

Supervisory Insights

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Supervisory Insights

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Letter from the Director

With the enactment on July 21, 2010, of the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (Dodd-Frank Act), a framework is now in place to address many of the weaknesses in the financial system that brought about the recent crisis. This legislation establishes enhanced prudential standards for systemic nonbank financial companies as well as bank holding companies, ends “too big to fail,” and strengthens consumer protections across financial sectors with the creation of the Consumer Financial Protection Bureau. Considerable work now lies ahead for financial institution regulators and supervisors to develop and implement the regulations required by this landmark legislation.

“Trust Preferred Securities and the Capital Strength of Banking Organizations” looks closely at the role of these hybrid securities during the financial crisis and highlights the fact that the use of TruPS in tier 1 capital enabled large bank holding companies (BHCs), as a group, to operate with substantially less loss-absorbing capital than permitted for insured banks. Evidence also suggests that institutions relying on these instruments took more risks and failed more often than those that did not include TruPS in tier 1 capital. The eventual elimination of TruPS from large BHC tier 1 capital, as mandated by the Collins Amendment and recent agreements by the Basel Committee on Banking Supervision, is expected to help move the U.S. banking industry toward a stronger capital foundation.

This issue of *Supervisory Insights* also sheds light on how insured institutions are responding to the recent period of economic and competitive challenges. Data collected and summarized in “Insights from the FDIC’s Credit and Consumer Products/Services Survey” show that institutions are implementing a variety of opera-

tional changes, including tightening underwriting standards and making use of third-party providers to offer new and innovative products. Ongoing analysis of the Survey data will help the FDIC understand how effectively bank safety-and-soundness and compliance risk management systems are keeping pace with these changes.

In addition, this issue focuses on the operations of farm banks, a critical component of the U.S. banking industry. Although the agricultural sector remains healthy, the industry is cyclical and subject to shocks from a variety of sources, including environmental pressures, market volatility, changes in interest rates, and the potential for declining farmland values. “Managing Agricultural Credit Concentrations” highlights best practices relating to agricultural lending and effective management of agricultural credit concentrations that will help farm banks manage the inherent uncertainties in this industry.

And finally, in recent years, Wall Street firms and financial advisors have stepped up efforts to interest consumers and investors in Senior Life Settlements. “Senior Life Settlements: A Cautionary Tale” explains how the market for these investment options has developed and discusses the significant risks associated with these transactions to financial institutions, investors, and consumers, including the potential for fraud.

We hope you read all of the articles in this issue and find the information relevant and useful, and we look forward to your feedback. Please e-mail your comments and suggestions for topics for future issues of *Supervisory Insights* to SupervisoryJournal@fdic.gov.

Sandra L. Thompson
Director
Division of Supervision and
Consumer Protection

Trust Preferred Securities and the Capital Strength of Banking Organizations

During the year 2010, legislators and regulators undertook a number of significant regulatory reforms in response to the financial crisis. One important theme of these reforms is the need for banking organizations to have stronger capital positions to weather periods of economic stress. This paper discusses one component of regulatory capital that was the subject of significant discussion, debate, and ultimately, reform during 2010: trust preferred securities (TruPS) issued by Bank Holding Companies (BHCs).

TruPS are hybrid securities that are included in regulatory tier 1 capital for BHCs and whose dividend payments are tax deductible for the issuer. Since the Federal Reserve Board's (Federal Reserve) 1996 decision to allow TruPS to meet a portion of BHCs' tier 1 capital requirements, many banking organizations have found these instruments attractive because of their tax-deductible status and because the increased leverage provided from their issuance can boost return on equity (ROE).

The increased leverage implied by the use of TruPS is a two-edged sword. Evidence suggests that banking organizations that issued these instruments were weaker as a result, took more risks, and failed more often than those that did not. The unsatisfactory experience with these instruments was one factor that set the stage for reforms that will require banking organizations to hold higher quality capital in the future.

An Introduction to TruPS

The significant use of TruPS on BHC balance sheets dates to an October 21, 1996 press release issued by the Federal Reserve. The press release described a financing structure in

which a BHC creates a wholly owned special purpose entity (SPE). The SPE issues cumulative preferred stock to investors. The BHC then borrows the proceeds from the SPE using a long-term subordinated note. Under then current accounting rules, the BHC consolidated the SPE, and the financing transaction gave rise to a minority interest in the consolidated subsidiary. The press release announced that under certain conditions, this minority interest in the SPE would meet a portion of the tier 1 capital requirements for BHCs.

Generally Accepted Accounting Principles (GAAP) in use at the time of the 1996 announcement masked the underlying economics of the transaction: the BHC was in effect issuing term subordinated debt into the marketplace and it was this subordinated debt that really was being permitted in tier 1 capital. Since the SPE's sole asset is the subordinated note from its parent BHC, any dividend payments the SPE pays to the trust preferred investors are, in substance, simply the BHC's interest payments on the subordinated debt. Moreover, while the TruPS themselves have no maturity date, their effective life is limited as the trust typically terminates at the maturity date of the subordinated debt, by which time the BHC bears a legal obligation to repay this debt in accordance with its contractual terms.

The Internal Revenue Service (IRS) recognized the economic substance of the trust preferred structure as a debt issuance of the BHC. As described by the Federal Reserve in a 2005 rule-making, "A key advantage of TruPS to BHCs is that for tax purposes the dividends paid on TruPS, unlike those paid on directly issued preferred stock, are a tax-deductible interest expense. The Internal Revenue Service

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ignores the trust and focuses on the interest payments on the underlying subordinated note.”¹

TruPS became extremely popular among banking organizations because their dividends are tax deductible and their issuance does not dilute equity of the BHC. Of the roughly 1,025 BHCs reporting on form Y-9C as of June 30, 2010, nearly two-thirds (664) reported some amount of TruPS in their tier 1 capital during the past five years, with close to half of those (308) reporting TruPS exceeding 25 percent of tier 1 capital at one point during that time. Roughly half the 308 banking companies with higher dependence on TruPS were smaller banking companies with total assets of \$1 billion or less.

The Federal Reserve’s decision to allow TruPS to satisfy part of BHCs’ tier 1 capital requirement was important to insured banks as well. As indicated in Table 1, more than 70 percent

of insured banks are subsidiaries of a bank holding company. Although banks are separately regulated from their parent holding companies, many are linked to their parent through capital transfers, including dividends from the bank to the holding company and capital infusions from the parent company down-streamed to the bank.

Smaller bank holding companies typically did not bring TruPS directly to market. Instead, these organizations often would sell their TruPS into a collateralized debt obligation (CDO). These CDOs, which commingled TruPS issued by smaller banking organizations and other entities, were tranching and sold to investors. Fitch reported that since the year 2000, 1,813 banking entities issued TruPS that were purchased by TruPS CDOs, in an aggregate amount of roughly \$38 billion.² The federal banking agencies deemed these CDOs permissible investments for insured institutions,³

Table 1

Distribution of Insured Depository Institutions by Parent				
Asset Range of Insured Depository Institutions	Subsidiaries of Top Tier Y-9C-filers	Subsidiaries of Other Holding Companies	No Bank Holding Company	All Insured Depository Institutions
Over \$100 billion	19	0	0	19
\$15-\$100 billion	38	5	10	53
\$1 to \$15 billion	431	20	137	588
\$500 million to \$1 billion	492	47	162	701
Under \$500 million	536	4,105	1,828	6,469
All Depository Institutions	1,516	4,177	2,137	7,830

Data as of June 30, 2010; Source Bank and Thrift Reports, Y-9C Reports.

Subsidiaries of other holding companies may include subsidiaries of foreign parents or non-financial holding companies.

Subsidiaries of thrift holding companies would be listed under “No Bank Holding Company.”

¹ See *Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital*, 70 Fed. Reg. 11827 (March 10, 2005). <http://www.federalregister.gov/articles/2005/03/10/05-4690/riskbased-capital-standards-trust-preferred-securities-and-the-definition-of-capital>.

