	
Single Tranche Repurchase Agreements ⁷	\$0	\$80	
Agency direct obligation purchase program ⁸	\$0	\$15	\$200
Agency MBS program ⁸	\$0	\$0	\$1,250
Asset-backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) ⁹	\$0	\$24	
Maiden Lane LLC (Bear Stearns) ⁹	\$0	\$27	
AIG (direct credit) ¹⁰	\$0	\$39	\$60
Maiden Lane II (AIG) ⁵	\$0	\$20	
Maiden Lane III (AIG) ⁵	\$0	\$27	
Reciprocal currency swaps ¹¹	\$14	\$554	
Term securities lending facility (TSLF) and TSLF options program (TOP) ¹²	\$0	\$173	\$250
Term Asset-Backed Securities Loan Facility (TALF) ¹³	\$0	\$0	\$1,000
Money Market Investor Funding Facility (MMIFF) ¹⁴	\$0	\$0	\$600
Treasury Purchase Program (TPP) ¹⁵	\$0	\$0	\$300
FDIC Programs			
Insured non-interest bearing transactions accounts ¹⁶	\$0	\$684	
Temporary Liquidity Guarantee Program (TLGP) ¹⁷	\$0	\$224	\$940
Joint Programs			
Citi asset guarantee ¹⁸	\$0	\$306	
Bank of America asset guarantee ¹⁹	\$0	\$0	\$118
Public-Private Investment Program (PPIP) ²⁰	\$0	\$0	\$500
Estimated Reductions to Correct for Double Counting			
TARP allocation to Citi and Bank of America asset guarantee ²¹			– \$13
TARP allocation to TALF ²¹			– \$80
TARP allocation to PPIP ²¹			– \$75
Total Gross Support Extended During 2008		\$6,788	
Maximum capacity of support programs announced through first quarter 2009²²			\$13,903

- ¹ \$300 is as of 1-23-2009 as reported in SIGTARP report of February 6 2009; EESA authorized \$700.
- ² Year-end reflects Treasury announcement of September 7, 2009, capacity reflects Treasury announcement of February 18, 2009; funding authorized under Housing and Economic Recovery Act.
- ³ Informal estimate of amount guaranteed at year-end 2008, provided by Treasury staff.
- ⁴ Year-end balances from Federal Reserve Statistical Release H.R. 1, "Factors Affecting Reserve Balances" (henceforth, H.R. 1); capacity from "Domestic Open Market Operations During 2008" (Report to the Federal Open Market Committee, January 2009), page 24.
- ⁵ Year-end balances from H.R. 1.
- ⁶ Year-end balances from H.R. 1; capacity from "Report Pursuant to Section 129 of the Emergency Economic Stabilization Act of 2008: Commercial Paper Funding Facility," accessed May 26, 2009, from <http://www.newyorkfed.org/aboutthefed/annual/annual08/CPFFfinstmt2009.pdf>.
- ⁷ Year-end balances from H.R. 1; see also "Domestic Open Market Operations During 2008" (henceforth "DOMO report") report to the Federal Open Market Committee, January 2009, page 11, summary of activity in program announced March 7 by the Federal Reserve.
- ⁸ Year-end balances from H.R. 1, capacity from Federal Reserve announcements of November 25, 2008 and March 18, 2009.
- ⁹ H.R. 1.
- ¹⁰ Year-end balances from H.R. 1; capacity from periodic report pursuant to EESA, "Update on Outstanding Lending Facilities Authorized by the Board Under Section 13(3) of the Federal Reserve Act," February 25, 2009, page 8, henceforth referred to as "Update;" Federal Reserve AIG support is separate from Treasury support that is included in the TARP line item.
- ¹¹ Year-end balances reported in DOMO report, page 25.
- ¹² Year-end balances from H.R. 1; capacity from Federal Reserve announcement of March 11, 2008, Federal Reserve Bank of New York press release of August 8, 2008, and discussion at page 22 of DOMO report.
- ¹³ From "Update," page 2.
- ¹⁴ From "Report Pursuant to Section 129 of the Emergency Economic Stabilization Act of 2008: Money Market Investor Funding Facility," accessed May 26, 2009, from <http://www.federalreserve.gov/monetarypolicy/files/129mmiff.pdf>; Federal Reserve to fund 90 percent of financing or \$540 billion.
- ¹⁵ Program and capacity announced by the Federal Reserve, March 18, 2009.
- ¹⁶ FDIC Quarterly Banking Profile, Fourth Quarter 2008, (henceforth, "QBP") Table III-C.
- ¹⁷ Year-end outstanding from QBP, Table IV-C; total estimated cap for all entities opting in the program from QBP, Table II-C.
- ¹⁸ Announcement by FDIC, Treasury, and Federal Reserve November 23, 2008.
- ¹⁹ Announcement by FDIC, Treasury, and Federal Reserve of January 16, 2009.
- ²⁰ To purchase legacy assets, as described in Treasury, FDIC, and Federal Reserve announcement of March 23, 2009. \$500 refers to maximum capacity of Legacy Loans Program; funding for the Legacy Securities Program is believed to be subsumed under the TALF.
- ²¹ SIGTARP quarterly report of April, 2009, page 38.
- ²² Year-end 2008 amounts plus the amount by which announced capacity exceeds the year-end 2008 amount, minus the amount of known double counting.

with significant concentrations of risky or illiquid assets, funded with shorter-term or credit-sensitive liabilities, experienced difficulties in this environment.

A Selective 2008 Chronology

The First Quarter

As 2008 began, policymakers were closely monitoring the economic effects of the credit market turmoil that had started in earnest in August 2007. For example, minutes of January 2008 meetings and conference calls of the Federal Open Market Committee (FOMC) cite economic developments that were more downbeat than expected, including ongoing strains in financial markets and credit conditions. Citing downside risks to the economic outlook, the FOMC reduced the target federal funds rate from 4.25 percent to 3.5 percent.

Special programs to stabilize the financial system already were in full swing in January. The Federal Reserve extended \$60 billion that month in auctions conducted through its Term Auction Facility (TAF), a temporary program the Federal Reserve established in December 2007. Through the TAF, the Federal Reserve extends short-term collateralized loans to depository institutions in sound financial condition. Loans to depository institutions under the TAF continued throughout 2008 in auctions conducted two to four times per month, and would reach \$450 billion outstanding by year-end.

Another program established by the Federal Reserve in December 2007 also was up-and-running in January. The Federal Reserve authorized a series of reciprocal currency agreements with foreign central banks to support

U.S. dollar liquidity in those markets. Balances under this program would swell from \$14 billion at the beginning of 2008 to \$554 billion by year-end.

A significant benchmark for market illiquidity occurred on February 7 when the auction-rate securities market started to fail. Auction-rate securities had been an important source of low-cost financing for municipalities. But when investor interest started to wane, and the large investment banks that had made a market in these securities stopped acting as buyers of last resort, auctions failed with rapidly increasing frequency. The market for auction-rate securities froze, interest rates paid by municipalities escalated abruptly, investors were unable to dispose of their holdings, and write-downs and numerous class action lawsuits ensued. The legal and financial ramifications of this market shutdown would be felt throughout 2008.²

Official concerns about the liquidity of financial institutions intensified as the first quarter progressed. On March 7, the Federal Reserve announced it would lend up to \$100 billion to primary dealers in the form of term repurchase agreements. The primary dealers are the large financial institutions with which the Federal Reserve conducts open market operations (see *The Primary Dealers* inset box). On March 11, the Federal Reserve announced a new Term Securities Lending Facility (TSLF) to lend up to \$200 billion in Treasury securities to primary dealers, secured for a term of 28 days by other securities. The Federal Reserve announced the \$200 billion allocated to the TSLF was a supplement to the initiative announced on March 7. TSLF lending would reach \$173 billion by year-end.

² See http://en.wikipedia.org/wiki/Auction_rate_security, accessed April 17, 2009.

The Primary Dealers

Primary dealers are the entities with which the Federal Reserve Bank of New York conducts open market operations. As listed on the Web site of the Federal Reserve Bank of New York, they are:

BNP Paribas Securities Corp.
Banc of America Securities LLC
Barclays Capital Inc.
Cantor Fitzgerald & Co.
Citigroup Global Markets Inc.

Credit Suisse Securities (USA) LLC
Daiwa Securities America Inc.
Deutsche Bank Securities Inc.
Dresdner Kleinwort Securities LLC
Goldman, Sachs & Co.
HSBC Securities (USA) Inc.
J. P. Morgan Securities Inc.
Mizuho Securities USA Inc.
Morgan Stanley & Co. Incorporated
RBS Securities Inc.
UBS Securities LLC³

During the week of March 11, a run developed on Bear Stearns, culminating in the March 14 announcement it would be acquired by JPMorgan Chase & Co. Under the terms of the agreement, the Federal Reserve Bank of New York provided \$30 billion in financing to facilitate the acquisition. JPMorgan Chase would bear the first \$1 billion of any losses associated with the Bear Stearns assets being financed, and the Federal Reserve would fund the remaining \$29

billion on a non-recourse basis to JPMorgan Chase.⁴

Bear Stearns was the first large investment bank to be acquired by a bank holding company during 2008. Of the other four largest investment banks in the United States, one would fail and the others would be acquired by, or become, bank holding companies (see 2008: *The Year of the Bank Holding Company* inset box).

2008: The Year of the Bank Holding Company

March 14: Bear Stearns (pre-acquisition assets \$399 billion) acquired by JPMorgan Chase with FRB assistance.

June 5: Federal Reserve announces approval of the notice of Bank of America Corporation to acquire Countrywide Financial Corporation (pre-acquisition assets \$199 billion).

September 15: Bank of America announces agreement to acquire Merrill Lynch (pre-acquisition assets \$966 billion).

September 21: Federal Reserve approves applications of Goldman Sachs (pre-conversion assets \$1,082 billion) and Morgan Stanley (pre-conversion assets \$987 billion) to become bank holding companies.

September 24: JPMorgan Chase acquires the banking assets of the failing Washington Mutual (pre-acquisition asset size \$309 billion).

November 10: Federal Reserve approves applications by American Express Company (pre-conversion assets \$127 billion) and American Express Travel Related Services Company, Inc., to become bank holding companies.

December 24: Federal Reserve approves application of GMAC, LLC (pre-conversion assets \$211 billion) to become a bank holding company.

Total assets converting to bank holding company status or acquired by bank holding companies in these transactions: \$4.3 trillion

³ List of the Primary Government Securities Dealers Reporting to the Government Securities Dealers Statistics Unit of the Federal Reserve Bank of New York. Effective February 11, 2009, Merrill Lynch Government Securities Inc. was deleted from the list of primary dealers as a result of the acquisition of Merrill Lynch & Co., Inc. by Bank of America Corporation (see <https://www.newyorkfed.org/markets/primarydealers.html>).

⁴ Federal Reserve Bank of New York, "Statement on Financing Arrangement of JPMorgan Chase's Acquisition of Bear Stearns," March 24, 2008 at www.newyorkfed.org/newsevents/news/markets/2008/rp080324.html.

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In the wake of the run on Bear Stearns, the Federal Reserve on March 16 authorized the Federal Reserve Bank of New York to create a lending facility to improve the ability of primary dealers to provide financing to securitization market participants. The new facility was to be available for business the following day. The Primary Dealer Credit Facility (PDCF) allows participants to borrow from the Federal Reserve against a wider range of collateral than would be acceptable for Federal Reserve Open Market Operations, with the rates on the borrowing being fixed rather than determined through an auction. Credit extended by the PDCF would reach \$37 billion outstanding by year-end.

The Second Quarter

Supervisory activity related to failing financial institutions entered a brief lull during the second quarter. Adverse economic developments and building credit and liquidity pressures nevertheless continued unabated, setting the stage for a tumultuous second half of the year. The second quarter saw about 53,000 downgrades of rated tranches of securitizations;⁵ insured bank and thrift bank earnings 87 percent below second quarter 2007 levels; a 25 percent reduction in the KBW Index of large cap bank stocks;⁶ and a decline in the 20-city S&P/Case-Shiller index of home prices⁷ to a mid-year level that was roughly 16 percent below its mid-2007 level and 19 percent below the July 2006 peak.

The Third Quarter

During third quarter 2008, the credit and liquidity pressures that had been building since the summer of 2007 were unleashed. The events of the third quarter fundamentally changed the way policymakers viewed the risks facing the economy and the financial system, and

set in motion the legislative rescue efforts that would be put in place in the fourth quarter of 2008 and early 2009.

IndyMac Bank, FSB, was closed by the Office of Thrift Supervision on July 11, and the FDIC was named conservator. At the time it was closed, IndyMac's assets of \$32 billion made it the second largest bank failure in FDIC history. The FDIC would operate the Bank through the remainder of 2008 until announcing, at year-end, its sale to an investor group.

IndyMac's losses, and the losses subsequently borne by the FDIC as receiver, were centered in a large portfolio of low- and no-documentation mortgage loans and securities backed by such loans. The failure of this institution thus underscored a broad and critical driver of the financial turmoil.

Hints of potential problems at Fannie Mae and Freddie Mac began to surface soon after the IndyMac failure. On July 13, Treasury Secretary Paulson announced he was working with Congress and other regulators to obtain temporary authority to purchase equity in these entities, if needed. On the same day, the Federal Reserve announced it had authorized the Federal Reserve Bank of New York to lend to Fannie Mae and Freddie Mac. Further evidence of official concern emerged on July 15, when the U.S. Securities and Exchange Commission (SEC) issued an emergency order to prohibit "naked" short selling in the shares of Fannie Mae, Freddie Mac, and commercial and investment bank primary dealers.

During the month of August, the SEC announced settlements with Citigroup, Wachovia, and Merrill Lynch in which those banks agreed to compensate investors who alleged they had purchased auction-rate securities on the basis of misleading information. Other

⁵ Bloomberg; this figure includes securities downgraded multiple times or by more than one ratings agency.

⁶ See Keefe, Bruyette, & Woods at <https://www.kbw.com>.

⁷ See <http://www2.standardandpoors.com>.

proposed and final settlements would be announced throughout 2008 by the SEC, the Financial Industry Regulatory Authority, and state attorneys general. Among the firms named in these announcements were UBS, Deutsche Bank, Credit Suisse, Bank of America, JPMorgan Chase, Goldman Sachs, and Morgan Stanley.⁸ Details varied, but the proposed settlements often involved agreements by institutions to repurchase auction-rate securities from investors, or compensate them for losses incurred in selling the securities.

On September 7, Fannie Mae and Freddie Mac were placed in conservatorship by the Federal Housing Finance Agency, with the Treasury agreeing to provide \$100 billion in financial support to each entity. The federal support evidenced by the conservatorship solidified expectations for the safety of government-sponsored enterprise (GSE) debt and mortgage guarantees, but equity owners and preferred shareholders were effectively wiped out. On the same day, the federal banking agencies announced their intention to work as needed with banks on capital restoration plans, and reminded banks that net unrealized losses on preferred and common stock were to be deducted from regulatory capital.

On September 15, Lehman Brothers Holdings, Inc. filed for Chapter 11 bankruptcy protection. Lehman Brothers had assets of \$639 billion. It is difficult to attribute the failure of a firm of this size to a single factor, but important factors contributing to Lehman's problems appear to have included its highly leveraged financial structure, a higher than normal volume of illiquid, complex, or otherwise hard-to-value assets, and reliance on short-term, credit-sensitive funding sources.

Losses to equity and preferred shareholders of the GSEs and prospective losses in bankruptcy of the Lehman creditors sharply increased the degree of risk aversion in the financial markets. Credit spreads in interbank lending markets spiked, and banks found it more difficult to fund their operations, both unsecured and through the market for repurchase agreements.

In an effort to head off problems in certain repo markets, on September 14, the Federal Reserve announced it would exempt from Section 23A of the Federal Reserve Act⁹ certain extensions of credit from insured depository institutions to their affiliates, for the purposes of financing securities traded in the tri-party repo market. On the same day, the Federal Reserve announced the collateral it would accept under the PDCF would extend beyond investment-grade securities, and the types of AAA securities it would accept as collateral for the TSLF would be expanded.

Another effect of the Lehman Brothers failure quickly became apparent when on September 16, shares in the Reserve Primary Fund "broke the buck"¹⁰ as a result of its holdings of Lehman Brothers' commercial paper. Investors' demands for redemption of money fund shares system-wide increased dramatically, triggering concerns about the effect a run on these funds would have on their bank sponsors and the broader economy.

Federal agencies very quickly made a series of announcements to mitigate the potential problems associated with mutual fund redemptions. First, on September 17, the SEC clarified that bank support to an affiliated money market fund would not necessarily trigger a requirement to consolidate the assets of the fund on the bank's balance

⁸ See www.sec.gov/news/press/sec-actions.htm and http://en.wikipedia.org/wiki/Auction_rate_security, accessed April 17, 2009.

⁹ Section 23A of the Federal Reserve Act is designed to limit a bank's credit exposure to its affiliates.

¹⁰ Money market funds seek a stable \$1.00 net asset value (NAV). If a fund's NAV drops below \$1.00, this is referred to as "breaking the buck."