² “Fitch Bank TruPS CDO Default and Deferral Index,” November 2010, Structured Credit Special Report, FitchRatings. http://www.fitchratings.com/creditedesk/reports/report_frame.cfm?rpt_id=576606.

³ See, for example, Interpretive Letter No. 777, Office of the Comptroller of the Currency, April 8, 1997; and “Investments in Trust Preferred Securities,” FDIC Financial Institution Letter FIL-16-99, February 19, 1999.

meaning that banking organizations could both issue these securities as capital and purchase them as debt.

TruPS are rated as debt instruments by the rating agencies. Correspondingly, for issuers, the rating agencies substantially discounted the contribution of TruPS to the capital strength of banking organizations. For example, according to Moody's, "[w]e have always considered TruPS to be far more debt-like in nature, and have generally not assigned them any 'equity credit' in evaluating the capital structure of highly rated issuers."⁴

The Federal Reserve imposed a number of conditions that, in its view, warranted allowing TruPS to meet a portion of BHCs' tier 1 capital requirements despite their economic substance as debt. Conditions for tier 1 status included the ability to defer dividends for at least five years; subordination of the BHC's long-term subordinated note to the SPE to other BHC debt including all other subordinated debt; maturity of this intercompany subordinated note at the longest feasible maturity; a prohibition on redemption without prior approval of the Federal Reserve; and a requirement for the TruPS along with other cumulative preferred stock to comprise no more than 25 percent of the BHC's core capital elements.

One of the most important features of TruPS the Federal Reserve relied upon in granting tier 1 capital status was the ability to defer dividends. This feature allows the BHC some flexibility to stop the interest payments on the subordinated debt and redirect cash flows within the company during a period

of adversity. Because of the cumulative dividend obligation, however, the deferral of dividends does not protect the accounting solvency of the organization. Specifically, during the deferral period, the BHC must record a liability and interest expense for the amount of the accrued but deferred interest payable on the subordinated debt at the end of each period in which dividends are deferred, and this liability and the related interest expense continue to accrue at the interest rate on the subordinated debt until all deferred interest and the corresponding amount of deferred dividends are paid.

The events that transpire in the event of deferral and ultimate non-payment of dividends are important to understanding the limits to the loss absorption capacity of TruPS. As described by the Federal Reserve, "The terms of the TruPS allow dividends to be deferred for at least a twenty-consecutive quarter period without creating an event of default or acceleration. After the deferral of dividends for this twenty quarter period, if the BHC fails to pay the cumulative dividend amount owed to investors, an event of default and acceleration occurs, giving [trust preferred] investors the right to take hold of the subordinated note issued by the BHC [to the SPE]. At the same time, the BHC's obligation to pay principal and interest on the underlying junior subordinated note accelerates and the note becomes immediately due and payable."⁵

At the end of the deferral period, then, the TruPS investors would be left holding a deeply subordinated

⁴ "Impact on Federal Reserve's Proposed Rule for Trust Preferred Securities on Moody's Ratings for U.S. Banks," Moody's Investors Service, May 2004. http://v3.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_87135. (Reader must register on this site to access documents.)

⁵ See *Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital*, 70 Fed. Reg. 11827 (March 10, 2005). <http://www.federalregister.gov/articles/2005/03/10/05-4690/riskbased-capital-standards-trust-preferred-securities-and-the-definition-of-capital>.

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note of the BHC, which would be likely to absorb substantial loss in the event of the BHC's failure. As noted, however, all cumulative dividend arrearages must be paid in full if the BHC is to continue to operate as a going concern.

TruPS and Regulatory Capital for Insured Banks

The most important function of bank capital is to absorb unexpected losses while the bank continues to operate as a going concern. This shock-absorber function increases the likelihood that a bank can withstand a period of economic adversity, while system-wide, adequate capital ensures the banking industry as a whole can continue to lend during a downturn. A secondary function of bank capital is to absorb losses after the bank has failed, thereby reducing the cost of the failure to the deposit insurance fund. Capital also plays an important role in mitigating moral hazard by ensuring that the owners, who reap the rewards when a bank's risk-taking is successful, have a meaningful stake at risk.

Bank regulators distinguish between "core capital elements" (tier 1) and "supplementary capital elements" (tier 2). Generally speaking, core capital elements are those that are fully available to absorb losses while the banking organization operates as a going concern. Regulators expect core or tier 1 capital to consist predominantly of voting common equity. Other permissible tier 1 capital elements for insured banks are noncumulative perpetual preferred stock and, in certain circumstances, minority

interest in consolidated subsidiaries. In addition, certain assets deemed to be insufficiently reliable or permanent are deducted for purposes of calculating a bank's tier 1 capital.⁶

Voting common equity is the ownership stake of those ultimately in control of the bank's risk-taking, has no contractual interest or dividend payments or redemption rights, and therefore is fully available to absorb losses while the bank continues to operate. Regulators view voting common equity, net of deductions, as the highest form of bank capital. Recently, this view was reinforced by an agreement announced by the Group of Central Bank Governors and Heads of Supervision on September 12, 2010.⁷

The regulatory capital treatment of preferred stock issued by insured banks illustrates the conceptual view of tier 1 capital just described. Preferred stock is senior to equity in liquidation but junior to other creditors. It may carry a stated dividend and, like a bond, may be rated by the major credit ratings agencies. To receive tier 1 capital status, however, an insured bank's preferred stock must not have a maturity date or any feature that will, legally or as a practical matter, require future redemption. Moreover, to qualify for tier 1 capital status for insured banks, the preferred stock cannot have a cumulative dividend obligation. Given these restrictions, noncumulative perpetual preferred stock is viewed by the banking agencies as having sufficient ability to fully participate in losses on a going-concern basis to warrant its inclusion in insured banks' tier 1 capital.

⁶ These deductions include goodwill and other intangible assets (except a limited amount of mortgage servicing assets, nonmortgage servicing assets, and purchased credit card relationships), certain credit-enhancing interest-only strips, certain deferred tax assets, identified losses, certain investments in financial subsidiaries and certain non-financial equity investments. These deductions, among others, are described in detail in the banking agencies' capital regulations.

⁷ <http://www.bis.org/press/p100912.htm>.

Historically, dating back to at least 1989, the definition of tier 1 capital at BHCs has been more permissive than the corresponding definition for insured banks. For example, since 1989 the Federal Reserve has permitted qualifying cumulative perpetual preferred securities to comprise up to 25 percent of a BHC's tier 1 capital.⁸ In contrast, cumulative preferred stock does not qualify as tier 1 capital for insured banks. As another example of differences in tier 1 capital definitions between BHCs and insured banks, mandatory convertible securities are subordinated debt securities that convert to common stock or perpetual preferred stock at a future date. For an insured bank, these securities are considered hybrid capital instruments that, subject to certain conditions, qualify as tier 2 capital. For BHCs, however, subject to prior approval by the Federal Reserve in each instance, these securities may qualify as tier 1 capital.

The 1996 approval of TruPS as tier 1 capital for BHCs was based in part on the fact that the cumulative preferred stock issued to investors by the SPE appeared on the BHC's balance sheet as a minority interest in a consolidated subsidiary. Since the minority interest consisted of cumulative preferred stock, however, this minority interest would not have qualified for tier 1 capital status if the SPE had been a subsidiary of an insured bank.⁹

Financial Reporting for TruPS

As noted in the first section, the economic substance of the issuance of TruPS was that the BHC was financing itself with subordinated debt. Financial reporting requirements eventually came to recognize this reality with the issuance by the Financial Accounting Standards Board (FASB) in January 2003 of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (FIN 46), followed by a revision (FIN 46R) in December of that year. These changes recognized the substance of the TruPS structure by normally no longer requiring the consolidation of the SPE created to issue the TruPS. As a consequence, BHCs began to report the subordinated debt issued to the SPE as a liability instead of reporting the preferred stock as a minority interest in a consolidated subsidiary.

In its March 2005 rulemaking¹⁰ to address the effects of the accounting change, the Federal Reserve decided to retain the tier 1 capital status of TruPS for BHCs, although with a lower limit for large, internationally active organizations. The rule specified that these large banks were required to reduce their reliance on restricted core capital elements¹¹ to 15 percent of core capital elements (including restricted core capital

⁸ See 12 CFR part 225, App. A, II.A.1a(iv). <http://www.fdic.gov/regulations/laws/rules/6000-1900.html#fdic6000appendixa>.

⁹ See Interpretive Letter No. 894, Office of the Comptroller of the Currency, March 10, 2000. <http://www.occ.gov/static/interpretations-and-precedents/oct00/int894.pdf>.

¹⁰ See 12 CFR part 225, App.A, II.A.1.b. <http://www.fdic.gov/regulations/laws/rules/6000-1900.html#fdic6000appendixa>.

¹¹ 12 CFR part 225, App.A, II.A.1.a. Restricted core capital elements are defined to include qualifying cumulative perpetual preferred stock (and related surplus), minority interest related to qualifying cumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary (Class B minority interest), minority interest related to qualifying common or qualifying perpetual preferred stock issued by a consolidated subsidiary that is neither a U.S. depository institution nor a foreign bank (Class C minority interest) and qualifying trust preferred securities. <http://www.fdic.gov/regulations/laws/rules/6000-1900.html#fdic6000appendixa>.

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elements)¹² net of goodwill less any associated deferred tax liability, down from 25 percent of core capital elements before the deduction of goodwill, by March 31, 2009.¹³

The Federal Reserve's limit for restricted core capital elements for smaller organizations remained at 25 percent of the sum of core capital elements (including restricted core capital elements), net of goodwill less any associated deferred tax liability. To put this another way, TruPS could comprise up to 25 percent of a grossed up tier 1 capital number that did not reflect deductions for disallowed intangible assets, disallowed deferred tax assets and other deductions. Thus, in effect, TruPS for

smaller organizations could—and as described below, often did—comprise significantly more than 25 percent of actual tier 1 capital.

TruPS are by far the most popular of the unique tier 1 capital elements available only to BHCs. As indicated in Table 2, as of June 30, 2010, the amount of qualifying TruPS outstanding in tier 1 capital at BHCs reporting on form Y-9C was \$130 billion, representing the majority of the roughly \$161 billion in total restricted capital items.¹⁴ While most of the dollar volume of these items was at the largest banks, smaller bank holding companies as a group had the highest reliance on TruPS in tier 1.

Table 2

Restricted Elements in BHC Tier 1 Capital					
Asset Range of Bank Holding Companies	Trust Preferred Securities	Mandatory Convertible Securities	Cumulative Preferred Stock	Share of Tier 1 Capital	% of Trust Preferred in Tier 1
Over \$100 billion	\$105.5	\$20.1	\$9.1	15.1%	11.8%
\$15 to \$100 billion	\$8.4	\$0.0	\$0.1	7.1%	7.0%
\$1 to \$15 billion	\$13.0	\$0.0	\$1.2	12.3%	11.3%
\$500 million to \$1 billion	\$2.9	\$0.0	\$0.2	10.8%	10.1%
Under \$500 million	\$0.4	\$0.0	\$0.0	13.0%	13.0%
All Reporting BHCs	\$130.1	\$20.2	\$10.5	13.9%	11.2%

Data as of June 30, 2010; Source Y-9C Reports.

¹² 12 CFR part 225, App.A, II.A.1. Core capital is defined as common stockholders' equity; qualifying noncumulative perpetual preferred stock (including related surplus); qualifying cumulative perpetual preferred stock (including related surplus); and minority interest in the equity accounts of consolidated subsidiaries. <http://www.fdic.gov/regulations/laws/rules/6000-1900.html#fdic6000appendixa>.

¹³ 12 CFR part 225, App. A, II.A.1.b. Compliance was later delayed until March 31, 2011; <http://www.fdic.gov/regulations/laws/rules/6000-1900.html#fdic6000appendixa> and <http://federalregister.gov/a/E9-6096>.

¹⁴ "Fitch Bank TruPS CDO Default and Deferral Index," November 2010, Structured Credit Special Report, FitchRatings. http://www.fitchratings.com/creditedesk/reports/report_frame.cfm?rpt_id=576606.

TruPS in a Stressed Banking Environment

The experience of the past several years suggests that BHCs that relied on TruPS as regulatory capital were weaker because of that reliance, assumed more risk, and failed at a higher rate than other BHCs. There are four reasons for this.

- First, reliance on TruPS increased the financial leverage in banking organizations, making them less resilient in the face of adversity.
- Second, heavy users of TruPS appear to have levered the proceeds to make riskier than normal loans, perhaps in response to pressures to meet aggressive return on equity targets.
- Third, when an organization has issued TruPS, the FDIC has more difficulty attracting investors to the institution in a stressed situation while the institution remains open. This increases the likeli-

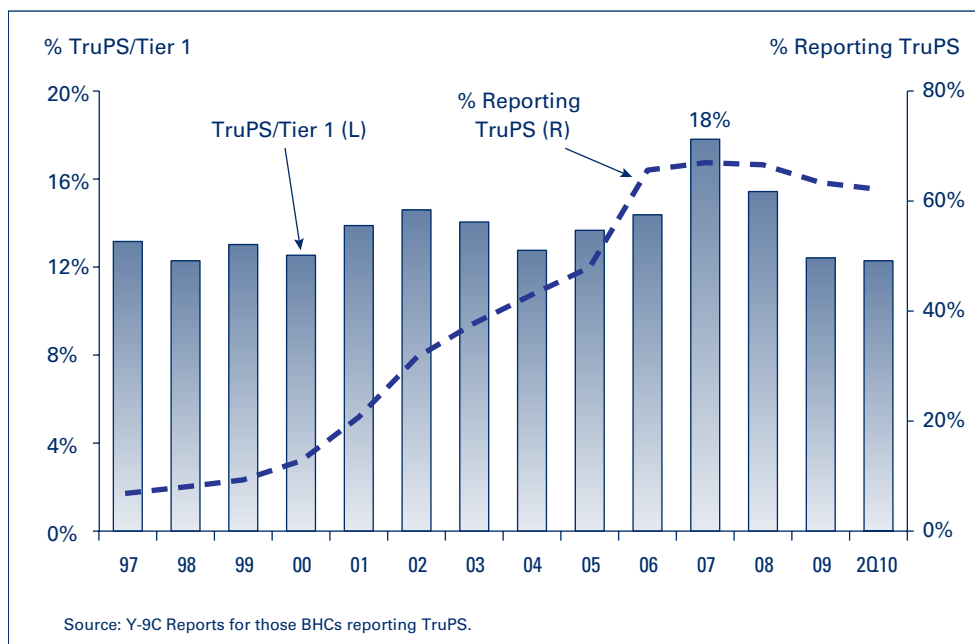
hood of failure rather than rescue, which increases the FDIC's costs.

- Finally, when TruPS are issued by one BHC as capital and owned by another bank, the resulting double counting of capital in the banking system creates inter-linkages that magnify the effects of losses.

Leverage. As noted earlier in the paper, issuing TruPS became very popular among banking organizations. Chart 1 shows the percentage of BHCs (those filing a form Y-9C) that have used TruPS over time to meet part of their tier 1 capital requirements. Among those BHCs that issued TruPS, the percentage of TruPS in tier 1 capital increased steadily during the years leading up to 2007, when the average reached 18 percent.

The TruPS dependence figures reported in Chart 1 are averages. Many BHCs' TruPS comprised more than 25 percent of their tier 1 capital. For example, almost one-half of the 664 BHCs that filed a form Y-9C

Chart 1: Percent of Qualifying TruPS to Tier 1 Risk-Based Capital



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as of June 30, 2010 and included TruPS as regulatory capital between 2005 and 2009 reported that their TruPS represented over 25 percent of tier 1 capital at one time.

A small minority of the many smaller BHCs that did not file a form

Y-9C also issued TruPS. Specifically, 685 of the 4,025 small parent BHCs reporting in June 2010 had subordinated debt outstanding to SPEs that issued TruPS. Among these 685 small BHCs, comprising 734 FDIC-insured subsidiaries, reliance on TruPS was very high. In aggregate, TruPS stood at about 35 percent of GAAP equity for these 685 organizations.