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sheet. Shortly thereafter, the Treasury on September 19 announced the creation of a temporary guarantee program for the U.S. money market mutual fund industry. In exchange for a fee, the Treasury would insure the holdings of any publicly offered eligible money market mutual fund. Within days, to address concerns about how this program might draw deposits away from banks, the Treasury clarified the coverage would be available only for amounts held in eligible funds as of September 19, not to newly accepted funds.

Also on September 19, the Federal Reserve announced the establishment of the Asset-backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF). This facility would lend to banks and bank holding companies to finance their purchases of high-quality asset-backed commercial paper from money market mutual funds (amounts outstanding under the AMLF would reach \$24 billion by year-end). The Federal Reserve also announced that commercial paper purchased by banks and bank holding companies under this program would enjoy a temporary exemption from leverage capital requirements, risk-based capital requirements, and Sections 23A and 23B of the Federal Reserve Act. On the same day, the Federal Reserve also announced it would purchase short-term debt of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks from primary dealers.

A theme that was much discussed in 2008 was whether the activities of short sellers were exacerbating the financial crisis. The SEC took its most forceful step in this regard on September 19, when it announced a temporary ban on short-selling the securities of 799 financial companies; this ban expired on October 17.

Notwithstanding all these actions, the liquidity crunch continued unabated.

On September 21, the Federal Reserve announced it had authorized the Federal Reserve Bank of New York to extend credit to the U.S.-based and London-based broker dealer subsidiaries of Goldman Sachs, Morgan Stanley, and Merrill Lynch. On the same day, the Federal Reserve approved the applications of Morgan Stanley and Goldman Sachs to become bank holding companies.

The largest bank failure in FDIC history occurred on September 25, when Washington Mutual Bank, Seattle, Washington (WMB) was closed by the Office of Thrift Supervision, and the FDIC was appointed receiver. JPMorgan Chase acquired the banking operations of Washington Mutual, including the \$307 billion combined assets of WMB and Washington Mutual, FSB, Park City, Utah. The claims of equity, subordinated and senior debt holders were not acquired. The estimated cost of the transaction to the FDIC was zero.

On September 29, the Federal Reserve authorized the Federal Reserve Bank of New York to lend up to \$85 billion to American International Group (AIG). The amount of government assistance to AIG would subsequently be increased, and the potential amount of support stood at about \$180 billion as of March 20, 2009.¹¹ The assistance to AIG is best viewed as a form of support to the economy generally, and to the financial services industry in particular. It has since emerged that a number of large bank counterparties to credit default swaps (CDS) guaranteed by AIG have been made whole as a result of the AIG assistance. The problems at AIG have been attributed to its unsupportable volume of CDS activity. Thus, ironically, the use of CDS, a financial engineering tool that was supposed to disperse risk and lessen the likelihood of a credit crisis, in this instance appeared to add to policymakers' concerns about the potential for financial instability and contagion

¹¹ This figure comprises a \$70 billion maximum allocation from TARP, a \$60 billion line of credit from the Federal Reserve, and roughly \$50 billion in aggregate in the Federal Reserve's Maiden Lane II and III LLCs. See also "AIG Loan Facility," an archive of press releases and documents related to the financial support of American International Group at www.newyorkfed.org/newsevents/aig_loan.html.

should this important CDS guarantor default.

On the same day that the Federal Reserve assisted AIG, the FDIC, Treasury, and Federal Reserve announced an open bank assistance transaction to facilitate the acquisition of the banking operations of Wachovia Corporation, Charlotte, North Carolina, by Citigroup. Subsequently, an offer emerged from Wells Fargo to acquire Wachovia in a transaction that did not require government assistance. The offer from Wells Fargo ultimately was consummated.

The Fourth Quarter

As the fourth quarter began, it was apparent that legislation was needed to boost market confidence, stimulate the

economy, and supplement the resources of the financial regulatory agencies to address the crisis.

The Emergency Economic Stabilization Act of 2008 (EESA) was signed by the President on October 3, “to restore liquidity and stability to the financial system of the United States.” Among other things, the EESA provided the Treasury up to \$700 billion to establish a Troubled Asset Relief Program (TARP) (see inset box below) and temporarily increased the basic deposit insurance coverage limit to \$250,000. (On May 20, 2009, President Obama signed into law the “Helping Families Save Their Homes Act,” which extended the \$250,000 basic deposit insurance limit to January 1, 2014.)

Troubled Asset Relief Program Capital Purchase Program

The Emergency Economic Stabilization Act of 2008 (EESA) provided for the establishment of the Troubled Asset Relief Program (TARP). The EESA vests in the Treasury explicit authority to administer the TARP and pursuant to such authority the Treasury established its Capital Purchase Program (CPP). Financial institutions were permitted to apply within prescribed deadlines to receive CPP funds under conditions specified in Term Sheets developed by the Treasury.¹²

Of the \$700 billion approved for TARP as part of the EESA, the Treasury is reported to have allocated funding of \$590 billion as of March 31, 2009, as follows: \$218 billion invested in 532 banks through the CPP program; \$25 billion for the Automotive Industry Financing Program (Chrysler, Chrysler Financial, General Motors and GMAC); \$5 billion for the Auto-Supplier Support Program; \$15 billion for the Unlocking Credit for Small Business Program; \$70 billion for the Systemically Significant Failing Institutions Program (AIG); \$40 billion in the Targeted Investment Program (investments in Citigroup, Bank of America); \$12.5 billion for the Asset Guarantee Program

(guarantees on selected assets of Citigroup and Bank of America); \$80 billion for the Term Asset-Backed Securities Loan Facility (TALF); \$50 billion for the Making Home Affordable Program; and \$75 billion for the Public-Private Investment Program.¹³

The term sheets, and implementing Treasury regulations, place a number of requirements on institutions accessing CPP funds. Specific limitations are placed on the payment of dividends and the repurchase or redemption of capital stock. There are limits on compensation designed to exclude incentives for senior executives to take excessive risks, requirements to recover bonus or incentive compensation paid to a senior executive based on information later shown to be materially inaccurate, restrictions on the use of golden parachutes, and a prohibition on the deduction of executive compensation in excess of \$500,000 for tax purposes. For details about the executive compensation rules, see the Treasury’s interim final rules at 31 CFR Part 30 and available at <http://www.treas.gov/press/releases/hp1364.htm>.

Although the CPP does not impose specific requirements about the use of

funds, the federal banking agencies expect institutions receiving CPP funds to ensure the adequacy of their capital base, support prudent lending to creditworthy borrowers, and work with borrowers to avoid preventable foreclosures. These expectations are described in more detail in the November 2008, *Interagency Statement on Meeting the Needs of Creditworthy Borrowers (Interagency Statement)*. In addition, the FDIC announced that state non-member banks should implement processes to monitor their use of capital injections, liquidity support, or financing guarantees obtained through recent financial stability programs. The FDIC encouraged institutions to include, in shareholder and public reports, information about how the funds were used to support prudent lending and assist borrowers in avoiding unnecessary foreclosures.¹⁴

As part of its examination program, the FDIC assesses compliance with the CPP securities purchase agreements and the associated requirements of the EESA and reviews banks’ efforts to implement the *Interagency Statement*.

¹² See FIL-109-2008 at <https://www.fdic.gov/news/inactive-financial-institution-letters/2008/fil08109a.html>.

¹³ *SIGTARP: Office of the Inspector General for the Troubled Asset Relief Program, Quarterly Report to Congress*, April 21, 2009, page 38.

¹⁴ “Monitoring the Use of Funding from Federal Financial Stability and Guaranty Programs,” FDIC FIL-1-2009, January 12, 2009. See <https://www.fdic.gov/news/inactive-financial-institution-letters/2009/fil09001.html>.

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Actions to stabilize the financial system did not end with the EESA. Less than a week after the EESA was signed, on October 7, the Federal Reserve announced the creation of the Commercial Paper Funding Facility (CPFF) to provide liquidity to U.S. issuers of commercial paper through a special-purpose vehicle that would purchase three-month unsecured and asset-backed commercial paper directly from eligible issuers. CPFF credit would increase to \$334 billion outstanding by year-end.

On October 14, the Treasury, the FDIC, and the Federal Reserve announced further actions to strengthen market stability. Treasury made available \$250 billion in capital to U.S. financial institutions pursuant to its authority under the EESA; nine large institutions would subscribe to this facility in a total amount of \$125 billion. The FDIC announced the Temporary Liquidity Guarantee Program (TLGP) (see *Temporary Liquidity Guarantee Program* inset box).

Further action to support financial institutions came on October 21, when the

Federal Reserve announced the creation of the Money Market Investor Funding Facility (MMIFF). Through this program, the Federal Reserve Bank of New York would provide liquidity to a series of special-purpose vehicles to finance the purchase of eligible assets from U.S. money market mutual funds and potentially, over time, from other investors. MMIFF credit outstanding was zero through year-end.

On November 23, the Treasury, FDIC, and Federal Reserve provided assistance to Citigroup. The Treasury and FDIC provided protection against the possibility of unusually large losses on a pool of approximately \$306 billion in assets on Citigroup's balance sheet, with Citigroup issuing preferred shares to the Treasury and FDIC in exchange. The agreement provided that the Federal Reserve stands ready to backstop residual risk in the pool through a non-recourse loan. Treasury invested \$20 billion in Citigroup from the TARP in the form of preferred stock.

Temporary Liquidity Guarantee Program

On October 13, 2008, the FDIC established the Temporary Liquidity Guarantee Program (TLGP) to provide a temporary guarantee for certain newly issued senior unsecured debt issued by banks and their eligible affiliates, up to 125 percent of the senior unsecured debt outstanding as of September 30, 2008 (or, for insured depository institutions, the greater of this amount or two percent of consolidated liabilities at such date). The TLGP also fully insures certain non-interest bearing deposit transaction accounts. Participating institutions are assessed fees for guaranteed amounts they have outstanding under both programs.

The TLGP was established pursuant to a systemic risk determination by the Board of

Directors of the FDIC, with the agreement of the Board of Governors of the Federal Reserve System, and the Secretary of Treasury in consultation with the President. The FDIC initiated the TLGP to address disruptions in the credit markets, notably the interbank lending market, which reduced the liquidity of financial institutions and their ability to lend.

As of year-end 2008, 7,207 insured depositories had opted into the transaction account guarantee program, and 4,561 insured institutions and 3,630 holding companies and affiliates had opted into the debt guarantee program. Of the 8,191 institutions opting into the debt program, 64 institutions had issued TLGP-guaranteed debt as of year-end 2008, in an aggregate

amount of \$224 billion. These and other TGLP statistics are available in the FDIC *Quarterly Banking Profile* at

<http://www2.fdic.gov/QBP/qbpSelect.asp?menuItem=QBP>.

The definitions of debt and non-interest bearing deposits eligible to be guaranteed or insured under TLGP, and the requirements for participation in the program, are found at Part 370 of the FDIC's Rules and Regulations.¹⁵

All entities that participate in the FDIC's TLGP are subject to supervisory oversight to prevent rapid asset growth or excessive risk taking. The FDIC, in consultation with an entity's primary regulator, determines eligibility and use of the TLGP and supervises compliance with the TLGP requirements as part of its examination program.

¹⁵ This rule, as well as the Master Agreement that participants in the debt program must sign, Frequently Asked Questions, and other resources can be found at <http://www.fdic.gov/regulations/resources/TLGP/index.html>.

On November 25, the Federal Reserve announced it would initiate a program to purchase from primary dealers up to \$100 billion in direct obligations of GSEs (Fannie Mae, Freddie Mac, and the Federal Home Loan Banks), and up to \$500 billion of mortgage-backed securities backed by Fannie Mae, Freddie Mac, and Ginnie Mae. These purchases were expected to occur over several quarters.

On the same day, the Federal Reserve announced the creation of the Term Asset-Backed Securities Loan Facility (TALF) to support the issuance of asset-backed securities (ABS) collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration. Under this program, the Federal Reserve Bank of New York would lend up to \$200 billion on a non-recourse basis to holders of recently originated ABS. The Treasury provided up to \$20 billion of credit protection to the Federal Reserve Bank of New York in connection with the TALF.¹⁶

On December 11, the SEC announced that it was charging Bernard L. Madoff and his investment firm, Bernard L. Madoff Securities LLC, with securities fraud in connection with a multi-billion dollar Ponzi scheme that he had allegedly perpetrated on clients of his firm. Mr. Madoff subsequently pleaded guilty to such charge. Although not directly relevant to the activities of insured banks and bank holding companies, this development was widely reported and further contributed to the erosion in market confidence that has adversely affected the financial services industry, and reinforced the support for regulatory reform.

As 2008 came to a close, indicators of financial and economic performance continued to disappoint. During fourth

quarter 2008, FDIC-insured banks and thrifts posted a \$37 billion loss, driven by high loan-loss expenses, trading losses, and goodwill write downs. More than 67,000 rated securitization tranches were downgraded during the fourth quarter.¹⁷ The S&P/Case-Shiller Index of home prices in 20 large cities stood about 19 percent below year-end 2007 levels and about 27 percent below the July 2006 peak. Fourth quarter GDP growth (revised) as reported by the National Bureau of Economic Research was negative 6.2 percent. Consistent with these trends, the FDIC reported higher levels of failed and problems banks at year-end (See *Problem and Failing Banks* inset box).

On a positive note, the various federal assistance programs appear to have stabilized the ability of financial institutions to access the credit markets. For example, the spread between the 3-month London Interbank Offered Rate (LIBOR) and a comparable maturity government index (the TED spread) narrowed from a peak of 4.64 percent, reached on October 10 just before the announcement of the

Problem and Failing Banks

During 2008, the FDIC's problem bank list grew from 76 institutions with \$22 billion in assets at the beginning of the year to 252 institutions with \$159 billion in assets at the end of the year. Twenty-five banks failed during the year with assets of \$372 billion.

Community banks. A majority of the community banks that became problem banks or failed during 2008 had similar risk profiles. These banks often had extremely high concentrations, relative to their capital, in residential acquisition, development, and construction lending.

Loan underwriting and credit administration functions at these institutions typically were criticized by examiners. Frequently these institutions had exhibited rapid asset growth funded with brokered deposits.

Larger banks. Substantial losses to the FDIC insurance fund in 2008 came from portfolios of low- and no-documentation subprime and Alt-A mortgage loans and securities backed by such loans. In some cases, marketplace concerns about large exposures to these assets resulted in liquidity runs.

¹⁶ As indicated in the table accompanying this article, the Federal Reserve would announce a significant expansion of the TALF early in 2009.

¹⁷ See footnote 5.

TLGP and Capital Purchase Programs, to 1.35 percent at year end. This spread declined further to 0.99 percent at March 31, 2009.

Areas of Bank Regulatory and Supervisory Focus Beyond 2008

Underwriting

A look back on the buildup to the financial crisis reveals similarities to earlier cycles of boom and bust. During the expansion, financial firms engage in a competitive relaxation of credit standards and risk tolerances to gain and maintain revenue growth. Easy credit allows borrowers to refinance ever-greater obligations in lieu of repayment, driving down default rates. This fuels the perception that credit risk is minimal, stimulating further loosening of credit terms in a self-perpetuating cycle. To some banks operating in such an environment, traditional lending standards can appear an unnecessary impediment to revenue growth.

A decline in loan underwriting standards belongs on any list of the factors responsible for the current crisis. To varying degrees, subprime mortgages, Alt-A mortgages with little or no documentation of income, residential construction loans, loans to leveraged corporate borrowers, commercial real estate loans, and other consumer loans have exhibited weakness in underwriting standards. Underwriting weaknesses have contributed to investor uncertainty about the quality of bank assets and amplified the adverse impact of the economic downturn on bank performance.

Over the years, the banking agencies have issued a number of supervisory guidance documents regarding adverse credit risk trends. These included guidance on managing the risks in leveraged corporate loans, credit cards, home

equity loans, commercial real estate loans, non-traditional mortgages, and subprime mortgages. These guidance documents indicate that the agencies were generally aware of, and concerned about, emerging potential credit risks. A future focus of supervision in responding to such emerging risks may well include a careful look at where the line should be drawn between guidance and informal supervisory expectations on the one hand, and more tangible requirements on the other.

Consumer Protection

This crisis also has demonstrated the linkages between safe-and-sound banking, and banking that complies with the letter and spirit of laws designed to protect consumers and investors. Indeed, the triggering event for this crisis was the origination, and often the subsequent securitization, of large volumes of mortgages with little or no documentation of income or consideration of the borrower's ability to repay the loan under the contractual terms from sources other than the collateral. These features were made worse by low initial interest rates that reset to much higher rates, causing explosive payment shock. Along with their profoundly negative safety-and-soundness implications that included a multi-year wave of foreclosures and the collapse in value of many mortgage-backed securities, these lending practices were harmful to consumers and in many cases involved alleged unfair, deceptive, or abusive behavior.