Including TruPS within tier 1 capital at these levels materially reduces a banking organization's ability to absorb losses. For example, a BHC reporting a tier 1 leverage ratio of 5 percent, of which 25 percent or 1.25 percentage points consists of TruPS, has loss absorbing capital of 3.75 percent of assets, a level of capital that would result in an undercapitalized designation for an insured bank. If losses equal to 1 percent of assets are sustained, the organization will report a tier 1 leverage ratio of 4 percent but have loss absorbing capital of 2.75 percent of assets, resulting in a significantly undercapitalized designation if the entity were an insured bank.

Charts 2 and 3 convey a sense of how the use of TruPS by BHCs has reduced the effective loss absorbing capital of these organizations relative to the capital strength of their insured bank subsidiaries. The 634 BHCs that reported TruPS in their tier 1 capital at June 30, 2010, had 929 insured depository institution subsidiaries. Only 6 percent of all these insured banks reported tier 1 risk-based capital ratios (not including TruPS) of less than 8 percent of risk-weighted assets. Another 10 percent of these insured banks reported tier 1 risk-based capital ratios of between 8 percent and 10 percent of risk-weighted assets.

When the same entities are viewed as consolidated BHCs, their distribution of capital ratios is markedly weaker. About 28 percent of these

Chart 2: Bank Holding Companies with TruPS - Distribution of 2Q10 Adjusted Tier 1 RBC Ratio, Less TruPS

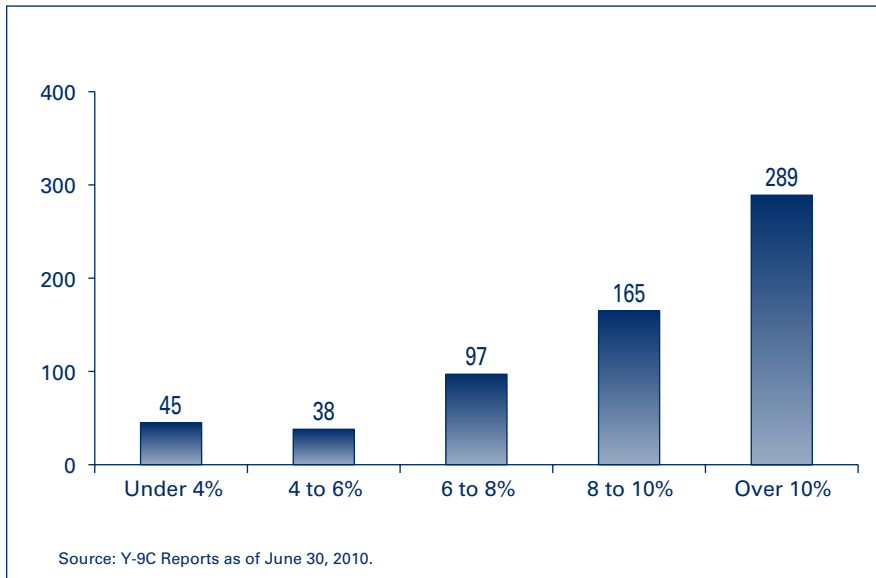
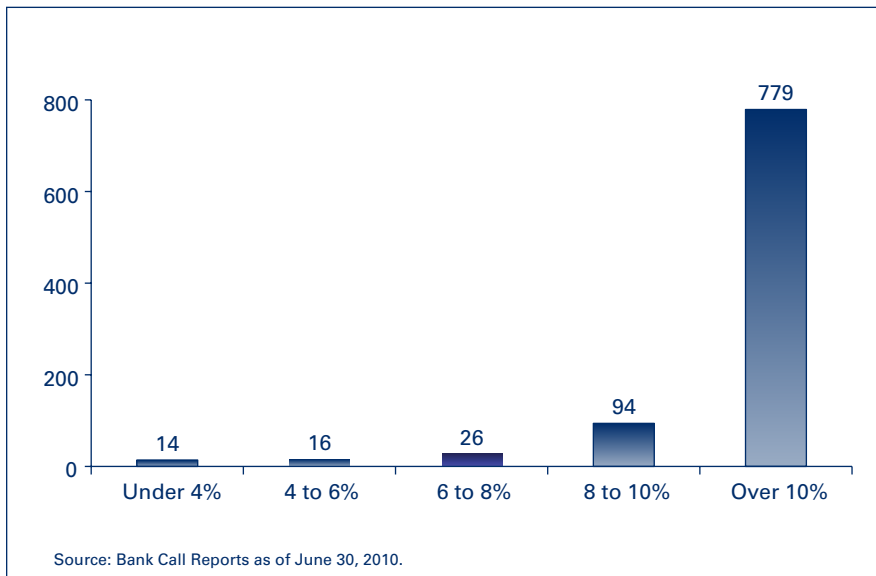


Chart 3: Insured Banks of BHCs with TruPS - Distribution of 2Q10 Tier 1 RBC Ratio



634 BHCs would have tier 1 risk-based capital ratios of less than 8 percent if their TruPS were excluded from tier 1 capital as it is excluded for an insured bank. Another 26 percent of these BHCs would have reported tier 1 risk-based capital ratios of between 8 percent and 10 percent of risk-weighted assets if their TruPS were excluded from tier 1 capital.

In short, the use of TruPS in tier 1 capital enabled these banking organizations, as a group, to operate with substantially less loss absorbing capital on a consolidated basis than did their insured bank subsidiaries.

Risk profile. BHCs that relied on TruPS to meet tier 1 capital requirements exhibited a higher risk profile

than other BHCs. Moreover, BHCs with the heaviest reliance on TruPS exhibited a higher risk profile than BHCs that used TruPS but had less reliance on them.

Table 3 shows selected financial ratios for the 1,025 bank holding companies filing form Y-9C as of June 30, 2010 over the five-year period 2005-2009. The 308 BHCs with a higher dependence on TruPS showed less favorable financial performance compared to those that had a smaller amount of TruPS and those that had no TruPS during that period. Delinquency ratios and net charge-offs were higher, and earnings were lower. Similar trends were noted at the insured banking subsidiaries of these holding companies, as is expected since the assets of most of

Table 3

Financial Performance Time Series by Dependence on TruPS					
Bank Holding Companies with Higher Dependence on TruPS					
Financial Ratios (%)	2005	2006	2007	2008	2009
Average Delinquency Ratio	1.25	1.28	2.20	3.83	6.02
Average Net-Charge off Ratio	0.21	0.21	0.36	0.93	1.85
Average Return on Assets	1.11	1.04	0.77	-0.26	-0.78

Bank Holding Companies with Some Amount of TruPS in Capital					
Financial Ratios (%)	2005	2006	2007	2008	2009
Average Delinquency Ratio	1.24	1.15	1.77	3.14	5.13
Average Net-Charge off Ratio	0.24	0.22	0.33	0.73	1.55
Average Return on Assets	1.23	1.21	0.98	0.27	-0.28

Bank Holding Companies with No TruPS included in Capital					
Financial Ratios (%)	2005	2006	2007	2008	2009
Average Delinquency Ratio	1.20	1.05	1.59	2.83	4.31
Average Net-Charge off Ratio	0.15	0.15	0.23	0.54	1.17
Average Return on Assets	1.23	1.20	1.12	0.55	0.10

Source: SNL, Y-9C Reports; Based on Y-9C filers reporting as of June 30, 2010.

High Dependence indicates TruPS exceeding 25% of tier 1 at any time during the period.

Some Amount indicates a positive amount of TruPS, less than 25% of tier 1, during that period.

No TruPS indicates no TruPS were included in tier 1 capital at all during that period.

These ratios are unweighted averages.

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these BHCs consist almost entirely of the assets of their subsidiary banks.

The BHCs that relied on TruPS were also much more likely to exhibit concentrations in construction and development (C&D) lending and to be involved in non-traditional mortgage lending. For example, roughly 70 percent of BHCs with high dependence on TruPS had C&D concentrations over 100 percent of risk-based capital at some point during the past 5 years, compared to over 50 percent of BHCs with some TruPS, and nearly 40 percent of BHCs with no TruPS. BHCs with TruPS also held 99 percent of the volume of closed-end loans with negative amortization features during that time period.

This suggests that BHCs' use of TruPS correlated to some degree with their appetite for risk. For a given level of tier 1 capital, having more TruPS and less equity acts to directly boost ROE. Institutions whose ROE focus was primarily short term, as opposed to a focus on the sustainability of earnings, may have been motivated both to accept the higher leverage implied by the use of TruPS, and to invest in riskier portfolios.

Certainly, all the indicators cited in Table 3 suggest that the portfolios of the "high TruPS" BHCs were riskier than the portfolios of other BHCs with TruPS, and riskier still than the portfolios of BHCs with no TruPS.

Obstacles to recapitalization. In the preamble to a 1991 proposed rule, the Federal Reserve wrote of the issues that could arise from reliance on cumulative preferred stock in a bank's capital. "A principal reason for the [Federal Reserve] Board's decision to limit the amount of perpetual preferred stock in bank holding

[company] Tier 1 capital is the fact that cumulative preferred, the type of perpetual preferred most prevalent in U.S. financial markets, normally involves preset dividends that cannot be cancelled, but only deferred. An institution that passes dividends on cumulative preferred stock must pay off any accumulated arrearages before it can resume payment of its common stock dividends. Thus, undue reliance on cumulative perpetual preferred stock and the related possibility of large dividend arrearages could complicate an organization's ability to raise new common equity in times of financial difficulty."¹⁵

In retrospect, these words foreshadowed issues that the banking agencies would have to confront during the current crisis. As noted earlier, deferring dividends on TruPS does not protect the accounting solvency of the organization and, when the interest payments on the related subordinated debt also are deferred, results in a build-up of a dividend arrearage that accumulates at the stated dividend rate. In a situation where a capital injection into an open bank is being contemplated, the trust preferred investors may not have incentive to accept a reduction in their claims.

The FDIC's experience has been that the holders of TruPS have been an impediment to recapitalizations or sales of troubled banks. Potential investors in an open but troubled bank may need some reduction in claims from the TruPS holders to make a transaction feasible. However, there have been a number of occasions where, even when the common shareholders are poised to vote in favor of a transaction or sale (even one that results in significant dilution of equity), the trust preferred holders

¹⁵ See *Notice of Proposed Revisions to Capital Adequacy Guidelines*, 12 CFR parts 208 and 225, 56 Fed. Reg. 56949 (November 7, 1991).

will not vote at all, or will not vote in favor of the transaction. One of the problems is that many trust preferred issues are in pools, which the holders say precludes voting on particular exchanges or discounts (e.g., BHC A offers to exchange its TruPS for common equity, or offers to redeem its TruPS at a specified discount). In some cases, the FDIC has found that downgraded TruPS are held by private equity investors who purchased the securities at a steep discount to par and may wish to hold out for a large “upside” in a transaction. In other cases, trustees of the TruPS will not vote for fear of litigation, or the percentage of TruPS holders needed to vote in favor may be very high.

Losses to holders of TruPS. As noted earlier, TruPS fulfilled a dual role for the banking system. Viewed as capital by the issuers, they carried tax deductible dividends and enhanced organizations’ opportunities to boost ROE with leverage. Viewed as debt instruments, and often as highly rated instruments at that, TruPS were permissible investments for banks and grew to occupy an important niche in the investment portfolios of many of them.

Over 300 FDIC-insured institutions reported investment in TruP CDOs in their September 30, 2010 Call Reports. Insured institutions typically invested in the mezzanine classes. When issued, the mezzanine bonds were rated investment grade. Today, they are typically rated Caa or worse because of the dramatic deterioration in the underlying collateral. Fitch-Ratings, which rates all the bonds in the TruP CDO universe, reported

that nearly 34 percent of the dollar volume of trust preferred collateral that underlies the CDOs had either defaulted or deferred dividend payments as of October 31, 2010.¹⁶

TruP CDOs are typically structured into senior, mezzanine, and income classes. Performance triggers, including overcollateralization tests and interest coverage tests, are common features in these structures. These triggers essentially act as a credit enhancement to the senior bonds. When the overcollateralization performance test fails, cash flows are redirected from the mezzanine bonds to the most senior bond outstanding. With many of the TruP CDOs, overcollateralization tests that govern the mezzanine bonds have failed. Consequently, many mezzanine bonds are now nonearning assets.

Recovery rates on defaulted collateral have been nonexistent during the banking crisis and cure rates on deferring collateral have been minimal, with seven examples identified where dividend payments have been resumed since the banking crisis began.¹⁷ The high volume of nonperforming collateral means many mezzanine bondholders are, or could become, dependent on the securitization structure’s excess spread, meaning the difference between the interest generated from the collateral and that owed on the various bond classes.

The banking industry has experienced significant write-downs of mezzanine bond holdings. Over the past two years, the failure of several federally insured depository institutions was due largely, or in part, to their investment in TruP CDOs.

¹⁶ “Fitch Bank TruPS CDO Default and Deferral Index,” November 2010, Structured Credit Special Report, FitchRatings. http://www.fitchratings.com/creditdesk/reports/report_frame?rpt_id=576606.

¹⁷ Information based on conversation with ratings agency analyst.

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The bottom line. It is difficult to disentangle the separate effects of higher imbedded financial leverage, a higher credit risk profile and increased difficulties with recapitalization that are associated with the issuance of TruPS. The experience with bank failures during the crisis, however, points to the role that relying on TruPS to meet a portion of their tier 1 capital requirements had in producing weaker banking organizations.

As indicated in Table 4, banking organizations issuing TruPS failed at much higher rates during the period January 1, 2008 through November 5, 2010 than did insured banks generally or insured banks in BHCs that did not issue TruPS. In the table, “No TruPS” refers to BHCs that did not report any TruPS, “some TruPS” refers to organizations with TruPS greater than zero and less than 25 percent of tier 1 capital, while “high TruPS” refers to organizations with TruPS exceeding 25 percent of tier 1 capital at the beginning of that time period (or 25 percent of equity in the case of small BHCs). More than 10 percent of the insured bank subsidiaries of the Y-9C filing BHCs with high TruPS issuance failed during this period, almost three times the failure rate of insured institutions generally.

Capital Reform

As became evident during the crisis, analysts and other market participants were ultimately looking to the tangible equity capital strength of banking organizations when assessing their capital adequacy. This is in part why U.S. bank regulators did not allow TruPS to be included in the bottom line tangible equity targets being established for the largest banks as part of the Supervisory Capital Assessment Program (SCAP) conducted in the spring of 2009.

The consensus of policymaking groups reflecting on the financial crisis has been that TruPS should no longer be deemed tier 1 capital for banking organizations. The Basel Committee on Banking Supervision (BCBS) published a comprehensive capital reform paper in December 2009, “Enhancing the Resilience of the Financial System.” That paper made a number of important proposals, many of which were ultimately agreed by the Committee and its parent organization, the Group of Central Bank Governors and Heads of Supervision. An important goal of these Basel 3 reforms was to strengthen the definition of regulatory capital by moving much closer to a “tangible common equity” approach. Part of this strengthening of the definition of capital included

Table 4

Cumulative Failure Rate, 1/1/2008 through 11/5/2010			
Institution Group	No TruPS	Some TruPS	High TruPS
Larger BHCs (Y-9C filers)	3.2%	5.3%	10.5%
Smaller BHCs	1.9%	6.2%	6.0%
All insured institutions	3.6%		

Source: Y-9C Reports, YPSP Reports, Bank Call Reports, FDIC failure list. Based on active insured depository institutions as of December 31, 2007.

phasing out, beginning in 2013, the tier 1 capital treatment of TruPS and similar hybrid capital instruments lacking the ability to absorb losses.

In the U.S., in July 2010, Congress enacted and the President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Act). The Act had a number of important purposes, one of which was to strengthen capital in the banking industry.