Individual consumers were not alone in expressing concern about harmful financial practices. In a number of cases, institutional buyers of complex securities marketed by banking organizations and large investment banks claimed that they were misled or not told about significant risks associated with these securities. The most prominent example involved the allegations surrounding the failure of the auction-rate securities market.

Concerns about practices in the auction-rate securities market were not new. In 2006, the SEC issued a cease-and-desist action in connection with its investigation of 15 firms that sold auction-rate securities during 2003 and 2004.¹⁸ The investigation found violations of federal laws that prohibit material misstatements or omissions. The shut-down of the auction-rate securities market in February 2008 prompted numerous class action lawsuits and investigations by state attorneys general, alleging violations of securities law and non-compliance with the SEC's 2006 cease-and-desist action. Most of the lawsuits were settled out of court; investment banks have agreed to repurchase about \$50 billion in auction-rate securities.¹⁹ The collapse of the auction-rate securities market dramatically illustrates that market conduct is of concern not only to investors, but can affect the safety-and-soundness of institutions and have spillover effects on the broader economy.

Developments such as these will likely heighten future regulatory and supervisory focus on investor and consumer protection. Examples of initiatives underway at the FDIC include enhancement of communication across the safety-and-soundness and compliance examination disciplines, including ratings reconciliation to ensure adverse findings in one discipline have been adequately considered by the other; the expanded use of joint examination teams where significant crosscutting safety-and-soundness and compliance issues appear to exist; and the development of red flags for individual institutions' compliance risk to assist in establishing supervisory priorities. In addition, the FDIC has and will continue to work with other federal and state regulatory agencies to identify and address consumer abuses in a unified and robust manner.

Capital

Another issue receiving attention from financial regulators in the wake of this crisis is capital adequacy regulation. Concerns have been raised about the quality of bank capital (for example, whether banks have sufficient common equity as compared to debt-like or other instruments that qualify as regulatory capital), the adequacy of the risk-based capital rules, and the lack of simple restrictions on financial institutions' leverage in most foreign jurisdictions and for most non-banks.

Regulators have stressed that common equity should be the predominant form of bank capital because of its ability to absorb unexpected losses while the bank continues to operate as a going concern. Regulatory tier 2 capital is of lower quality in this respect and may constitute set-asides for identified losses (e.g., the allowance for loan and lease losses) or claims on the bank that can absorb losses only in a bank failure, but not while the bank operates as a going concern. Some types of tier 1 capital (e.g., deferred tax assets and debt-like instruments such as Trust Preferred Securities and deferred tax assets) are subject to quantitative regulatory limits, reflecting the recognition that they are not coequal with common equity in their ability to absorb unanticipated losses while a bank operates as a going concern.

Policymakers also are focusing on improving the performance of the risk-based capital framework. The crisis revealed severe deficiencies with these rules. An in-depth treatment of these issues is well beyond the scope of this paper, but thus far, banks' largest losses appear to have been in the asset classes accorded the most favorable risk-based capital treatment. Large losses have been experienced in trading books, certain

¹⁸ "15 Broker-Dealer Firms Settle SEC Charges Involving Violative Practices in the Auction Rate Securities Market," SEC press release 2006-83.

¹⁹ See http://en.wikipedia.org/wiki/Auction_rate_security, accessed April 17, 2009.

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highly rated securitizations, and mortgage portfolios that were deemed low risk under current risk-based capital rules (capital requirements for these exposures would have been reduced even further under Basel II). Certain types of structured investment vehicles (SIVs) avoided capital requirements altogether, both under current rules and under Basel II.

Another aspect of the buildup to the crisis was that the financial system became more highly leveraged. Within the regulated commercial and investment banking sector, this trend was most pronounced at some entities that were not subject to clear-cut regulatory restrictions on the use of leverage: large European banks, large U.S. investment banks, and the non-bank segments of some U.S. bank holding companies. Given the magnitude of losses banks have experienced, in many cases centered in exposures deemed low risk by the risk-based capital rules, the merits of leverage-based capital requirements to complement the risk-based rules are becoming better understood.

The Basel Committee on Banking Supervision has announced its intention to develop proposals for comment in all of these areas by the end of 2009, for implementation once the crisis has passed. Going forward, banks and supervisors can expect a heightened focus on capital adequacy.

Concentrated Risk

This crisis also has underscored the dangers of excessive risk concentrations on banks' balance sheets. This risk manifested itself both in direct credit concentrations by sector or by counterparty and, more subtly, by concentration in exposures correlated in unexpected ways to a common risk factor or excessively reliant on the representations of third parties.

Balance sheet concentrations in commercial real estate (CRE) lending,

especially acquisition, development and construction lending, were a problem in the 1980s and they are a problem now for some banks and thrifts. While the 1980s CRE problems were driven largely by commercial property overbuilding, problems in this cycle thus far have centered in residential CRE fueled by demand generated by unsustainable lending. Problems have been most acute for institutions that relied on brokered deposits to rapidly grow a poorly underwritten loan portfolio.

Excessive concentrations of exposure to the default, downgrade, or other adverse developments affecting a single counterparty have contributed both to the magnitude and speed of transmission of this crisis. Whether the exposures were to Fannie or Freddie, to Lehman Brothers, to AIG, to the continued AAA-rating of monoline bond insurers, or to other entities, the crisis revealed selected instances where individual banks had large exposures, or where the fear of unknown exposures drove marketplace or policy reactions.

Problems in some investment portfolios revealed another form of concentration that became important for some institutions: concentrated exposures to the accuracy of, and market confidence in, risk metrics employed by Nationally Recognized Statistical Ratings Organizations (NRSROs). Some 221,000 downgrades²⁰ of rated securitization tranches during 2008 illustrated that investment-grade securities could not always be assumed to be a source of safety and liquidity.

Another concentrated risk that proved problematical for some institutions was excessive reliance on third parties to perform significant bank functions. Banks are accountable for the consequences of their reliance on mortgage brokers; on entities that market credit cards and generate receivables; on investment advisors that market purportedly

²⁰ See footnote 5.

low-risk but high-yielding securities; and indeed on any third party that purports to offer pre-packaged revenue-generating solutions with minimal effort by the bank. This is not to suggest that third-party activities cannot be conducted in compliance with laws and regulations and in amounts that do not pose concentration risks. However, failure to control such activities can, and has, resulted in violations of law and regulation and safety-and-soundness problems.

In short, concentrated risks can manifest themselves in a number of ways. These risks are addressed in law, regulation, and supervisory guidance.²¹ As the dust settles from the current crisis and lessons are absorbed, it seems reasonable to expect there will be a heightened focus on addressing risk concentrations during the next economic expansion, be it through the moral suasion of supervision or through enhancements to regulatory policy.

Liquidity

The events of 2008 also brought to the forefront liquidity risk as a real and significant risk facing financial institutions. A number of the liquidity failures of 2008 were unexpected, in some cases as late as the weeks or even days before they occurred. In response to these developments, bank regulators around the world are devoting more attention to liquidity risk management. For example, the Basel Committee on Banking Supervision published “Liquidity Risk Management and Supervisory Challenges” in February

2008 and “Principles for Sound Liquidity Risk Management and Supervision” in September 2008.²² Also during 2008, the FDIC published guidance titled “Liquidity Risk Management” (FIL-84-2008, August 26, 2008), as well as an article in the Winter 2008 issue of this journal, “The Changing Liquidity Landscape.”²³

Examples of problems that emerged in this crisis at some banks include inadequate holdings of liquid assets, insufficient analysis of potential future cash flow needs under adverse scenarios, reliance on volatile or concentrated funding sources, or insufficient liquidity contingency planning. Given the demonstrated importance of liquidity risks in this crisis and the work underway to strengthen liquidity risk management practices, it appears safe to assume that a future focus of supervision will include increased attention to assessing liquidity risk.

No discussion of bank liquidity would be complete without mention of the central role government support has played during the crisis. At year-end 2008, about \$6.8 trillion in new federal government loans, liability guarantees or asset guarantees to financial services firms was outstanding that had not existed a year earlier (see Table 1 on page 4). By the end of the first quarter of 2009, the total maximum capacity of new programs in place or announced exceeded \$13 trillion.

This massive infusion of financial support reflects, in part, the perceived gravity of the problems in the financial system, the potential ramifications of

²¹ A partial list of references would include: the legal lending limits at 12.CFR Part 32 that address some but not all counterparty exposures; Federal Reserve Regulation F that addresses inter-bank liabilities; interagency “Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices,” December 2006; the 1998 interagency “Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities,” available at <http://www.fdic.gov/regulations/laws/rules/5000-4400.html>, which lays out the agencies’ expectations for board oversight of risk concentrations, including establishing appropriate limits, and the importance of understanding and measuring the risks to which securities, and particularly complex or highly leveraged securities, may expose an institution; and the FDIC’s 2008 Third-Party Risk: Guidance for Managing Third-Party Risk, FIL-44-2008, June 6, 2008, at www.fdic.gov/news/news/financial/2008/fil08044.html.

²² See <https://www.bis.org/publ/bcbs144.htm>.

²³ Peter A. Martino and Lloyd E. McIntyre, III, “The Changing Liquidity Landscape,” *Supervisory Insights*, Winter 2008, Vol. 5, Issue 2. See <https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin08/siwinter08-article1.pdf>

which were manifested in September of 2008. The financial support also reflects the importance of banks and the financial system in supporting economic activity.

The government's support of the financial sector has put an end to the crisis atmosphere of September, reduced inter-bank lending spreads and bank borrowing costs, and by lowering interest rates generally, has helped support the value of financial assets. The support programs also have given regulators time to work through the issues facing the financial system in a more deliberative manner.

The flip side of the support is the extent to which banks, ratings agencies, and other market participants may become skittish as it is removed. This suggests that policymakers will have an important transition to manage, as they consider whether and when to phase out the various temporary programs. Supervisors, for their part, will need to closely monitor the implications for individual institutions of the various exit strategies that policymakers may consider.

Public Stakeholders

Recent federal support to financial institutions also has created an important new reality for supervisors, and that is the expanded role played by public stakeholders. Because a safe-and-sound banking system that complies with laws and regulations is in the public interest, Congress and the public will always be stakeholders in bank supervision. But with large sums extended to or newly guaranteeing the performance of individual institutions, the interest of public stakeholders in bank supervision is increased. Areas of interest include preventing government funds from being used inappropriately to enrich shareholders and senior management, maximizing the likelihood that the government funds will be recovered, and promoting

sufficient transparency to allow for an evaluation of whether the use of funds is consistent with legislative intent.

Conclusion

Lessons about the causes of the financial crisis are still being learned. If there is one overarching lesson, perhaps it is this. Strong regulation and supervision of financial institutions is more important, not less, than some have previously thought. The future challenges facing bank supervisors will be great, but meeting those challenges provides an important opportunity for public service.

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Remote Deposit Capture: A Primer

To remain competitive, financial institutions continually look for ways to cut costs, attract new customers, and boost revenues. Remote deposit capture (RDC) technology helps to streamline and improve the efficiency of one area of bank operations: processing check deposits. RDC allows financial institution customers to “deposit” checks electronically at remote locations, usually in the customers’ offices, for virtually instant credit to their account. Paper checks are digitally scanned, and an image of the check is electronically transmitted to the customer’s bank.

Most RDC customers are merchants who want to reduce the costs of transporting paper checks to their financial institution and gain faster access to their funds. Funds from a paper check are typically available within five business days. However, with RDC, funds from checks remotely deposited on Monday often are available on Tuesday or Wednesday of the same week—a significant financial advantage to all businesses, particularly for small- and medium-sized businesses. Some banks are marketing RDC to doctors and lawyers, two professions that often receive payment for their services by check.¹ Other types of businesses that are customarily paid in cash or by credit card, such as restaurants, would not necessarily benefit from RDC.

This article discusses the development and recent growth in the use of the RDC technology, identifies risks to financial

institutions that offer this service, and highlights appropriate risk management techniques described in recently issued Federal Financial Institutions Examination Council (FFIEC) guidance.

Background

The Check Clearing for the 21st Century Act (Check 21 Act), which took effect October 28, 2004, paved the way for the development of RDC. The Check 21 Act created a new negotiable instrument called a “substitute check,” which is the legal equivalent of an original check. A substitute check contains an image of the front and back of the original check that can be processed as the original check.² The customer transmits this image electronically, usually via the Internet, to the depository financial institution. The substitute check is cleared and settled electronically, thereby expediting credit to the customer’s account.

First Tennessee Bank in Memphis was one of the first financial institutions to implement RDC. It introduced the “First Deposit Plus” product³ in 2003 as a way to expand its deposit base. As of March 2008, First Tennessee had customers in 46 states using its RDC service.⁴ In July 2007, Forrester Research, an information technology research company, reported that 88 percent of the top 25 U.S. banks were offering RDC to their business customers.⁵ For example, Bank of America, Citibank, and PNC offer RDC to their commercial customers.⁶

¹ Anonymous, “Cherry-Picking Remote Deposit Customers,” *US Banker*, August 2008, pp. A8–10.

² See FIL-116-2004, “Check Clearing for the 21st Century Act,” October 27, 2004.

³ First Tennessee Bank, “Every Office Needs a Time Machine” brochure, 2008.

⁴ Peggy Bresnick Kendler, “Can Remote Deposit Capture Drive Growth?” *Bank Systems & Technology*, March 2008, <http://www.banktech.com/channels/showArticle.jhtml?articleID=206900812>.

⁵ Forrester Research, “Coming Soon: Remote Deposit Capture for Consumers?” research note, July 27, 2007; updated August 3, 2007.

⁶ Bank of America, “Bank of America Expands Remote Deposit Service Globally,” press release, September 16, 2008, http://newsroom.bankofamerica.com/index.php?s=press_releases&item=8257; Citibank, “Citibank Introduces Remote Electronic Deposit Service for Business Clients,” press release, June 7, 2007, <https://www.citigroup.com/global/news/press-release/2007/citibank-introduces-remote-electronic-deposit-service-for-business-clients>; PNC, “PNC Bank to Offer Ease of Online Deposit Service Integrated with QuickBooks to Small Businesses,” press release, July 24, 2006,

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As of year-end 2008, Celent, an international financial services consulting firm, estimated that two-thirds of all U.S. banks were offering RDC services.⁷ And in March 2008, the *ABA Banking Journal* published the 12th Annual Community Bank Competitiveness Survey, which reported that 38 percent of the community banks surveyed offered RDC, and another 26 percent were planning to offer the service by year-end 2008. The survey noted that the adoption rate for RDC is “much faster than we saw with bank Web sites.”⁸

For financial institutions using RDC, the numbers are impressive. For example, in 2008, Zions Bancorporation in Utah and its affiliates reported that more than 11,000 customers were using their RDC service, depositing more than \$400 million daily. Zions reported adding 45 new RDC customers per week.⁹

Some banks offer RDC for free on the condition that the customer maintains a certain minimum deposit balance. Others charge a fee, perhaps \$60 a month.¹⁰ Specialized scanners record and transmit images of the front and back of the check being deposited.¹¹ Scanners, which cost between \$225 and \$2,500, can be purchased by the customer or leased from the financial institution as part of the RDC service. One bank reports that RDC costs less than \$10,000 to implement, well below the \$300,000 minimum capital cost of a new branch office.¹²

Although RDC offers considerable benefits to financial institutions and their customers, the service is not without risks. For example, an institution no longer has the opportunity to examine the physical item being deposited, which heightens risk in the check-clearing process. The operational, legal, and compliance risks associated with RDC are discussed below, with particular emphasis on the risk of fraud.

Managing RDC Risks

In response to the increasing use of RDC, in January 2009, the FFIEC issued guidance to help financial institutions identify risks in their RDC systems and evaluate the adequacy of controls and risk management practices.¹³ The guidance also should be useful to bank examiners, especially those who may be examining a bank offering RDC for the first time. Examination procedures targeting the use of RDC, which are consistent with the guidance, are scheduled to be published in a revised and updated version of the *FFIEC Retail Payment Systems Booklet*.¹⁴

The risks associated with the use of RDC should be identified within the financial institution's overall risk assessment process. The primary risk is the potential for fraud. When an institution takes a risk-sensitive function, in this case accepting items for deposit and credit to a customer's account, and allows it to be conducted outside the

⁷ Celent, “State of Remote Deposit Capture 2008: Sprint Becomes a Marathon,” press release, October 15, 2008.

⁸ 12th Annual Community Bank Competitiveness Survey, *ABA Banking Journal*, March 2008, http://www.aba.com/News/CBOnline_Mar08_1.htm.

⁹ Anonymous, “Remote Deposit Capture Partnerships for Success,” *US Banker*, August 2008, p. A11.

¹⁰ Orla O'Sullivan, “Prized Deposits Grow for Boston Bank Using RDC,” *Bank Systems & Technology*, November 2008, p. 41. See <http://www.banktech.com/architecture-infrastructure/showArticle.jhtml?articleID=211600480>.

¹¹ Financial institutions generally recommend specialized scanners that read a check's magnetic ink character recognition line and optical character recognition to determine the dollar amount of the check in characters and words.

¹² O'Sullivan, “Prized Deposits Grow for Boston Bank Using RDC.”