Section 171 of the Act (generally referred to as the Collins Amendment after Senator Susan Collins of Maine, its sponsor) contains a number of important provisions, including that the generally applicable insured bank capital requirements (and specifically including the capital elements that appear in the numerator of regulatory capital ratios) shall serve as a floor for the capital requirements applicable to depository institution holding companies.

This part of Section 171 can be viewed as affirming the concept that bank holding companies should be a source of strength for insured banks. Specifically, bank holding companies should not be a vehicle for achieving levels of financial leverage at the consolidated BHC level that are impermissible for subsidiary banks. As TruPS are impermissible as tier 1 capital elements for insured banks, under section 171 they would be (subject to specified exceptions) impermissible as tier 1 capital for BHCs.

Section 171 provides that the tier 1 capital treatment of TruPS issued before May 19, 2010, by depository institution holding companies with at least \$15 billion in total consolidated assets as of year-end 2009 will be phased-out during a three-year period starting January 1, 2013. TruPS of these organizations issued on or after May 19, 2010, would not be included in tier 1 capital.

Except as described in the next paragraph, BHCs with total consolidated assets less than \$15 billion as of year-end 2009, and organizations that were mutual holding companies on May 19, 2010, face the same prohibition on the inclusion of new TruPS in tier 1 capital as do the larger organizations. The key difference for these institutions is that their pre-existing TruPS (those issued before May 19, 2010) are grandfathered: that is, Section 171 does not require them to phase out these securities from their tier 1 capital.

Finally, organizations subject to the Federal Reserve's Small Bank Holding Company Policy Statement (which applies to most BHCs with assets less than \$500 million) are completely exempt from any requirement of Section 171.

It is anticipated that the requirements of Section 171 restricting BHCs' ability to use TruPS to satisfy tier 1 capital requirements would be implemented by Federal Reserve regulation at some future date.

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Conclusion

The life of TruPS as a tier 1 capital instrument for large U.S. BHCs dates from birth in a 1996 Federal Reserve press release to a Collins Amendment-mandated sunset at year-end 2015. Their 20 year lifespan was witness to the full dynamics of both economic and regulatory cycles.

Organizations took full advantage of the opportunity to issue subordinated debt as tier 1 capital, boosting ROEs with tax deductible dividends and increased financial leverage. Institutions that relied on TruPS for regulatory capital were financially weaker for it, took more risks, and failed more frequently than those that did not. As is often the case after a crisis, reforms were put in place to correct observed problems, and the elimination of TruPS from large BHCs' tier 1 capital agreed by the Basel Committee and required by the U.S. Congress is a case in point. Moving away from reliance on TruPS and towards real loss-absorbing capital will be manageable for most institutions, will challenge

some, but will in the end result in a stronger U.S. banking industry.

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Insights from the FDIC's Credit and Consumer Products/Services Survey

Introduction

The Federal Deposit Insurance Corporation (FDIC) and other regulators conduct numerous on-site examinations every year. The information gleaned from the examination process can assist in the prioritization of supervisory resources and the identification of issues for further attention. This article summarizes the initial results of a process the FDIC has implemented to enhance its ability to synthesize and analyze the complex and multi-dimensional information being generated by the examination process.

The FDIC implemented the *Credit and Consumer Products/Services Survey* (Survey) in October 2009 to supplement the collection of more traditional examination information and provide a means to marry this information with other data for horizontal analysis. The Survey replaced an FDIC underwriting survey introduced in 1995 and includes a series of questions to examiners to assess the level of risk and quality of underwriting practices associated with these credit products: construction and development (C&D), commercial real estate (CRE), commercial and industrial (C&I), 1-4 family residential mortgages, home equity, consumer, credit cards, agriculture, and reverse mortgages. The Survey also extends beyond underwriting practices and solicits information about new and evolving activities and products, local market conditions for CRE loans, funding practices, and consumer compliance issues.

The more comprehensive data collected in the new Survey will enable additional forward-looking analyses on a wider variety of areas. One of the underlying strengths of the new Survey is the ability to join Survey data together with other existing sources. These data sources include: financial (Call Report, Uniform Bank Performance Report (UBPR), etc.); economic (unemployment, real estate and commodities trends, etc.); consumer (credit score trends, housing loan demand, etc.); and examination data (ratings and adverse classification trends, etc.). These combined data sets will enable richer analysis of changing trends and products and how they might affect financial institutions and consumers.

The Survey is completed by examiners at FDIC-supervised banks of all types and sizes across the country; however, the vast majority result from examinations of smaller community banks. The broad base of topics covered by the Survey – combined with its emphasis on the examiner's evaluation of risks being taken on by the institution – make the information a good complement to surveys conducted by other bank regulatory agencies, such as the Federal Reserve Board's senior loan officer survey of larger domestic banks and U.S. branches of foreign banks and the Office of the Comptroller of the Currency's (OCC) annual underwriting survey of examiners on commercial and retail lending standards and credit risk at the largest national banks.¹

¹ The Federal Reserve Board contacts senior loan officers at up to 60 large domestic banks and 24 large U.S. branches of foreign banks as frequently as six times a year. This survey collects qualitative and quantitative information on credit availability and demand along with new developments and changes in lending practices. The OCC conducts an annual underwriting survey to assist in monitoring commercial and retail lending standards and credit risk at the largest national banks. In 2009, OCC examiners completed the survey on 59 banks with assets of at least \$3 billion.

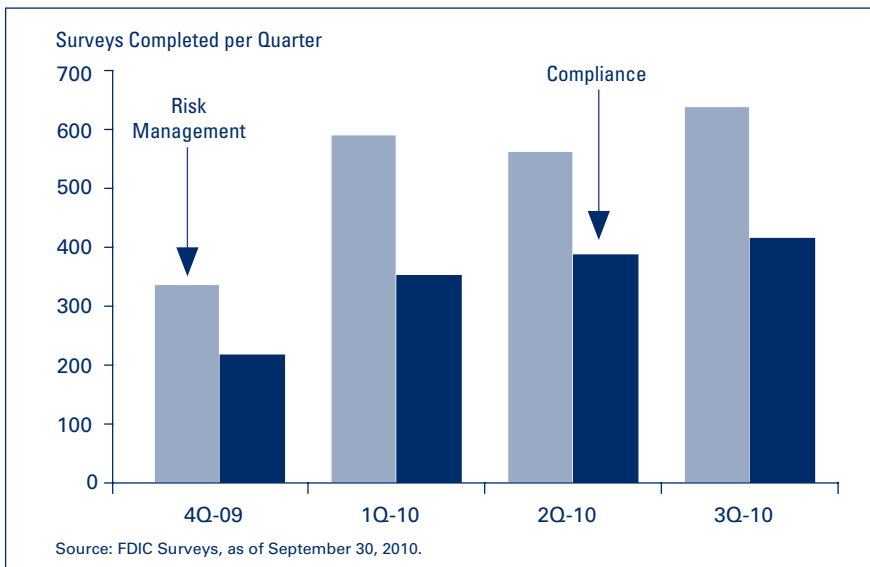
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Through September 30, 2010, more than 2,100 Surveys have been completed based on findings from risk management examinations and nearly 1,400 have been completed based on findings from consumer compliance examinations. (See Chart 1 for information on the number of Surveys completed by quarter.)

The FDIC plans to review and analyze Survey data on an ongoing basis and provide insights on how evolving economic conditions and resulting operational strategies are affecting the risk profiles of insured institutions. Based on analysis of recent survey results, this article summarizes areas of particular interest to regulators and bankers.