¹³ FIL-4-2009, “Risk Management of Remote Deposit Capture,” January 14, 2009. See www.fdic.gov/news/news/financial/2009/fil09004.html.

¹⁴ FFIEC IT Examination Handbook, *Retail Payment Systems Booklet*, March 2004.

“trusted zone” that includes its internal network and closed check-processing environment, the risk of fraud increases. A financial institution can control what occurs on its internal network or in its check-processing facility, including the implementation of fraud prevention processes, but it cannot exert the same control over items deposited remotely.

The FFIEC guidance identifies three categories of risk to financial institutions that offer RDC: operational, legal, and compliance. The following discussion identifies these risks and outlines effective risk management strategies.

Operational Risks and Controls

The FFIEC guidance covers several issues that require management attention. Many of these risks relate directly to the potential for fraud, while others may also result in fraud in certain circumstances. Some of the key risks are as follows:

- Redeposit of items/duplicate presentment
- Alteration of deposited items/forged endorsement
- Deposit of counterfeit items
- Poor image quality
- Safety and integrity of deposited items held by customers (i.e., protection of personal information)
- Proper disposal of deposited items by customers
- Customer authentication when accessing the RDC system
- Data security of and lack of encryption in the RDC system
- Reliability of the RDC vendor

Customer Screening

Customer screening is the single most effective risk mitigation technique that financial institutions should implement when offering RDC. Not all customers need RDC services, and not all may qualify for them. The institution should consider whether the customer is a long-standing client with effective management and close control of financial processes or a new customer whose business characteristics and transaction history are relatively unknown. Many financial institutions offering RDC services require customers to maintain minimum deposit balances to insulate the institution from the risk of fraudulent deposits or items that do not clear owing to insufficient funds.

Financial institutions also should consider the customer’s business line, geographic location, and client base. In evaluating a customer’s client base, the institution should carefully scrutinize those from higher-risk industries, such as mail order or Internet retailers, adult entertainment, offshore businesses, and online gambling. These industries have demonstrated a greater risk of fraud and nonpayment than more traditional, domestic, face-to-face businesses. Customers that serve these higher-risk businesses may not be appropriate candidates for RDC or may be required to maintain higher deposit balances or agree to more stringent on-site audit procedures.

To date, the federal financial institution regulatory agencies have not observed increased fraud rates related to RDC services. In fact, the RDC fraud rate is lower than the average for general item processing.¹⁵ The consensus among the agencies is that this is due primarily to satisfactory customer screening on the part of financial institutions offering RDC.¹⁶

¹⁵ Risk Management of Remote Deposit Capture, internal presentation for FFIEC supervisory staff, January 28, 2009.

¹⁶ Ibid.

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Monitoring and Reporting

Financial institutions should regularly produce internal reports on the status of their RDC service. For example, the reports should cover duplicate deposits, violations of deposit thresholds (the total value of checks that may be deposited daily via RDC), velocity metrics (the number of items being deposited daily), transaction dollar volume, return item dollar volume, the number of checks rejected owing to poor image quality or other factors, and other adjustments made after deposit owing to discrepancies in the check amount. Management should review these reports in a timely manner, and any aberrations should be addressed promptly within the institution or with the customer or the RDC vendor.

Vendor Screening

Most banks offering RDC services work with a vendor that provides, installs, maintains, and updates the hardware and software. Although this is generally a sound approach, management should evaluate the track record of RDC vendors to ensure that they are reputable and competent. Financial institutions should look for vendors with experience in providing RDC services and should check references. Either the institution or the vendor should ensure that the customer's employees are trained in the use of the RDC system. The FFIEC *Outsourcing Technology Services Booklet* contains information and recommendations on how financial institutions should screen, evaluate, and monitor technology vendors, including those providing RDC services.¹⁷

Customer Audits

After determining that a customer's business is suitable for RDC services, the institution may consider evaluat-

ing the customer's operational controls (i.e., separation of duties, implementation of dual controls, endorsement of items to prevent redeposit, and secure storage and disposal of original checks) on-site; assessing how the customer's employees responsible for depositing items will be trained; and reviewing the physical and logical security measures surrounding the RDC system. Confirming that the customer securely stores and disposes of the original paper checks is particularly important as these items contain sensitive financial information (name, address, bank name, and account number) that can be used by identity thieves. In some cases, an independent audit of the customer may be warranted.

Business Continuity Planning

The FFIEC requires every financial institution to have a business continuity plan (BCP) in place.¹⁸ If an institution offers RDC, its BCP should describe actions to be taken if the RDC system fails and the steps to return the RDC service to operation.

Change Control Processes

As is the case with any technology system, RDC hardware, software, and procedures will need to be updated over time. Financial institutions and, if appropriate, their RDC vendor should have in place written change control procedures (i.e., mutually agreed-upon procedures governing how software and hardware will be updated and how policies will be revised) with all customers using the RDC service. Thus, all parties will be on the same page when software or hardware is updated or policies and procedures are revised. Change control procedures can help avoid glitches from checks not being deposited or funds not being credited to the customer's account.

¹⁷ FFIEC IT Examination Handbook, *Outsourcing Technology Services Booklet*, June 2004.

¹⁸ FFIEC IT Examination Handbook, *Business Continuity Planning Booklet*, March 2008.

Insurance

Financial institutions should investigate whether commercial insurance coverage is available to protect them from liability in the event of problems with the RDC service. Management will need to determine whether the amount of coverage available justifies the cost of the insurance.

Legal Risks and Controls

When a bank accepts a check image for deposit through its RDC system and clears and settles the check, it exposes itself to certain legal risks under the Check 21 Act, Regulation CC,¹⁹ Regulation J,²⁰ and applicable state laws, as well as under clearinghouse rules or other agreements. Most legal risks associated with offering RDC services can be mitigated through the use of appropriate contracts and customer agreements. The RDC service agreement should describe the responsibilities and liabilities of the financial institution and its customer, including record retention periods for the original deposited items, physical and logical security measures protecting the RDC scanner, and proper disposal of the original deposited items once the retention period has expired. The agreement also should describe the types of items that can be deposited remotely, individual item dollar limits, overall per-day dollar limits, and minimum image quality standards. The institution should consider requiring a periodic audit of RDC processes at the customer location and, if so, include such terms in the agreement. Banks also should ensure that customer agreements describe the policies and procedures that must be followed at the customer's RDC location, including applicable operational controls to help mitigate possible fraud, such as

dual controls and appropriate separation of duties.

Compliance Risks and Controls

Financial institutions must determine whether and to what extent the use of RDC systems increases exposure to the risk of money laundering or other suspicious activities. Institutions should refer to the *FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual* for a description of their responsibilities.²¹ In general, when less personal interaction occurs between a bank and its customers, or a bank's ability to examine financial instruments is limited, the risk of violating laws and regulations in these areas increases.

Financial institutions and their customers are legally obligated to comply with laws and regulations implemented to help prevent and detect money laundering and international terrorist financing. Banks offering RDC services should ensure their own Bank Secrecy Act compliance experts or outside consultants, if used, consider how these laws and regulations may impact RDC and develop policies, procedures, and processes to mitigate this risk. Bank staff responsible for RDC services should receive appropriate training to ensure compliance with bank policies and procedures as well as existing laws and regulations.

Conclusion

Because of the significant business advantages provided through the use of RDC, the number of financial institutions offering RDC services and the number of customers using these services are expected to continue to increase in the near term. However, along with the

¹⁹ Regulation CC governs the availability of funds.

²⁰ Regulation J governs check collection and funds transfer.

²¹ *FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual*, pp. 189–190, <https://bsaaml.ffiec.gov/>.

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advantages comes the responsibility of bank management and examiners to be aware of the risks associated with providing RDC services and how those risks should be mitigated.

The primary risks are operational, specifically the risk of fraud, and these risks can be mitigated by using effective risk management techniques, such as those outlined in the FFIEC guidance. These techniques are not costly or complex, and they can easily be implemented by both large and small banks. All risk management strategies described in this article should be considered; however, customer screening is the first step financial institutions should take when deciding to provide RDC services to a particular customer.

Future Prospects

When considering what lies ahead for the use of RDC technology in the longer term, institutions should note that the number of checks being written in this country has declined steadily since 1995. Conversely, the number of electronic payments has grown, and as of 2003, exceeded the number of checks for the first time. These statistics suggest that RDC may be a “gap” technology that perhaps will exist only for the next five to ten years.

In the very near future, financial institutions may apply RDC technology in other ways to reduce deposit-processing costs and expand their deposit base. The first way is making RDC available to retail customers in their homes. Consumers would not need to visit a branch or ATM to deposit checks, but rather would simply run the check through a scanner connected to a personal computer with Internet access.²²

The second is offering RDC to mobile professionals who travel to client sites and are paid in person by check. The technology exists to enable these individuals to deposit checks at a client's location or in their car using a cell phone camera.²³ Although neither of these applications is now in widespread use, both suggest intriguing opportunities for the future of RDC for banks and customers alike.

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²² CheckFree, Remote Deposit Capture for Consumers, <http://www.checkfreesoftware.com/cda/software/L5.jsp?layoutId=51629&contentId=51624&menuId=51633&pId=60524>. (Note: CheckFree is now Fiserv.)

²³ J&B Software, Using Your Mobile Phone for Remote Capture.

From the Examiner's Desk: Changes to Regulation Z Afford Increased Consumer Protections

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

The Home Ownership and Equity Protection Act of 1994 (HOEPA) targets certain deceptive and unfair mortgage lending practices by amending the Truth in Lending Act (TILA) to require special disclosures and impose prohibitions for mortgage loans with high rates or fees. However, the protections afforded consumers under the 1994 TILA amendments extended *only* to homeowners who already owned their homes (i.e., home equity mortgages). Furthermore, in promulgating implementing regulations under Regulation Z, the Board of Governors of the Federal Reserve System (Federal Reserve), exercising its discretion under TILA and HOEPA, further restricted the reach of these protections to home equity mortgages that met or exceeded specific cost parameters (i.e., “high-cost” mortgages).¹

In 2008 and 2009, pursuant to its continuing authority under TILA and HOEPA, the Federal Reserve further amended Regulation Z.² The 2008/2009 Regulation Z amendments extend specific protections to consumers of a newly created category of mortgage loans called “higher-priced” home mortgages. In addition, the 2008/2009 Regulation Z amendments enhance existing protections for consumers of high-cost mort-

gages to match more closely many of the newly created protections for higher-priced mortgage loans.³ The amendments also add protections for consumer mortgages other than higher-priced or high-cost mortgages and expand and enhance the early disclosure requirements of Regulation Z.

New and Enhanced Protections for Consumers of Higher-Priced and High-Cost Mortgage Loans

Although TILA and Regulation Z attempt to protect consumers primarily through requirements to provide sufficient information (i.e., disclosures) with which to make an informed credit decision, Congress, through its broad grant of authority to the Federal Reserve to explicitly prohibit unfair or deceptive mortgage lending practices, recognized that disclosures alone cannot always protect consumers from the significant harm (e.g., high costs and unsustainable loans) caused by certain mortgage terms and lending practices.

Many have attributed the rising number of home mortgage delinquencies, defaults, and foreclosures, as well as declining home values—and even, to some degree, the general decline of entire communities—to the relatively recent practice of “flipping” (i.e., repeated refinancing by the same lender) unsustainable home mortgage loans. With each flip, a homeowner’s equity is

¹ Regulation Z requires disclosures of terms of closed-end and open-end consumer credit. It also contains several limitations and prohibitions pertaining to certain categories of mortgage loans. See 12 CFR 226.32, 226.34, and 226.35. <https://www.ecfr.gov/current/title-12/chapter-II/subchapter-A/part-226/subpart-E/>.

² For the 2008 amendments, see <http://www.fdic.gov/news/news/financial/2008/fil08134a.html>. For the 2009 amendments, pursuant to the Mortgage Disclosure Improvement Act of 2008, see <http://www.fdic.gov/news/news/financial/2009/fil09026.html>.

³ Unlike higher-priced mortgage loans, high-cost home mortgage loans are, by definition, limited to home equity mortgage loans and refinancings.

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tapped to cover the cost of the refinancing. This constant churning of mortgages and repeated collection of fees has become known as “fee harvesting.” This pattern of home mortgage lending typically disregards a consumer’s repayment ability, which, in turn, leads to repeated refinancings and the imposition of often exorbitant prepayment penalties and other fees. As a result, a home’s equity is often stripped and larger mortgage balances are created, which ultimately can result in foreclosure and loss of a consumer’s home.

More recently, many of the harmful practices typically associated with home equity lending have been seen in the financing of home purchases as well, resulting in unsustainable homeownership and other harm to consumers.⁴ To address this unwelcome trend in financing of home purchases, Regulation Z has been amended. TILA’s prohibition against making certain home equity mortgage loans based on the underlying collateral without regard to the consumer’s repayment ability has been extended under Regulation Z to certain purchase-money mortgages as well.

Overall, the amended provisions (which, with limited exception, become effective on October 1, 2009) do the following:

1. Establish consumer protections specific to a new category of mortgage loans called higher-priced mortgage loans,

2. Strengthen current consumer protections relating to prepayment penalty and repayment ability provisions for high-cost (section 32, HOEPA) mortgage loans,
3. Establish new consumer protections relating to prohibited behavior toward appraisers and prohibited practices by servicers, and
4. Expand and enhance the regulation’s early disclosure requirements and impose new prohibitions against deceptive advertising.

This article examines and discusses each of these four significant amendments to Regulation Z and offers suggestions for FDIC examiners (and other compliance professionals) responsible for ensuring compliance with these critical regulatory changes.

New Protections for Consumers of Higher-Priced Mortgage Loans

Although TILA and Regulation Z seek to protect consumers primarily through disclosure, by enacting HOEPA Congress sought to protect consumers by specifically prohibiting certain unfair and harmful mortgage lending practices. And during 2008 and 2009, the Federal Reserve amended Regulation Z by establishing specific consumer protections for a new category of mortgage loans, i.e., higher-priced mortgage loans.⁵ A higher-priced mortgage loan is any mortgage (purchase-money or

⁴While home ownership has been expanded through use of alternative financing products, such as “nontraditional” (i.e., interest-only and payment-option) and “subprime” (i.e., hybrid adjustable-rate mortgages [ARMS], ARMs with an initial fixed-rate period that later adjusts, often significantly) mortgage loans, such alternative loan products often contain terms and features that result in unsustainable homeownership and other harm to consumers. The offering of such alternative mortgage loan products by institutions should present red flags to FDIC examiners and others concerned with compliance with these latest amendments to Regulation Z. For further discussion relating to FDIC guidance on nontraditional mortgage loans and subprime mortgage lending, see “Impact of Regulation Z’s Higher-Priced and High-Cost Mortgage Amendments on Nontraditional and Subprime Mortgage Guidance” below, at page 36.

⁵These higher-priced mortgage loan protections are similar to and complement those protections already established for high-cost mortgages under sections 32 and 34 of CFR Part 226, discussed below.

non-purchase-money) secured by a consumer's principal dwelling, extended for a consumer (i.e., personal, family, or household) purpose, with an annual percentage rate (APR) exceeding the "average prime offer rate" on prime loans (published by the Federal Reserve) by at least 1.50 percentage points for first-lien loans and 3.50 percentage points for subordinate-lien loans.⁶ Mortgage lenders originating higher-priced mortgage loans are prohibited from engaging in specific practices deemed unfair under Regulation Z, including the following.⁷

Relying on the collateral securitizing the loan without regard to the consumer's ability to repay the loan

A mortgage lender is prohibited from originating a higher-priced mortgage loan based on the value of the collateral

securing that loan without regard to the consumer's ability to repay the loan as of consummation.⁸ In determining repayment ability, a mortgage lender may consider a consumer's current and reasonably expected income,⁹ employment, assets other than the collateral, current obligations, and mortgage-related obligations. Mortgage-related obligations include obligations such as property taxes (relating to the property securing the mortgage), premiums for mortgage-related insurance required by the mortgage lender, homeowners association dues, and condominium fees, as well as secondary mortgages taken on the same property before or at consummation. For example, when underwriting a higher-priced mortgage as a first lien to purchase a home, the mortgage lender must consider any piggy-back second-lien transaction used to finance part of the down payment on the house.

⁶ The average prime offer rate used to establish a higher-priced mortgage loan is an annual percentage rate (APR) derived from average interest rates, points, and other loan pricing terms offered to consumers by a representative sample of creditors for mortgage transactions with low-risk pricing characteristics. To determine current average prime offer rates go to <http://www.ffiec.gov/ratespread/newcalc.aspx>. Higher-priced mortgage loans do not include mortgage loans to finance the initial construction of a dwelling, a temporary or bridge loan with a term of 12 months or less, a reverse mortgage, or a home equity line of credit. See section 226.35(a)(3). Note: Home Mortgage Disclosure Act (HMDA) Regulation C requires the reporting of rate spreads for higher-priced mortgage loans. However, currently under Regulation C, mortgage lenders collect and report the spread between the APR on a mortgage loan and the yield on a Treasury security of comparable maturity if the spread is greater than 3.0 percentage points for a first-lien loan or greater than 5.0 percentage points for a subordinate-lien loan. Under the revised HMDA rule, a mortgage lender will report the rate spread for higher-priced mortgage loans in conformance with these amendments to Regulation Z; that is, a mortgage lender will report the spread between a loan's APR and the survey-based estimate of APRs currently offered on prime mortgages of a comparable type (average prime offer rate) if the spread is equal to or greater than 1.5 percentage points for a first-lien loan or equal to or greater than 3.5 percentage points for a subordinate-lien loan. For further discussion on the implications of the Regulation Z amendments for HMDA reporting, see "Higher-Priced Mortgages and HMDA," below, at page 32.