Chart 1: Approximately 3,500 Surveys Completed Since Program's Revision



General Underwriting and Credit Trends

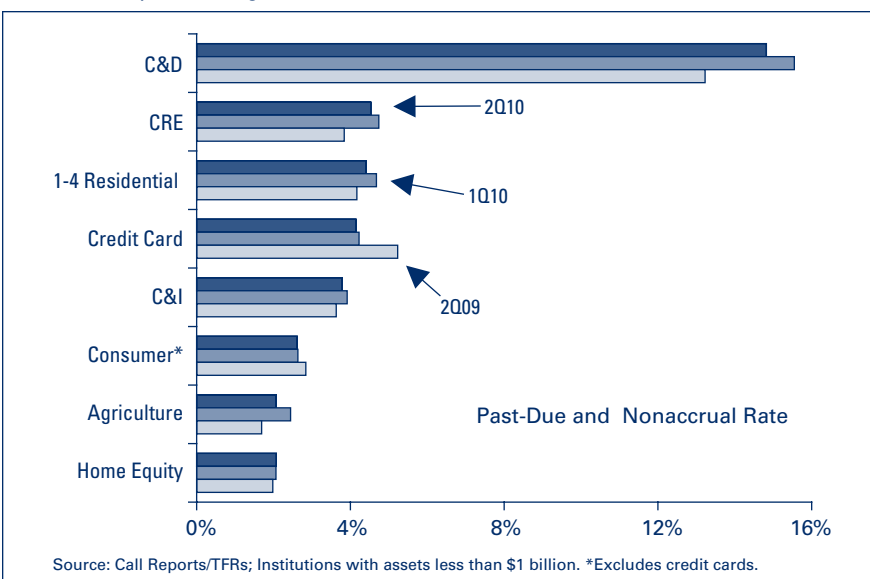
Overall, Survey responses tend to confirm portfolio performance metrics that appear in other published industry reports, such as the FDIC's *Quarterly Banking Profile*. As reflected in Chart 2, delinquency rates are highest in C&D loans while Chart 3 shows that Survey respondents are reporting credit risk at the highest level in C&D portfolios. The level of credit risk associated with non-C&D commercial real estate and C&I lending also is considered high at many institutions.

Not surprisingly, Survey results indicate that certain weak underwriting practices have contributed to elevated levels of credit risk; these practices include:

- funding C&D projects on a speculative basis;
- funding loans without consideration of the borrower's repayment ability via global cash flows;
- failing to verify the quality of alternative repayment sources; and
- using appraisal values that appear unrealistic when current economic conditions or trends in real estate prices are weakening.

Survey data suggest that many institutions with concentrations in CRE loans would benefit from stronger portfolio management. Specifically, 45

Chart 2: Delinquencies Highest in C&D and CRE Portfolios



percent of the Surveys for institutions with CRE concentrations (focused primarily on a subset of institutions with CRE loans exceeding 300 percent of total capital) indicate management of that portfolio segment is less than satisfactory. Further, compliance with interagency CRE guidance is considered poor or weak at 39 percent of the institutions in this subset. Appropriately, institutions exhibiting material weaknesses in this group have been assigned a composite “3,” “4,” or “5” under the Uniform Financial Institutions Rating System (UFIRS).²

Although portfolios with weak underwriting and poor loan administration were first affected by the downturn in the economy and the nation’s real estate markets, stressed market conditions now are pressuring even prudently underwritten loans. For example, approximately 90 percent of the Surveys for banks with CRE loan concentrations describe local real estate conditions as “sluggish,” “very weak,” or “distressed.” These same Surveys also tend to suggest that a strong turnaround in market conditions in the near term is unlikely as approximately 80 percent report deteriorating property values. In addition, more than 90 percent describe the inventory of unsold CRE property in their markets as “excess supply” or “saturated.”

As detailed in Chart 4, Survey results to date indicate most insured institutions have reacted to adverse market conditions by tightening underwriting standards. Specifically, tighter standards are being applied in the areas of maximum size of credit lines, maximum maturity of loans or credit lines, spreads of loan rates over banks’ cost of funds, loan covenants, and collateral requirements.

Chart 3: C&D, CRE and C&I Considered the Riskiest Loan Portfolios among Most Respondents

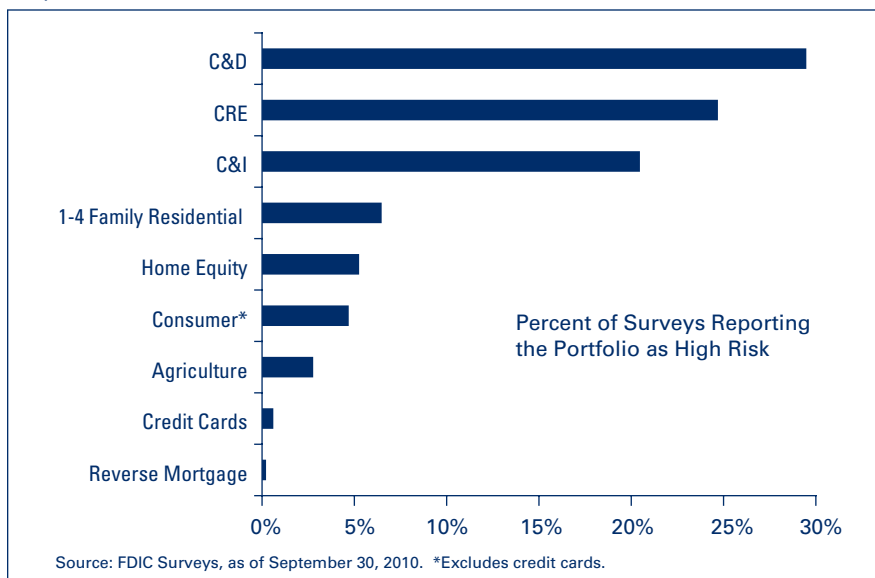
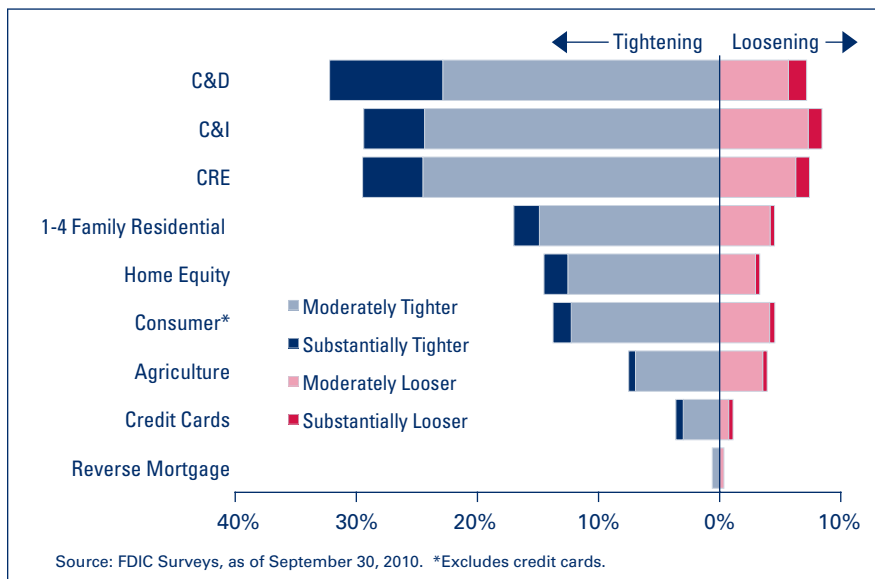


Chart 4: Most Portfolios Seeing Tightened Underwriting Standards



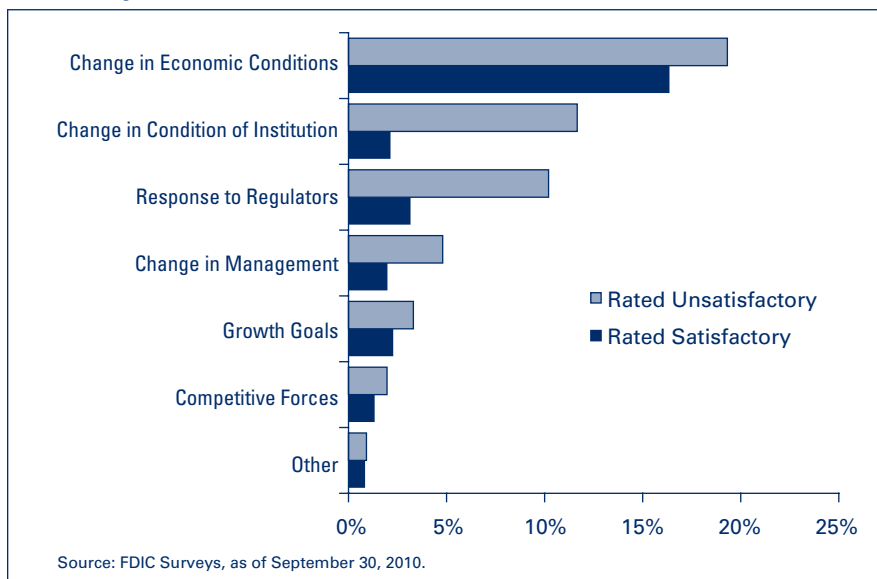
² Under the UFIRS, each institution is assigned a composite CAMELS rating based on an evaluation and rating of these component factors: adequacy of Capital, quality of Assets, capability of Management, quality and level of Earnings, adequacy of Liquidity, and Sensitivity to market risk.