⁷ In addition to these practices, Regulation Z also prohibits as unfair the practice of structuring a home-secured loan as an open-end plan to evade the higher-priced mortgage provisions of Regulation Z. See section 226.35(b)(4).

⁸ As previously noted by the FDIC and the other federal banking agencies, predatory lending practices often involve inducing a borrower to refinance a loan repeatedly to charge high points and fees each time the loan is refinanced (loan flipping). See FIL-9-2001 (<http://www.fdic.gov/news/news/financial/2001/fil0109.html>). The rule's prohibition against originating a higher-priced mortgage loan based on the value of the collateral securing that loan without regard to the consumer's ability to repay the loan is equally applicable to high-cost mortgages under sections 226.32 and 226.34.

⁹ For instance, a medical resident's income can be expected to significantly increase on completion of his or her residency, and a mortgage lender may consider this information in determining repayment ability. However, if an applicant states an intention to retire within 12 months of consummation of the loan with no plans to obtain new employment, the mortgage lender also must consider this reduction in income in determining repayment ability.

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Relying on the consumer's income or assets without verifying such amounts through reasonably reliable third-party documents

When evaluating a consumer's ability to repay a higher-priced mortgage, a mortgage lender is prohibited from relying on the consumer's income, assets, or obligations without verifying such amounts through reasonably reliable third-party documentation.¹⁰ For example, if a consumer earns a salary and states that he or she is paid an annual bonus, but the creditor relies only on the applicant's salary to evaluate repayment ability, the creditor need verify only the salary. However, if a future annual bonus is relied on to qualify the consumer at consummation, the expectation of the future bonus must be reasonable and verified with third-party documentation demonstrating past bonuses in amounts bearing a reasonable relationship to

the amount of the expected bonus.¹¹ Although reliance on documentation specific to a consumer's individual income obtained from an employer's third-party database is permissible, information about average incomes for the consumer's occupation in the local geographic location or information about average incomes paid by the consumer's employer does not satisfy the verification-of-income requirement. With respect to obligations, a mortgage lender may rely on the information contained in a credit report to verify a consumer's obligations.¹²

A mortgage lender is presumed to have complied with Regulation Z's prohibition against granting higher-priced mortgage loans without regard to a consumer's ability to repay and without verifying income, assets, and obligations if the lender¹³ (1) verifies the consumer's repayment ability per the requirements described above,¹⁴ (2) determines the consumer's repayment ability using the

¹⁰ Compliance practitioners should note that the Regulation Z amendments supersede previously issued Nontraditional Mortgage (NTM) Guidance relative to higher-priced mortgages that allowed stated income documentation. The superseded provision of the NTM Guidance provides, "Reduced Documentation—Institutions increasingly rely on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and unverified information for analysis of a borrower's repayment capacity and general creditworthiness, they should be used with caution. As the level of credit risk increases, the Agencies expect an institution to more diligently verify and document a borrower's income and debt reduction capacity. Clear policies should govern the use of reduced documentation. For example, stated income should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. For many borrowers, institutions generally should be able to readily document income using recent W-2 statements, pay stubs, or tax returns" <http://www.fdic.gov/news/news/financial/2006/fil06089.html>. Compliance practitioners should also note that Regulation Z's prohibition against relying on the consumer's income, assets, or obligations without verifying such amounts through reasonably reliable third-party documentation is equally applicable to high-cost mortgages under sections 226.32 and 226.34.

¹¹ Higher-priced mortgage lenders (as well as high-cost mortgage lenders, discussed below) may *not* rely on information provided orally by third parties, but may rely on various forms of correspondence from third parties, such as letters or e-mails. See Supplement I to section 226.34(a)(4)(ii)(A)(3).

¹² Where a consumer lists an obligation not reflected in a credit report, a higher-priced mortgage lender (as well as a high-cost mortgage lender, discussed below) must consider such obligation in determining a consumer's ability to repay the higher-priced mortgage, but it is not required to verify the obligation. See Supplement I to section 226.34(a)(4)(ii)(C)(1).

¹³ No presumption of compliance is available for higher-priced mortgage loans where the loan provides for negative amortization (a feature prohibited for high-cost mortgages, discussed below) or where a balloon payment can occur within seven years of consummation. See section 226.34(a)(4)(iv).

¹⁴ Verification of a consumer's ability to repay is a requirement under Regulation Z regardless of the presumption of compliance; in other words, forgoing this available presumption of compliance does not relieve a mortgage lender from its regulatory obligation to verify a consumer's repayment ability.

largest payment of principal and interest scheduled in the first seven years following consummation (and considering current and mortgage-related obligations in the manner described above),¹⁵ and (3) assesses the consumer's repayment ability taking into account the ratio of total debt obligations to income or the income the consumer will have after paying all debt obligations.¹⁶

Compliance Practitioner Note:

Where a higher-priced mortgage loan has a fixed monthly payment for the first seven years concluding with a balloon payment, a mortgage lender may, for purposes of the presumption, determine the consumer's repayment ability by considering the amount of the consumer's fixed monthly payment. But where a balloon payment comes due before the end of seven years, the balloon payment must be considered in determining repayment ability, in effect, prohibiting higher-priced mortgage loans with balloon payments due in less than seven years in almost all cases.

This seemingly innocuous provision of the Regulation Z amendments has the potential to significantly impact real estate lending activity among banks, predominately smaller banks, which commonly originate and portfolio three- or five-year balloon mortgages. These mortgage loans are originated in this manner because they often do not qualify for sale into the secondary mortgage market. Banks offering these short-term, in-house mortgage loans tend to charge more in

interest, but often less in fees, than loans conforming to and sold into the secondary mortgage market.

Typically, the interest rates charged for these mortgage loans qualify them as higher-priced mortgages and, therefore, subject them to the repayment ability standard of the Regulation Z amendments. Consumers seeking these three- or five-year balloon mortgage loans likely will not satisfy the repayment ability standard owing to the balloon payment. Banks continuing to offer these mortgage loans on or after October 1, 2009, likely will have to reduce the APR charged to prevent these loans from being higher-priced mortgages.

Many banks adopting this approach might consider compensating for the APR reduction by increasing loan fees. However, banks contemplating any such rate or fee restructuring must take into account whether the fees are finance charges under Regulation Z and therefore must be included in the APR calculation.

Further, where the purpose of the mortgage is other than purchase or construction of the borrower's home, banks choosing to restructure their pricing of these short-term balloon loans by adding loan fees must remain aware of and in compliance with Regulation Z's provisions relating to high-cost mortgages. As discussed elsewhere in this article, the Regulation Z provisions governing high-cost mortgages, unlike higher-priced mortgages, have thresholds both for fees and APR, and the fees included here are broader than just those that are considered finance charges under other Regulation Z provisions.

Of course, where the borrower has the right under the mortgage contract to renew the loan beyond seven years, there is no balloon payment that needs to be considered in determining repayment ability. While this right may be conditional, it is important to note that satisfying the conditions must be within the borrower's control.¹⁷

¹⁵ For examples of how to determine the maximum scheduled payment in the first seven years under several mortgage product types, see Supplement I to section 226.34(a)(4)(iii)(B)(1), applicable to higher-priced mortgage loans (and to high-cost mortgage loans, discussed below).

¹⁶ Although the regulation does not set forth specific numerical standards for establishing repayment ability, it does note that the presumption of compliance with the prohibition against extending higher-priced mortgages without regard to repayment ability is rebuttable by a consumer showing that a mortgage lender that otherwise followed the regulation's delineated underwriting procedures disregarded the consumer's ability to repay the loan. As an example, the regulation states that evidence of a very high debt-to-income ratio or very limited residual income could be sufficient to rebut the presumption of compliance. However, the regulation clarifies that merely failing to follow one of the nonrequired underwriting procedures (#2 or #3) does not result in a presumption of violation of Regulation Z; rather, determination of a mortgage lender's compliance with the regulation in such cases must turn on the individual facts and circumstances.

¹⁷ See comment 17(c)(1)-(7) for conditions within a consumer's control in connection with renewable balloon-payment loans.
<http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&rgn=div5&view=text&node=123.0.1.1.7&idno=123.0.1.1.7.5.8.7.33>.

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Compliance Practitioner Note:

With respect to the requirement to verify or document income or assets, the Federal Reserve has created a safe harbor for a mortgage lender that does *not* verify or document income or assets used to determine repayment ability. Under the safe harbor, a mortgage lender does *not* violate Regulation Z if it demonstrates that the stated income or assets it relied upon were not materially greater than the amounts it could have verified. For example, if a mortgage lender determines a consumer's repayment ability by relying on the consumer's stated annual

income of \$100,000, but fails to obtain reliable third-party documentation verifying that amount before consummating a higher-priced mortgage loan, the mortgage lender will *not* have violated Regulation Z if it later obtains reliable evidence that would satisfy Regulation Z's verification requirement. Such evidence might be a W-2 or tax return information showing that the mortgage lender could have documented, at the time the higher-priced mortgage loan was consummated, that the consumer had an annual income not materially less than \$100,000. However, FDIC-supervised

institutions engaging in mortgage loan underwriting practices that base extensions of mortgage credit on consumers' stated income (without verification through reliable third-party documentation) will be carefully evaluated on a case-by-case basis to determine whether such practices raise (1) safety and soundness concerns, particularly if seen on a portfolio-wide basis; or (2) consumer protection concerns under section 5 of the Federal Trade Commission (FTC) Act (Unfair or Deceptive Acts or Practices) or other consumer protection laws or FDIC guidance.¹⁸

Imposing a prepayment penalty after two years or imposing a prepayment penalty at any time under certain circumstances¹⁹

A mortgage lender is prohibited from imposing a prepayment penalty on a higher-priced mortgage loan after the first two years. In addition, a mortgage lender is prohibited from imposing a prepayment penalty *at any time* during the term of a higher-priced mortgage loan if

– Other applicable law (e.g., state law) prohibits such penalty.²⁰

– The consumer's mortgage payment (i.e., payment of principal or interest or both) can change during the first four years of the loan term. For example, the imposition of a prepayment penalty on a higher-priced adjustable-rate mortgage that resets every five years would be permissible. However, if the loan contract in this example permits negative amortization and the right of the mortgage lender to accelerate the payment reset date, for instance, when the loan balance reaches a contractually set threshold caused by the negative amortization within the first four years

¹⁸ For example, see FDIC's Supervisory Policy Statement on Predatory Lending, <http://www.fdic.gov/news/news/financial/2007/fil07006a.html>. "Predatory lending involves ... making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation." In its comment letter to the Federal Reserve on the 2008 Regulation Z amendments, the FDIC expressed its belief that the Federal Reserve should eliminate the safe harbor and stand firm in requiring lenders to adequately verify borrowers' income and assets. Specifically, the FDIC wrote, "Verifying a borrower's income and assets is a fundamental principle of sound mortgage loan underwriting that protects borrowers, neighborhoods, investors, and the financial system as a whole.... Requiring borrowers to document their income will make it far less likely that consumers will receive loans that they cannot afford to pay. Documentation also will provide the markets with greater confidence in the quality of pools of higher-priced (and nontraditional) mortgage loans and their projected income streams. Thus, both consumers and the economy as a whole will benefit." See http://www.federalreserve.gov/SECRS/2008/April/20080409/R-1305/R-1305_1075_1.pdf.

¹⁹ These prepayment penalty prohibitions are equally applicable to "high-cost mortgages" under sections 226.32 and 226.34. Note: Under Regulation Z, 12 CFR 226.23(a)(3), footnote 48, a high-cost mortgage loan having a prepayment penalty that does not conform to the requirements of section 226.32(d)(7) is subject to a three-year right of the consumer to rescind. The FRB is revising footnote 48 to clarify that a higher priced mortgage loan (whether or not it is a HOEPA loan) having a prepayment penalty that does not conform to the requirements of section 226.35(b)(2) also is subject to a three-year right of rescission.

²⁰ FDIC-supervised institutions may not impose prepayment penalties on *any* consumer mortgage, even if it is not higher-priced or high-cost under Regulation Z, if other applicable law prohibits such penalties.

of the loan term, the imposition of a prepayment penalty would be prohibited.²¹

- The source of the prepayment funds is a refinancing by the same mortgage lender or an affiliate of the mortgage lender. This prohibition is specifically designed to prevent equity stripping through repeated loan flipping by the same mortgage lender, a historically common practice among subprime mortgage lenders.²²

Failing to escrow for property taxes and mortgage-related insurance when the mortgage loan is secured by a first lien

A mortgage lender is prohibited from originating a higher-priced mortgage loan secured by a first lien without establishing an escrow account for property taxes and premiums for mortgage-related insurance required by the mortgage lender. Mortgage-related insurance includes insurance against loss of or damage to the property securing the loan, against liability arising out of the ownership or use of the property, or protecting the mortgage lender against the consumer's default or other credit loss.²³ A mortgage lender is permitted to offer the borrower an opportunity to cancel the escrow account, but such cancellation can occur only in response to a written request from the consumer received by the mortgage lender no earlier than one year after consummation.²⁴

Higher-Priced Mortgages and HMDA

Compliance practitioners should note the Home Mortgage Disclosure Act (HMDA) and Regulation C implications of Regulation Z's higher-priced mortgage amendments. Pursuant to the amendments to Regulation Z, the Federal Reserve has amended Regulation C, implementing HMDA. The amendments to Regulation C revise the rules for reporting price information on higher-priced mortgage loans. Regulation C currently requires mortgage lenders to collect and report the spread between the APR on a mortgage loan and the yield on a Treasury security of comparable maturity if the spread is greater than 3.0 percentage points for a first-lien loan or greater than 5.0 percentage points for a subordinate-lien loan. This difference is known as the rate spread. Under the revised rule, a mortgage lender will report the spread between the loan's APR and a survey-based estimate of APRs currently offered on prime mortgages of a comparable type (average prime offer rate) if the spread is equal to or greater than 1.5 percentage points for a first-lien loan or equal to or greater than 3.5 percentage points for a subordinate-lien loan.²⁵

The changes are intended to improve the accuracy and usefulness of data reported under HMDA and conform the threshold for rate-spread reporting to the definition of higher-priced mortgage loans adopted under the Regulation Z amendments

discussed above. By adopting this rate-spread-reporting threshold, the Federal Reserve expressed its intent to cover subprime mortgages and generally avoid covering prime mortgages. The Federal Reserve believes applying the new, market survey-based benchmarks in place of Treasury security yields will better achieve this purpose and ensure more consistent and more useful data. In addition, by implementing the same pricing threshold test under both regulations, the Federal Reserve aims to reduce the overall regulatory burden on mortgage lenders.

Regulation C's (HMDA) amended higher-priced mortgage loan reporting requirements take effect October 1, 2009. Thus, any subsequent HMDA analysis of higher-priced mortgage lending using 2009 loan data will be bifurcated between the loan data collected for the January through September period (using the former thresholds of APRs of 3.0 percentage points or 5.0 percentage points over Treasury yields) and the loan data collected for the October through December period (using the new benchmark of 1.5 percent points or 3.5 percent points over the average prime offer rate). Any year-over-year aberration noted in an institution's higher-priced mortgage lending involving 2009 loan data must be analyzed in the context of this bifurcation of collection thresholds.

²¹ For examples demonstrating whether prepayment penalties are permitted or prohibited based on changes in mortgage payments due to negative amortization, see Supplement I to Part 226 under 226.35(b) (2) i-ii, applicable to both higher-price and high-cost mortgages. Exception: Negative amortization is prohibited for high-cost mortgage loans under section 226.32. Thus, the negative amortization examples contained in the rule are applicable only to higher-priced mortgage loans under section 226.35(b). For other examples demonstrating whether prepayment penalties are permitted or prohibited based on changes in mortgage payments during the first four years of a mortgage, see Supplement I to Part 226 under 226.32(d)(7)(iv). These examples also are applicable to higher-priced mortgages under 226.35 and high-cost mortgages under 226.32. Exception: The example relating to debt-to-income ratio is not applicable to higher-priced mortgages.

²² As previously noted by the FDIC and the other federal banking agencies, predatory lending practices often involve inducing a borrower to refinance a loan repeatedly to charge high points and fees each time the loan is refinanced (loan flipping). See FIL-9-2001, <http://www.fdic.gov/news/news/financial/2001/fil0109.html>.

²³ Regulation Z provides two exemptions from this general prohibition. A mortgage lender is not required to (1) establish an escrow account for mortgage loans secured by a cooperative, or (2) escrow for mortgage-related insurance premiums for mortgage loans secured by a condominium where the condominium association has an obligation to the condominium unit owners to maintain a master policy insuring condominium units.

²⁴ Unlike the other amendments to Regulation Z discussed in this article that have an October 1, 2009, effective date, the provisions relating to escrowing for higher-priced mortgage loans have a delayed effective date of April 1, 2010. Thus, all mortgage loans for which written applications were received by April 1, 2010, must comply with Regulation Z's escrow provisions for higher-priced mortgage loans.

²⁵ The Federal Reserve intends to publish average prime offer rates based on the Primary Mortgage Market Survey® currently published by Freddie Mac. To determine current average prime offer rates go to <http://www.ffiec.gov/ratespread/newcalc.aspx>.

Enhanced Protections for Consumers of High-Cost Mortgage Loans

Although higher-priced mortgage loans represent a new category of loans covered by Regulation Z, high-cost mortgage loans do not. A high-cost mortgage is any closed-end, home-equity mortgage (either in a first or a subordinate position), extended for a consumer (i.e., personal, family, or household) purpose, secured by a consumer's principal dwelling with either (1) an APR at consummation greater than 8.0 percentage points for first-lien loans or 10.0 percentage points for subordinate-lien loans above the yield on Treasury securities with comparable maturities, or (2) points and fees payable by the consumer at or before loan closing exceeding the greater of 8 percent of the total loan amount or \$583.²⁶

Because these mortgage loans are secured by "the roof under which one sleeps," consumers taking out high-cost mortgage loans have long been afforded special protections under Regulation Z.²⁷ In addition to receiving information

(i.e., disclosures) specific to the high-cost mortgage loan (information beyond that which is provided to consumers in connection with a non-high-cost mortgage loan), homeowners obtaining high-cost mortgage loans receive several substantive protections as well.²⁸ However, pursuant to the same laws under which consumer protections for higher-priced mortgage loans have been promulgated, enhancements to some of the long-established consumer protections for high-cost mortgage loans also have been promulgated. To a significant degree, these enhancements parallel and conform to Regulation Z's higher-priced mortgage loan protections and relate to collateral-based lending without regard to repayment ability and prepayment penalties.

Collateral-based Lending without Regard to Repayment Ability

As with higher-priced mortgage lending, mortgage lenders extending high-cost mortgage loans are prohibited from extending such loans based on the collateral securing the loan without regard

²⁶ The \$583 figure is as of 2009. This amount is adjusted annually by the Federal Reserve based on changes in the Consumer Price Index.

²⁷ Unlike higher-priced mortgage loans under section 226.35 of Regulation Z (which include both purchase-money and non-purchase-money mortgage loans secured by a consumer's principal dwelling), section 32 high-cost mortgage loans are limited to non-purchase-money home loans (i.e., mortgage loans on homes already owned, such as refinancings or home equity loans) secured by a consumer's principal dwelling. As with higher-priced mortgage loans, high-cost mortgage loans exclude home equity lines of credit and reverse mortgages.

²⁸ Sections 32 and 34 of Regulation Z prohibit a high-cost mortgage lender from (1) imposing, with limited exception, a balloon payment in connection with a high-cost mortgage loan with a term of less than five years; (2) imposing negative amortization; (3) collecting advance payments, i.e., the consolidation and collection of more than two periodic payments, paid in advance from the loan proceeds; (4) increasing an interest rate upon default; (5) including, with limited exception, a due-on-demand clause; (6) unfairly calculating interest to be rebated to a consumer in connection with loan acceleration resulting from default; (7) making, with limited exception, a direct payment of loan proceeds to a home improvement contractor, payable solely in the name of the home improvement contractor; (8) failing to furnish the required Regulation Z notice to an assignee of a high-cost mortgage loan (such notice informs the assignee that this is a mortgage subject to special protections under TILA and that the assignee could be liable for claims and defenses that the consumer could assert against the lender); (9) refinancing a high-cost mortgage loan that was made by the same mortgage lender into another high-cost mortgage loan to the same homeowner within one year of consummation, unless the refinancing is in the homeowner's interest (e.g., a lower interest rate); (10) extending a high-cost mortgage loan based on the value of the collateral securing the loan without regard to the homeowner's repayment ability; and (11) imposing prepayment penalties in certain circumstances. In addition to these practices, Regulation Z also prohibits as unfair the practice of structuring a home-secured loan as an open-end plan to evade the high-cost and higher-priced mortgage provisions of Regulation Z.

to the homeowner's ability to repay the loan. This is not a new prohibition under the high-cost mortgage loan provisions of Regulation Z. However, under the previous regulation, such practice was a violation of Regulation Z only when a "pattern or practice" of such behavior was demonstrated. Under amended Regulation Z, there is no longer a requirement to demonstrate a pattern or practice of engaging in this form of underwriting to establish a violation.

In addition, the previous regulation created a mere presumption of violation if a mortgage lender engaged in a pattern or practice of making high-cost mortgage loans without verifying and documenting a consumer's repayment ability. Under amended Regulation Z, this presumption has been eliminated. Instead, the new high-cost mortgage loan provisions (and the higher-priced mortgage loan provisions) *specifically prohibit* relying on a consumer's income or assets without verifying such amounts through reasonably reliable third-party documentation, such as W-2s, tax returns, payroll receipts, or financial institution records.²⁹

Prepayment Penalties

Other changes to Regulation Z's high-cost mortgage loan provisions pertain to prepayment penalties and provide enhanced consumer protections. Prepayment penalties may be imposed on high-cost mortgage loans only if such penalties are permitted by other applicable law

(e.g., state consumer protection laws) and, per the Regulation Z amendments, only if imposed within the first two years of the loans.

High-cost mortgage loans share most of the prepayment penalty prohibitions for higher-priced mortgage loans.³⁰ As with higher-priced mortgage loans, prepayment penalties on high-cost mortgage loans may not be imposed:

- At any time during the term of the loan if other applicable law (e.g., state law) prohibits such penalty. This represents no change from previous high-cost mortgage loan prohibitions.
- After the first two years of the loan term. This is a change from the previous regulation and enhances consumer protection by reducing the period after consummation from five to two years, after which no prepayment penalty may be imposed.
- At any time during the term of the loan if the consumer's mortgage payment (i.e., payment of principal or interest or both) can change during the first four years of the loan term. This is a completely new provision added to the prepayment penalty prohibitions for high-cost mortgage loans.³¹
- At any time during the term of the loan if the source of the prepayment funds is a refinancing by the same mortgage lender or an affiliate of the

²⁹ With respect to a consumer's obligations, a mortgage lender may verify such obligations via a credit report. With respect to obligations listed on an application but not appearing on a credit report, the mortgage lender has no further duty regarding such obligation other than to consider it in determining a consumer's repayment ability. For further information, see discussion on ability to repay and income/asset/obligation verification under higher-priced mortgage loans above.

³⁰ Some of the prepayment penalty prohibitions for high-cost mortgage loans represent changes from the previous regulation, while others do not.

³¹ For examples demonstrating whether prepayment penalties are permitted or prohibited based on changes in mortgage payments during the first four years of a mortgage, see Supplement I to Part 226 under 226.32(d)(7)(iv). These examples are applicable to both higher-priced mortgages under 226.35, except for the example relating to debt-to-income ratio, which is not applicable to higher-priced mortgages, and high-cost mortgages under 226.32. Note: Negative amortization is prohibited for high-cost mortgage loans under section 226.32. Thus, the negative amortization examples provided are applicable only to higher-priced mortgage loans under section 226.35(b).

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mortgage lender. This represents no change from previous high-cost mortgage loan prohibitions.

However, unlike higher-priced mortgage loans, prepayment penalties on high-cost mortgage loans may not be imposed when, at consummation, the consumer's total monthly debt payments, including amounts owed under the mortgage, exceed 50 percent of the consumer's monthly gross income. This represents no change from previous high-cost mortgage loan prohibitions. This particular

prepayment penalty restriction for high-cost mortgage loans under section 226.32 was the only restriction *not* incorporated into the prepayment penalty provisions for higher-priced mortgage loans under section 226.35.

To summarize key features and prohibitions of higher-priced and high-cost mortgages originated on or after October 1, 2009, and high-cost mortgages originated prior to October 1, 2009, a side-by-side comparison of these categories of mortgages appears below.

Comparison of Higher-Priced and High-Cost Mortgages

	Higher-Priced Mortgage Loans (Purchase-Money, Refinancings, and Home Equity Loans) [10/1/09 and later originations]	High-Cost Mortgage Loans (Refinancings and Home Equity Loans Only) [10/1/09 and later originations]	High-Cost Mortgage Loans (Refinancings and Home Equity Loans Only) [pre-10/1/09 originations]
Thresholds	Thresholds based on average prime offer rate: APR must exceed the average prime offer rate by at least 1.5 percentage points for first-lien loans and 3.5 percentage points for subordinate-lien loans.	Thresholds based on either Treasuries or fees: An APR greater than 8.0 percentage points for first-lien loans or 10.0 percentage points for subordinate-lien loans above the yield on Treasury securities with comparable maturities – OR – Points and fees exceeding the greater of 8 percent of the total loan amount or \$583.	<Same
Prohibition	May not rely on the collateral securing the loan without regard to the consumer's ability to repay.	<Same	May not engage in a <i>pattern or practice</i> of asset-based lending.
Prohibition	May not rely on the consumer's income or assets without verifying such amounts through reasonably reliable third-party documents.	<Same	May not fail to use documented, independent sources when considering the consumer's repayment ability.
Prohibition	May not impose a prepayment penalty after two years.	<Same	May not impose a prepayment penalty after five years.
Prohibition	May not impose a prepayment penalty at any time if <ul style="list-style-type: none"> ■ other applicable law prohibits such penalty; ■ the consumer's mortgage payment can change during the first four years of the loan term; or ■ the source of the prepayment funds is a refinancing by the same mortgage lender or an affiliate. None>	May not impose a prepayment penalty at any time if <ul style="list-style-type: none"> <Same <Same <Same ■ The consumer's total monthly debt payments (at consummation), including amounts owed under the mortgage, exceed 50 percent of the consumer's monthly gross income. 	May not impose a prepayment penalty at any time if <ul style="list-style-type: none"> <Same <None <Same <Same

Comparison of Higher-Priced and High-Cost Mortgages

	Higher-Priced Mortgage Loans (Purchase-Money, Refinancings, and Home Equity Loans) [10/1/09 and later originations]	High-Cost Mortgage Loans (Refinancings and Home Equity Loans Only) [10/1/09 and later originations]	High-Cost Mortgage Loans (Refinancings and Home Equity Loans Only) [pre-10/1/09 originations]
Prohibition	May not fail to escrow for property taxes and mortgage-related insurance when the mortgage loan is secured by a first lien	<None	<None
Prohibition	May not structure a home-secured loan as an open-end plan to evade Regulation Z's <i>higher-priced</i> mortgage provisions.	May not structure a home-secured loan as an open-end plan to evade Regulation Z's <i>high-cost</i> mortgage provisions	<Same
Prohibition	None>	<p>May not</p> <ul style="list-style-type: none"> ■ impose, with limited exception, a balloon payment on loans with a term of less than five years; ■ impose negative amortization; ■ collect advance payments, i.e., the consolidation and collection of more than two periodic payments, paid in advance from the loan proceeds; ■ increase an interest rate upon default; ■ include, with limited exception, a due-on-demand clause; ■ unfairly calculate interest due to be rebated to a consumer in connection with loan acceleration resulting from default; ■ make, with limited exception, a direct payment of loan proceeds to a home improvement contractor, payable solely in the name of the contractor; ■ fail to furnish the required Regulation Z notice to an assignee of a high-cost mortgage (informs the assignee this mortgage is subject to special TILA protections and the assignee could be liable for claims and defenses the consumer could assert against the lender); ■ refinance a high-cost mortgage made by the same lender into another high-cost mortgage to the same homeowner within one year of consummation unless the refinancing is in the homeowner's interest, e.g., a lower interest rate. 	<p>May not</p> <p><Same</p> <p><Same</p> <p><Same</p> <p><Same</p> <p><Same</p> <p><Same</p> <p><Same</p> <p><Same</p> <p><Same</p>

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Impact of Regulation Z's Higher-Priced and High-Cost Mortgage Amendments on Nontraditional and Subprime Mortgage Guidance

Responsible creative financing, which often can help many borrowers obtain a prudent, affordable loan, sometimes gives way to irresponsible, costly, and (in certain cases) unsustainable and abusive financing. While Regulation Z has long provided protections against certain abusive mortgage lending practices, these protections applied primarily to a limited class of high-cost home equity mortgage loans (i.e., mortgage loans taken out by consumers who already owned their homes). Such protections did not extend to consumers first purchasing their homes (i.e., purchase-money home mortgage loans). Compounding the situation, home purchasers most vulnerable to these aggressive mortgage terms and lending practices are those who, by virtue of the fact they are often first-time or unsophisticated homebuyers, are least able to protect themselves against the onerous terms or practices often associated with these products.

To address and mitigate the risks associated with many of these mortgage loans and lending practices, whether relating to home purchase or refinancing, the FDIC and other bank regulators issued guidance to their respective supervised institutions advising them of supervisory expectations with respect to the origination of these mortgage products (often referred to as nontraditional or subprime home mortgage loans), including expectations with respect to consumer protection.³² The Nontraditional Mortgage (NTM) and Subprime

Mortgage Guidance documents reflect the FDIC's position on appropriate lending behavior with respect to mortgage loans subject to this guidance.

Many of the mortgage loan characteristics, and the risks they present, discussed in these guidance documents are the subject of the recent amendments to Regulation Z. Thus, with the promulgation of these Regulation Z amendments, much of the previously issued guidance relating to managing heightened risk levels has been superseded by Regulation Z's outright prohibitions against certain mortgage lending practices. What was guidance in the form of admonishment has essentially become law. As discussed in this article, many of the risk-layering practices of concern addressed in those documents—such as relying on reduced or no documentation, failing to verify a borrower's repayment ability, and the imposition of prepayment penalties without limit—are now prohibited by Regulation Z where the terms of a mortgage loan constitute a higher-priced or high-cost mortgage. As such, a comprehensive review for predatory or abusive mortgage lending practices should reference the amendments to Regulation Z along with the NTM and Subprime Mortgage Guidance documents. And, of course, any practices of concern not specifically addressed by Regulation Z or other consumer protections laws should be scrutinized under the unfair or deceptive prongs of section 5 of the Federal Trade Commission Act.

Appraisal and Servicing Protections for Consumers of Mortgage Loans Secured by the Consumer's Principal Dwelling

To prevent practices that the Federal Reserve describes as “unfair, deceptive, associated with abusive lending practices, or otherwise not in the interest of the borrower,”³³ Regulation Z has been amended to extend new protections to consumers of all mortgage loans (i.e., not limited to higher-priced or high-cost mortgage loans) secured by the consumer's principal dwelling, extended for a consumer (i.e., personal, family, or household) purpose. These protections are intended to ensure the accuracy and integrity of appraisals and the fair treatment of borrowers by servicers. The Federal Reserve believes these protections will also enhance a consumer's informed use of credit.

The amended regulation prohibits mortgage lenders and mortgage brokers from coercing, influencing, or encouraging an appraiser to misrepresent the value of the property. The rule also prohibits creditors from extending credit when a creditor knows that a person has coerced, influenced, or encouraged an appraiser, unless the creditor acts with reasonable diligence to determine that the appraisal does not materially misstate or misrepresent the value of the property.³⁴ Given the prevalence of these types of unfair appraisal practices among brokered mortgages loans, FDIC-supervised institutions should pay particular attention to and closely monitor for the existence of such practices when originating mortgage loans through third parties.³⁵

³² See <http://www.fdic.gov/news/news/financial/2006/fil06089.html> and <http://www.fdic.gov/news/news/financial/2007/fil07062.html>.

³³ See page 44563 of the July 30, 2008 *Federal Register* notice at <http://www.fdic.gov/news/news/financial/2008/fil08134a.html>.

³⁴ Though Regulation Z limits the coverage of this prohibition to mortgage loans secured by a consumer's principal dwelling, the FDIC will examine and potentially cite such practices relative to all mortgage loans pursuant to section 5 of the FTC Act, under the standards for unfair or deceptive acts or practices. Furthermore, the FDIC has promulgated regulations and guidance that set forth standards for the policies and procedures FDIC-supervised institutions are expected to implement to ensure the independent judgment of appraisers when valuing property. See Appraisals at 12 CFR 323, <http://www.fdic.gov/regulations/laws/rules/2000-4300.html>, and Real Estate Lending Standards at 12 CFR 365, <http://www.fdic.gov/regulations/laws/rules/2000-8700.html>.

³⁵ Bill Garber, director of government affairs for The Appraisal Institute (Institute), notes that “there are a number of pressure points for appraisers, and that pressure can come from any number of parties in a given transaction (mortgage broker, loan officer, realty agent, etc.).” Garber goes on to say that, according to the Institute's members, “the most pervasive pressure comes from mortgage brokers or other parties that are ‘volume’ driven.” See http://realtytimes.com/rtpages/20050208_appraisers.htm.

In addition, under the amendments to Regulation Z, servicers are prohibited from (1) failing to credit a payment to the consumer's account as of the date of its receipt,³⁶ (2) "pyramiding" late fees (i.e., levying or collecting a delinquency charge on a payment, when the only delinquency is attributable to late fees or delinquency charges assessed on earlier installments),³⁷ and (3) failing to provide a payoff statement within a reasonable amount of time after receiving a request from the consumer.³⁸

Expanded and Enhanced Early Disclosure Requirements and New Prohibitions against Deceptive Advertising

Regulation Z also has been amended to provide new and enhanced protections to consumers of all home mortgage loans secured by "any" dwelling (i.e., not limited to a consumer's principal dwelling), extended for a consumer (i.e., personal, family, or household) purpose. These protections relate to Regulation Z's early disclosure requirements and prohibited advertising practices.

Early Disclosures

The amendments to Regulation Z extend the early disclosure requirements of section 226.19 in several important ways. First, the amendments extend

these requirements, previously applicable only to purchase-money transactions, to refinancings and home equity loans. Second, the amendments extend the early disclosure requirements, previously applicable only to mortgage loans secured by a consumer's principal dwelling, to mortgage loans secured by *any* consumer dwelling. Third, the amendments require delivery or mailing of the early disclosures to occur at least seven business days before consummation. Fourth, if the annual percentage rate provided in the early disclosures changes (beyond the tolerances provided in section 226.22³⁹), the amendments require redisclosure at least three business days before consummation.⁴⁰ Fifth, except to the extent that such a fee is for the purpose of obtaining a credit report, the amendments prohibit charging an application fee until after a consumer has received the early disclosures.

Compliance Practitioner Note:

The amendments to Regulation Z pertaining to early disclosures under Section 226.19, "Certain residential mortgage and variable-rate transactions," have occurred over the course of ten months and two separate rulemakings, the first in the summer of 2008 and the second in the spring of 2009. The 2008 amendments had an effective date of October 1, 2009, and therefore did not

take effect before the superseding 2009 amendments. The 2009 amendments, prompted by Congress under the Mortgage Disclosure Improvement Act, take effect on July 30, 2009. Thus, all written applications received by mortgage lenders on or after July 30, 2009, must comply with the early disclosure requirements of Regulation Z as amended in 2009 and as described in this article.

³⁶ Section 226.36(c) provides limited exceptions to this prohibition, such as where the delay does not result in a charge to the consumer or negative reporting to a consumer reporting agency, or, where the consumer fails to follow the lender's written instructions for making payment, the servicer credits a payment received under such circumstances within five days of receipt.

³⁷ Note: Regulation AA, implementing section 5 of the FTC Act (UDAP) also prohibits the pyramiding of late fees in credit transactions, including transactions secured by real estate (other than for the purchase of real estate which are not covered by Regulation AA). However, unlike Regulation Z, Regulation AA applies only to institutions supervised by the federal banking agencies. By adding this explicit prohibition to Regulation Z, the Federal Reserve has extended this prohibition to all mortgage lenders, not just banks, thrifts, and credit unions.

³⁸ The Federal Reserve notes that while five days is reasonable, a longer period may be warranted under certain conditions.

³⁹ Section 226.22 provides a tolerance of one-eighth of 1 percent for regular transactions and one-quarter of 1 percent for irregular transactions.

⁴⁰ These timing restrictions notwithstanding, the rule allows consumers to expedite consummation to meet a bona fide personal financial emergency. See section 226.19(a)(3), <http://www.fdic.gov/news/news/financial/2009/fil09026.html>.

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A side-by-side comparison of the differences between the 2008 early disclosures amendments to Regulation Z (i.e., those that were to take effect October 1, 2009, but now will not) and the superseding 2009 early disclosure amendments (i.e., those that will take effect starting July 30, 2009) appears below.

Regulation Z Early Disclosure Requirements of Section 226.19 2008 Revisions (will not take effect) vs. 2009 Revisions (effective July 30, 2009)

Early TIL Disclosure	2008 Revisions (never took effect)	2009 Revisions (effective 7/30/09)
Applies to loan to:	Purchase or construct home, refinance home, and home equity loans	Same
Secured by:	Principal dwelling	Any consumer dwelling
Timing of delivery:	Within three business days of application	Within three business days of application and at least seven business days before consummation (Timing waiver for bona fide emergency)
Content:	Good faith estimate of 226.18 disclosures	Good faith estimate of 226.18 disclosures and the statement: "You are not required to complete this agreement merely because you have received these disclosures or signed a loan application."
Timing of re-disclosure (if APR outside 226.22 tolerance):	Must be given no later than consummation or settlement	Must be given at least three business days before consummation
Application fee:	No application fee allowed until after early disclosures provided, except for a credit report fee	Same

Advertising

In general, Regulation Z requires advertisements for mortgages (obtained for a personal, family, or household purpose, secured by a consumer's dwelling) to provide accurate and balanced information, in a clear and conspicuous manner, about rates, monthly payments, and other loan features. It prohibits advertisements that fail to do this.

Regulation Z, as amended, delineates several mortgage advertising practices and, effective October 1, 2009, specifically prohibits them as deceptive or misleading. The following two tables (one applicable to closed-end mortgages and the other to home-equity plans) set forth the practices and prohibitions addressed by the advertising provisions of amended Regulation Z.

Prohibited Advertisements for Closed-End Mortgages⁴¹

PRACTICE	PROHIBITED ADVERTISEMENT
Advertising "fixed" rates or payments.	Advertisements that state "fixed" rates or payments for loans whose rates or payments can vary without adequately disclosing that the interest rate or payment amounts are "fixed" only for a limited period of time, rather than for the full term of the loan.
Advertising an example of a rate or payment and comparing it to the consumer's rate or payment.	Advertisements that compare an actual or hypothetical rate or payment obligation to the rates or payments that would apply if the consumer obtains the advertised product unless the advertisement states the rates or payments that will apply over the full term of the loan.
Advertising a "government" association with the loan product.	Advertisements that characterize the products offered as "government-supported loans," or otherwise endorsed or sponsored by a federal or state government entity when, in fact, the advertised products are not government-supported or government-sponsored loans.
Advertising that includes the name of the consumer's current mortgage lender.	Advertisements, such as solicitation letters, that display the name of the consumer's current mortgage lender, unless the advertisement also prominently discloses that the advertisement is from a mortgage lender not affiliated with the consumer's current lender.
Advertising that makes claim of debt elimination.	Advertisements that make claims of debt elimination if the product advertised would merely replace one debt obligation with another.
Advertising that suggests the establishment of a "counselor" relationship.	Advertisements that create a false impression that the mortgage broker or lender is a "counselor" for the consumer.
Advertising selective attributes of a loan product in a foreign language.	Foreign-language advertisements in which certain information, such as a low introductory "teaser" rate, is provided in a foreign language, while required disclosures are provided only in English.

⁴¹ See Section 226.24 <http://www.fdic.gov/news/news/financial/2008/fil08134a.html>.

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Prohibited Advertisements for Home-Equity Plans⁴²

PRACTICE	PROHIBITED ADVERTISEMENT
Advertising discounted annual percentage rates (APR) for adjustable rate mortgage (ARM) loans.	<p>An ARM advertisement that states an initial APR that is not based on the index and margin used to make later rate adjustments that does not also state, with equal prominence and in close proximity to the initial rate:</p> <ul style="list-style-type: none"> ■ The period of time such initial rate will be in effect; and ■ A reasonably current annual percentage rate that would have been in effect using the index and margin.
Advertising a loan's minimum required payment.	<p>An advertisement that contains a statement of a loan's minimum periodic payment if, by making only the minimum payment, a balloon payment may result, unless:</p> <ul style="list-style-type: none"> ■ The advertisement also states, with equal prominence and in close proximity to the minimum periodic payment statement that a balloon payment may result.
Advertising the tax deductibility of interest expense.	<p>An advertisement that suggests that any interest expense incurred under the home-equity plan is or may be tax deductible when it is not.</p> <ul style="list-style-type: none"> ■ If an advertisement distributed in paper form or through the Internet (rather than by radio or television) is for a home-equity plan secured by the consumer's principal dwelling, and the advertisement states that the advertised extension of credit may exceed the fair market value of the dwelling, the advertisement shall clearly and conspicuously state that: <ol style="list-style-type: none"> 1. The interest on the portion of the credit extension that is greater than the fair market value of the dwelling is not tax deductible for federal income tax purposes; and 2. The consumer should consult a tax adviser for further information regarding the deductibility of interest and charges.
Advertising of promotional rate or promotional payment.	<p>If any APR that may be applied to a plan is a promotional rate,⁴³ or if any payment applicable to a plan is a promotional payment,⁴⁴ advertisements (other than television or radio advertisements) that fail to disclose the following information, in a clear and conspicuous manner with equal prominence and in close proximity to each listing of the promotional rate or payment:</p> <ul style="list-style-type: none"> ■ The period of time during which the promotional rate or promotional payment will apply.⁴⁵ ■ In the case of a promotional rate, any annual percentage rate that will apply under the plan. (If such rate is variable, the APR must be disclosed in accordance with Regulation Z's accuracy standards in §526.5b, or 226.16(b)(1)(ii) as applicable). ■ In the case of a promotional payment, the amounts and time periods of any payments that will apply under the plan. In ARM transactions, payments that will be determined based on application of an index and margin shall be disclosed based on a reasonably current index and margin. <p><i>Envelope / Electronic Advertisements Excluded</i></p> <p>The requirement to state the promotional period and post-promotional rate or payments does not apply to an advertisement on an envelope in which an application or solicitation is mailed, or to a banner advertisement or pop-up advertisement linked to an application or solicitation provided electronically.</p> <p><i>Alternative Disclosures for Television or Radio Ads</i></p> <p>An advertisement for a home-equity plan made through television or radio stating any of the terms requiring additional disclosures may alternatively comply by stating the information required by these advertising provisions and listing a toll-free telephone number, or any telephone number that allows a consumer to reverse the phone charges when calling for information, along with a reference that such number may be used by consumers to obtain additional cost information.</p>

⁴² See Section 226.16 <http://www.fdic.gov/news/news/financial/2008/fil08134a.html>.

⁴³ Promotional rate. The term "promotional rate" means, in a variable-rate plan, any annual percentage rate that is not based on the index and margin that will be used to make rate adjustments under the plan, if that rate is less than a reasonably current annual percentage rate that would be in effect under the index and margin that will be used to make rate adjustments under the plan.

⁴⁴ Promotional payment. The term "promotional payment" means—

For a variable-rate plan, any minimum payment applicable for a promotional period that is:

Not derived by applying the index and margin to the outstanding balance when such index and margin will be used to determine other minimum payments under the plan; and

Less than other minimum payments under the plan derived by applying a reasonably current index and margin that will be used to determine the amount of such payments, given an assumed balance.

For a plan other than a variable-rate plan, any minimum payment applicable for a promotional period if that payment is less than other payments required under the plan given an assumed balance.

⁴⁵ Promotional period. A "promotional period" means a period of time, less than the full term of the loan, that the promotional rate or promotional payment may be applicable.

Effective Dates

Regulation Z's *early disclosure provisions* (now applicable to non-purchase-money mortgage transactions and to mortgage transactions secured by any consumer dwelling) become effective on July 30, 2009. The effective date for the early disclosure provisions was initially October 1, 2009. However, the Federal Reserve, pursuant to the Mortgage Disclosure Improvement Act of 2008, subsequently moved up the effective date to July 30, 2009.

Regulation Z's *escrow provisions* for higher-priced mortgage transactions become effective on April 1, 2010. Given the limited industry infrastructure for escrowing for mortgage loans secured by manufactured housing, the effective date for compliance with Regulation Z's escrow provisions for higher-priced mortgage loans secured by manufactured housing is October 1, 2010.

All other provisions of the Regulation Z amendments take effect on October 1, 2009.

Conclusion

In promulgating its final rule implementing these amendments to Regulation Z, the Federal Reserve noted that

nothing in this rule should be construed or interpreted to be a determination that acts or practices restricted or prohibited under this rule are, or are not, unfair or deceptive before the effective dates of the rule's provisions. Accordingly, questionable mortgage lending practices, such as the ones addressed by this rule and discussed in this article, engaged in by FDIC-supervised institutions will continue to be scrutinized by the FDIC on a case-by-case basis under all applicable consumer protection laws, including section 5 of the FTC Act, through its examination-consultation process and, if warranted, through agency enforcement actions. For this reason, FDIC-supervised institutions should regularly monitor and update their compliance management programs and remain vigilant against engaging in unfair or deceptive mortgage lending practices that violate Regulation Z or any other consumer protection law or regulation.⁴⁶

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⁴⁶ The FDIC, in concert with other federal and state bank regulatory agencies, is in the process of promulgating interagency examination procedures pertaining to these amendments to Regulation Z and anticipates their issuance shortly.

Overview of Selected Regulations and Supervisory Guidance

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

ACRONYMS and DEFINITIONS

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

Subject	Summary
Solicitation of Comments on Legacy Loans Program (PR-48-2009, March 26, 2009)	The FDIC announced the opening of the public comment period for the Legacy Loans Program, which is designed to remove troubled loans and other assets from FDIC-insured institutions and attract private capital to purchase the loans. Comments were due by April 10, 2009. See http://www.fdic.gov/news/news/press/2009/pr09048.html .
Changes to Debt Guarantee Component Reporting Requirements of Temporary Liquidity Guarantee Program (FIL-15-2009, March 23, 2009)	This FIL amends certain reporting requirements, clarifies previously issued reporting guidance, and consolidates reporting instructions relating to the debt guarantee component of the Temporary Liquidity Guarantee Program. This FIL and its attachments supersede FIL-139-2008 and FIL-2-2009. See https://www.fdic.gov/news/inactive-financial-institution-letters/2009/fil09015.html .
Extension of Debt Guarantee Component of Temporary Liquidity Guarantee Program (PR-41-2009, March 17, 2009; FIL-14-2009, March 18, 2009)	The FDIC adopted an interim rule that extends the debt guarantee component of the Temporary Liquidity Guarantee Program from June 30, 2009, through October 31, 2009, and imposes surcharges on existing rates for certain debt issuances to gradually phase out the program. See https://www.fdic.gov/news/inactive-financial-institution-letters/2009/fil09014.html .
Statement in Support of the International Association of Deposit Insurers and Basel Committee on Issuance of Core Principles (PR-40-2009, March 17, 2009)	The FDIC issued support for the work of the Basel Committee on Banking and Supervision and the International Association of Deposit Insurers on issuing the <i>Core Principles for Effective Deposit Insurance Systems</i> for public consultation. These principles are a result of the Financial Stability Forum's call for authorities to agree on an international set of principles for effective deposit insurance systems and address a range of issues, including deposit insurance coverage, funding, and prompt reimbursement. See http://www.fdic.gov/news/news/press/2009/pr09040.html .
Statement in Support of the "Making Home Affordable" Loan Modification Program (PR-35-2009, March 4, 2009)	The Treasury Department announced guidelines for the "Making Home Affordable" loan modification program. The federal bank, thrift, and credit union regulatory agencies encourage all federally regulated financial institutions that service or hold residential mortgage loans to participate in the program. See http://www.fdic.gov/news/news/press/2009/pr09035.html .

Subject	Summary
Use of Volatile or Special Funding Sources by Financial Institutions That Are in a Weakened Condition (FIL-13-2009, March 3, 2009)	The FDIC issued guidance emphasizing that FDIC-supervised institutions rated “3,” “4,” or “5” are expected to implement a plan to stabilize or reduce their risk exposure and limit growth. This plan should not include the use of volatile liabilities or temporarily expanded FDIC insurance or liability guarantees to fund aggressive asset growth or otherwise materially increase the institution’s risk profile. Institutions in a weakened financial condition that engage in material growth strategies pose a significant risk to the deposit insurance fund and will be subject to heightened supervisory review and enforcement. Continuation of prudent lending practices generally would not be considered as increasing the risk profile. See http://www.fdic.gov/news/news/financial/2009/fil09013.html .
Interim Final Rule on Mandatory Convertible Debt Under the TLGP (FIL-11-2009, March 2, 2009)	The FDIC adopted an interim rule that allows entities participating in the debt guarantee portion of the Temporary Liquidity Guarantee Program to issue certain mandatory convertible debt (MCD). No FDIC-guaranteed MCD may be issued without the FDIC’s prior written approval. See https://www.fdic.gov/news/inactive-financial-institution-letters/2009/fil09011.html .
Final Rule on Deposit Assessments; Amended FDIC Restoration Plan; Interim Rule on Emergency Special Assessment (PR-30-2009, February 27, 2009; FIL-12-2009, March 2, 2009; <i>Federal Register</i>, Vol. 74, No. 41, p. 9564, March 4, 2009)	The FDIC Board of Directors voted to amend the restoration plan for the Deposit Insurance Fund (DIF), extending from five years to seven the time horizon to restore the DIF reserve ratio to 1.15 percent. The Board also took action to ensure the continued strength of the insurance fund by implementing changes to the risk-based assessment system, setting rates beginning the second quarter of 2009, and adopting an interim rule with request for comments imposing an emergency 20 basis-point special assessment on June 30, 2009, to be collected on September 30, 2009. Comments on the interim rule were due by April 3, 2009. See http://www.fdic.gov/news/news/financial/2009/fil09012.html .
Commencement of Forward-Looking Economic Assessments (PR-25-2009, February 25, 2009)	The federal bank regulatory agencies announced they will begin conducting forward-looking economic assessments of large U.S. banking organizations as the Capital Assistance Program gets under way. Supervisors will work with institutions to estimate the range of possible future losses and the resources to absorb such losses over a two-year period. See http://www.fdic.gov/news/news/press/2009/pr09025.html .
Interagency Statement on the Financial Stability Plan (February 10, 2009)	The federal bank and thrift regulatory agencies announced a comprehensive set of measures to restore confidence in the strength of U.S. financial institutions and restart the critical flow of credit to households and businesses. This program will help lay the groundwork for restoring the flow of credit necessary to support recovery. See http://www.fdic.gov/news/news/press/2009/pr_fsb.html .
Release of First National Survey of Banks’ Efforts to Serve the Unbanked and Underbanked (PR-15-2009, February 5, 2009)	In the first national survey of banks’ efforts to serve unbanked and underbanked individuals and families in their market areas, the FDIC found that improvement may be possible in the areas of focus, outreach, and commitment. The majority of banks (63 percent) offer basic financial education materials, but fewer participate in the types of outreach efforts viewed by the industry as most effective to attract and maintain unbanked and underbanked individuals as long-term customers. See http://www.fdic.gov/news/news/press/2009/pr09015.html .

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Subject	Summary
Revisions to the Consolidated Reports of Condition and Income for 2009 (FIL-7-2009, January 30, 2009)	The Federal Financial Institutions Examination Council has approved revisions to the reporting requirements for the Consolidated Reports of Condition and Income. These regulatory reporting revisions will take effect on a phased-in basis during 2009. The U.S. Office of Management and Budget must approve these changes before they become final. See https://www.fdic.gov/news/inactive-financial-institution-letters/2009/fil09007.html .
Interest Rate Restrictions on Institutions That Are Less Than Well-Capitalized (PR-9-2009, January 27, 2009; FIL-5-2009, January 28, 2009; <i>Federal Register</i>, Vol. 74, No. 21, p. 5904, February 3, 2009)	The FDIC issued a proposed rule that would make certain revisions to the interest rate restrictions under Part 337.6 ("Brokered Deposits") of the FDIC Rules and Regulations. The proposal would redefine the "national rate" as a simple average of deposit rates paid by U.S. depository institutions, discontinuing the use of Treasury yields (which are currently well below average deposit rates) in the definition. The proposal, in the absence of contrary evidence as to the rates in a particular market, also would specify that the prevailing rate in all market areas is deemed to be the "national rate" as defined by the FDIC. Comments on the proposed rule were due by April 4, 2009. See https://www.fdic.gov/news/inactive-financial-institution-letters/2009/fil09005.html .
Processing of Deposit Accounts in the Event of an Insured Depository Institution Failure – Final Rule (PR-8-2009, January 27, 2009; FIL-9-2009, February 4, 2009; <i>Federal Register</i>, Vol. 74, No. 20, p. 5797, February 2, 2009)	The FDIC issued a final rule on processing deposit accounts in the event of a bank failure. The rule finalizes the interim rule issued in July 2008, which established the FDIC's practices for determining deposit and other liability account balances at a failed insured depository institution. The final rule also requires institutions to prominently disclose to sweep account customers whether the swept funds are deposits and the status of the swept funds if the institution were to fail. The final rule took effect on March 4, 2009; however, the effective date of the sweep account disclosure requirements is July 1, 2009. See http://www.fdic.gov/news/news/financial/2009/fil09009.html .
Risk Management of Remote Deposit Capture (FIL-4-2009, January 14, 2009)	The Federal Financial Institutions Examination Council issued guidance to assist financial institutions in identifying risks in their remote deposit capture (RDC) systems and evaluating the adequacy of controls and applicable risk management practices. The guidance addresses the necessary elements of an RDC risk management process—risk identification, assessment, and mitigation—and the measurement and monitoring of residual risk exposure. The guidance also discusses the responsibilities of the board of directors and senior management in overseeing the development, implementation, and ongoing operation of RDC. See http://www.fdic.gov/news/news/financial/2009/fil09004.html .
Monitoring of the Use of Funding from Federal Financial Stability and Guaranty Programs (FIL-1-2009, January 12, 2009)	The FDIC announced that state nonmember institutions should implement a process to monitor their use of capital injections, liquidity support, or financing guarantees obtained through recent financial stability programs established by the U.S. Department of the Treasury, the FDIC, and the Federal Reserve. In particular, the monitoring processes should help to determine how participation in these federal programs has assisted institutions in supporting prudent lending or efforts to work with existing borrowers to avoid unnecessary foreclosures. The FDIC encourages institutions to include a summary of this information in shareholder and public reports, annual reports and financial statements, as applicable. See https://www.fdic.gov/news/inactive-financial-institution-letters/2009/fil09001.html .

Subject	Summary
Final Interagency Questions and Answers on Community Reinvestment (PR-3-2009, January 6, 2009; FIL-6-2009, January 28, 2009; <i>Federal Register</i>, Vol. 74, No. 3, p. 498, January 6, 2009)	<p>The federal bank and thrift regulatory agencies published final Interagency Questions and Answers Regarding Community Reinvestment (Questions and Answers). The agencies also published for comment one new and two revised questions and answers. The final Questions and Answers took effect on January 6, 2009. Comments on the proposed Questions and Answers were due by March 9, 2009. See https://www.fdic.gov/news/inactive-financial-institution-letters/2009/fil09006.html.</p>
FDIC Teleconference on Conducting a Fair Lending Risk Assessment (FIL-148-2008, December 30, 2008)	<p>FDIC Fair Lending Examination Specialists hosted a Fair Lending Conference Call for bankers on January 14, 2009. The call featured a presentation on how bankers can perform an effective fair lending risk assessment. See http://www.fdic.gov/news/inactive-financial-institution-letters/2008/fil08148.html.</p>
Revised Identity Theft Brochure (PR-143-2008, December 22, 2008)	<p>The federal bank and thrift regulatory agencies announced publication of a revised identity theft brochure—<i>You Have the Power to Stop Identity Theft</i>—to assist consumers in preventing and resolving identity theft. The updated brochure focuses on Internet “phishing” by describing how phishing works, offering ways to protect against identity theft, and detailing steps to follow for victims of identity theft. See http://www.fdic.gov/news/news/press/2008/pr08143.html.</p>
Release of Annual Community Reinvestment Act Asset-Size Threshold Adjustments for Small and Intermediate Small Institutions (PR-140-2008, December 17, 2008; FIL-145-2008, December 17, 2008)	<p>The federal bank and thrift regulatory agencies published the joint final rule amending the Community Reinvestment Act to make the annual adjustment to the asset-size threshold used to define “small bank” and “intermediate small bank” under the Act. As a result of the 4.49 percent increase in the Consumer Price Index for the period ending in November 2008, “small bank” or “small savings association” refers to an institution that, as of December 31 of either of the prior two calendar years, had assets of less than \$1.109 billion; “intermediate small bank” or “intermediate small savings association” refers to an institution with assets of at least \$277 million as of December 31 for both of the prior two calendar years and less than \$1.109 billion as of December 31 of either of the prior two calendar years. These asset-size threshold adjustments took effect January 1, 2009. See https://www.fdic.gov/news/inactive-financial-institution-letters/2008/fil08145.html.</p>
Regulatory Capital Standards Deduction of Goodwill Net of Associated Deferred Tax Liability (PR-139-2008, December 16, 2008; FIL-144-2008, December 16, 2008; <i>Federal Register</i>, Vol. 73, No. 250, p. 79602, December 30, 2008)	<p>The federal banking agencies jointly issued a final rule allowing goodwill, which must be deducted from tier 1 capital, to be reduced by the amount of any associated deferred tax liability. The final rule took effect January 29, 2009. However, a bank may elect to apply this final rule for regulatory capital reporting purposes as of December 31, 2008. See https://www.fdic.gov/news/inactive-financial-institution-letters/2008/fil08144.html.</p>
Final Rule on Recordkeeping Requirements for Qualified Financial Contracts (PR-138-2008, December 16, 2008; FIL-146-2008, December 18, 2008)	<p>The FDIC issued a final rule to improve the FDIC’s ability to monitor and evaluate risks in certain insured depository institutions with qualified financial contracts, as well as assure preparedness if such institutions fail. The recordkeeping requirements in the final rule require insured depository institutions in a troubled condition to provide certain crucial information to the FDIC in a timely manner, including adequate position level documentation of the counterparty relationships of failed institutions. See http://www.fdic.gov/news/news/press/2008/pr08138.html.</p>

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Subject	Summary
Final Rule on Deposit Insurance Assessments for the First Quarter of 2009 (PR-136-2008, December 16, 2008; FIL-143-2008, December 16, 2008)	The FDIC Board of Directors approved the final rule on deposit insurance assessment rates for first quarter 2009. The rule raises assessment rates uniformly by 7 basis points (annual rate) for first quarter 2009 only. Currently, banks pay between 5 and 43 basis points of their domestic deposits for FDIC insurance. Under the final rule, risk-based rates would range between 12 and 50 basis points (annualized) for the first quarter 2009 assessment. Most institutions would be charged between 12 and 14 basis points. See http://www.fdic.gov/news/news/financial/2008/fil08143.html .
Revisions to Regulatory Reports Filed by FDIC-Insured Depository Institutions (FIL-141-2008, December 11, 2008)	In response to the FDIC's adoption of the Temporary Liquidity Guarantee Program (TLGP), the Federal Financial Institutions Examination Council approved revisions to the Consolidated Reports of Condition and Income, the Thrift Financial Report, and the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks. These regulatory reporting revisions, which took effect December 31, 2008, will be applicable to FDIC-insured depository institutions that participate in the Transaction Account Guarantee Program. A participating institution will report the amount and number of its noninterest-bearing transaction accounts, as defined in the FDIC's regulations governing the TLGP, of more than \$250,000. Institutions have the option to exclude such accounts that are otherwise fully insured under the FDIC's deposit insurance rules as determined and documented by the institution. The FDIC will use this information to calculate assessments for participants in the Transaction Account Guarantee Program. See https://www.fdic.gov/news/inactive-financial-institution-letters/2008/fil08141.html .
Consumer Understanding of Increased Deposit Insurance Coverage (PR-130-2008, December 4, 2008)	Federal deposit insurance coverage has significantly increased, primarily as a result of a temporary boost in the basic insurance limit from \$100,000 to \$250,000. The FDIC issued an explanation of the new changes along with tips and information to help bank customers better understand their insurance coverage and how to be sure all their deposits are fully protected. See http://www.fdic.gov/news/news/press/2008/pr08130.html .
Regulation Z (Truth in Lending) and Regulation C (Home Mortgage Disclosure) – Amendments to the Regulations (FIL-134-2008, December 2, 2008)	The closed-end mortgage provisions of Regulation Z, which implement the Truth in Lending Act and the Home Ownership and Equity Protection Act, have been amended. Among other changes, these provisions now include consumer protections specific to "higher-priced mortgage loans." The compilation and reporting of loan data provisions of Regulation C, which implements the Home Mortgage Disclosure Act, now conform to the definition of higher-priced mortgage loans under Regulation Z. The amendments to Regulations Z (with limited exceptions) and C take effect on October 1, 2009. See http://www.fdic.gov/news/news/financial/2008/fil08134.html .
Expansion of Bidder List for Troubled Institutions (PR-127-2008, November 26, 2008)	The FDIC is establishing a modified bidder qualification process to expand the pool of qualified bidders for the deposits and assets of failing depository institutions. The process will allow interested parties that do not currently have a bank charter to participate in the bid process through which failing depository institutions are resolved. See http://www.fdic.gov/news/news/press/2008/pr08127.html .

Subject	Summary
Joint Statement by Treasury, Federal Reserve, and the FDIC on Citigroup (PR-125-2008, November 23, 2008)	In support of the U.S. government's commitment to supporting financial market stability, on November 23, 2008, the government entered into an agreement with Citigroup to provide a package of guarantees, liquidity access, and capital. As part of the agreement, the Treasury and the FDIC will provide protection against the possibility of unusually large losses on an asset pool of approximately \$306 billion of loans and securities backed by residential and commercial real estate and other such assets, which will remain on Citigroup's balance sheet. As a fee for this arrangement, Citigroup will issue preferred shares to the Treasury and FDIC. In addition and if necessary, the Federal Reserve stands ready to backstop residual risk in the asset pool through a non-recourse loan. See http://www.fdic.gov/news/news/press/2008/pr08125.html .
Adoption of TLGP Final Rule (PR-122-2008, November 21, 2008; FIL-132-2008, November 21, 2008)	The FDIC adopted the Final Rule implementing the Temporary Liquidity Guarantee Program inaugurated October 14, 2008. The TLGP consists of two basic components: a guarantee of newly issued senior unsecured debt of banks, thrifts, and certain holding companies (the debt guarantee program), and full guarantee of non-interest-bearing deposit transaction accounts, such as business payroll accounts, regardless of dollar amount (the transaction account guarantee program). The purpose of the debt guarantee and the guarantee of transaction accounts is to reduce funding costs and allow banks and thrifts to increase lending to consumers and businesses. See https://www.fdic.gov/news/inactive-financial-institution-letters/2008/fil08132.html .
Availability of IndyMac Loan Modification Model (PR-121-2008, November 20, 2008)	The FDIC announced the availability of a comprehensive package of information to give servicers and financial institutions the tools to implement a systematic and streamlined approach to modifying loans based on the FDIC Loan Modification Program initiated at IndyMac Federal Bank. The Program is designed to achieve affordable and sustainable mortgage payments for borrowers and increase the value of distressed mortgages by rehabilitating them into performing loans. See http://www.fdic.gov/news/news/press/2008/pr08121.html .
Proposed Revisions to the Interagency Appraisal and Evaluation Guidelines and Request for Comments (PR-117-2008, November 13, 2008; FIL-131-2008, November 19, 2008; <i>Federal Register</i>, Vol. 73, No. 224, p. 69647, November 19, 2008)	The federal bank, thrift, and credit union regulatory agencies jointly issued for comment proposed Interagency Appraisal and Evaluation Guidelines that reaffirm supervisory expectations for sound real estate appraisal and evaluation practices. The proposed guidance builds on the existing federal regulatory framework to clarify risk management principles and internal controls for ensuring that financial institutions' real estate collateral valuations are reliable and support their real estate-related transactions. The initiative is intended to respond to heightened concerns over appraisals and credit quality. The proposed guidance would replace the <i>1994 Interagency Appraisal and Evaluation Guidelines</i> to incorporate recent supervisory issuances and reflect changes in industry practice, uniform appraisal standards, and available technologies. Comments were due by January 20, 2009. See https://www.fdic.gov/news/inactive-financial-institution-letters/2008/fil08131.html .

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Subject	Summary
Stored Value Cards and Other Nontraditional Access Mechanisms—New General Counsel’s Opinion No. 8 (FIL-129-2008, November 13, 2008)	The FDIC Board of Directors approved the new General Counsel’s opinion on the insurability of funds underlying stored value cards and other nontraditional access mechanisms. The new opinion replaces the previous General Counsel’s Opinion No. 8, published in 1996. The new opinion addresses the issue of whether the funds underlying stored value cards and other nontraditional access mechanisms qualify as “deposits” as defined in the Federal Deposit Insurance Act. Under the new opinion, the funds will be “deposits” to the extent the funds have been placed at an insured depository institution. Consequently, the funds will be subject to assessments and will be insured (up to the insurance limit). See http://www.fdic.gov/news/news/financial/2008/fil08129.html .
Interagency Statement on Meeting the Needs of Creditworthy Borrowers (PR-115-2008, November 12, 2008; PR-116-2008, November 12, 2008; FIL-128-2008, November 12, 2008)	The federal government has recently put into place several federal programs to promote financial stability and mitigate the effects of current market conditions on insured depository institutions. This statement encourages financial institutions to support the lending needs of creditworthy borrowers, strengthen capital, engage in loss mitigation strategies and foreclosure prevention strategies with mortgage borrowers, and assess the incentive implications of compensation policies. See http://www.fdic.gov/news/news/financial/2008/fil08128.html .
Guidance on Payment Processor Relationships (FIL-127-2008, November 7, 2008)	The FDIC issued guidance that describes potential risks associated with relationships with entities that process payments for telemarketers and other merchant clients. These types of relationships pose a higher risk and require additional due diligence and close monitoring. The guidance outlines risk management principles for this type of higher-risk activity. See http://www.fdic.gov/news/news/financial/2008/fil08127.html .

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