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As reflected in Chart 5, Survey data indicate that underwriting practices were modified most frequently in response to changing economic conditions. Appropriately, institutions exhibiting material weaknesses and identified as a composite “3,” “4,” or “5” under the UFIRS also tended to tighten standards as a means of strengthening their financial condition.

Chart 5: Changes in Economy the Most Often Cited Factor Influencing Changes in Underwriting



Even with this shift toward more conservative underwriting practices, banks are attempting to find an appropriate balance when working with existing customers who may be under stress. For example, the Survey results note significant renewal activity regarding commercial, CRE, and C&D loans and, in some cases, these renewals were made without the bank obtaining a material principal reduction. Although the lack of principal reduction is not generally a desired practice on a widespread basis, such actions can be in the borrower’s and lender’s best interest when appropri-

ately reported and designed to maximize recovery of problem credits. In this regard, Survey results indicate the loan workout processes at many of these institutions were determined acceptable overall suggesting that, for the most part, institutions are trying to prudently work out troubled credits.

At this point, examiners view current underwriting practices for most institutions as “generally conservative” to “about average” for all credit types. Direction of any future changes will vary by institution, with much depending on economic conditions in the institution’s markets along with its overall financial condition.

Out-of-Territory Lending

The Survey results also have provided insights into other lending activities, such as out-of-territory lending. Although out-of-territory lending can potentially diversify an institution’s portfolio and reduce concentration risk, the Survey data indicate that some banks increased their overall risk profiles because of the loan types booked through this type of lending. Twenty-seven percent of all risk management examination Surveys report frequent or common out-of-territory lending in commercial, residential, or consumer portfolios. The overwhelming majority (89 percent) of out-of-territory lending activity was reported in commercial/CRE (includes construction and development) portfolios with considerably less activity identified in residential and consumer portfolios.

Institutions captured in the Survey that exhibit frequent or common out-of-territory lending activity tended to have higher levels of credit risk and looser overall underwriting standards, particularly in C&D portfolios.

Chart 6 shows that during the recent crisis, these banks tended to reflect weaker earnings performance. At the same time, past-due loan rates reported by institutions identified as having elevated out-of-territory lending activity have risen more steeply since 2008 (see Chart 7), and almost two-thirds of these institutions are rated “Unsatisfactory.”³ Further, Material Loss Reviews indicate that out-of-territory lending has played a role in several bank failures during this economic cycle.⁴

Before engaging in out-of-territory lending, institutions should ensure the infrastructure is in place to monitor and administer these loans. The infrastructure should include an assessment of how stress conditions may affect this portfolio segment. Further guidance is available as part of the Loan Participation section of the *Risk Management Manual of Examination Policies*.⁵

Trends Likely to Affect Compliance Programs

As institutions seek new and diversified sources of income and ways to reduce operating costs, management must consider how any operational changes or introduction of new products may affect consumers. A review of recent Survey results identifies the following trends with implications for an institution’s consumer compliance program.

Chart 6: Surveys with Elevated Out-of-Territory Lending Report Weaker Earnings

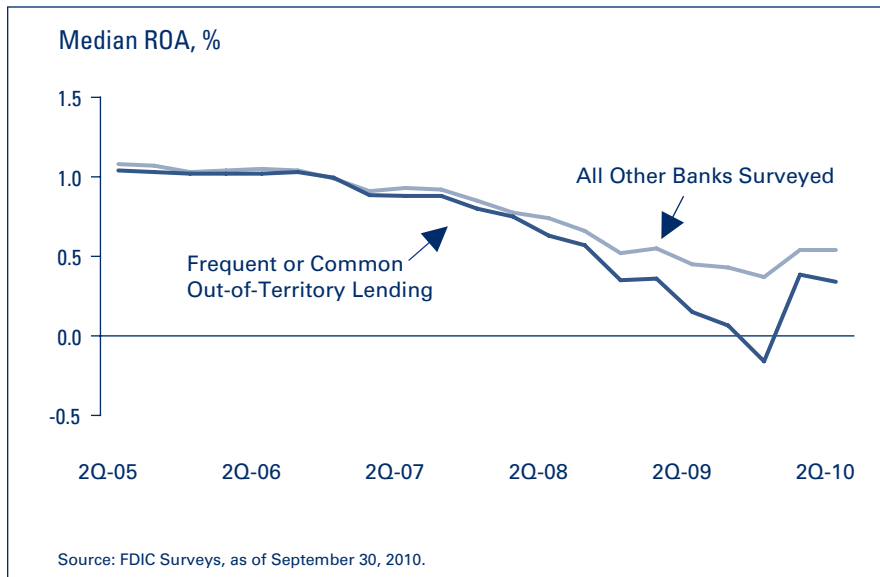
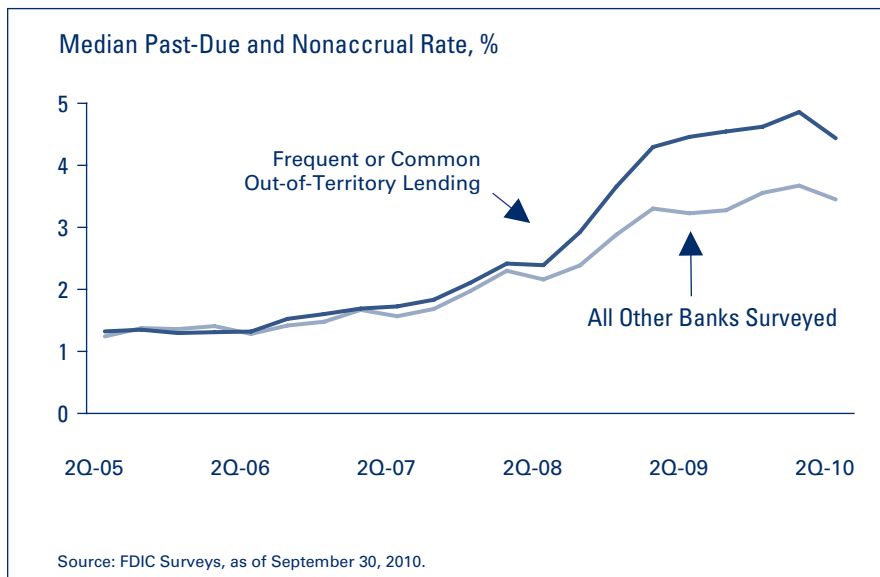


Chart 7: Surveys with Elevated Out-of-Territory Lending See Sharper Rise in Delinquencies



³ An Unsatisfactory rating is defined as having a CAMELS composite rating of “3,” “4,” or “5.”

⁴ In accordance with Section 38(k) of the Federal Deposit Insurance Act, if failure of an insured institution causes the Deposit Insurance Fund to incur a material loss, the Inspector General of the appropriate federal banking agency must review the agency’s supervision of the institution and make a written report (referred to as a Material Loss Review) to the agency.

⁵ FDIC Division of Supervision and Consumer Protection’s *Risk Management Manual of Examination Policies* <http://www.fdic.gov/regulations/safety/manual/section9-1.html#part5>.

Credit and Consumer Products/ Services Survey

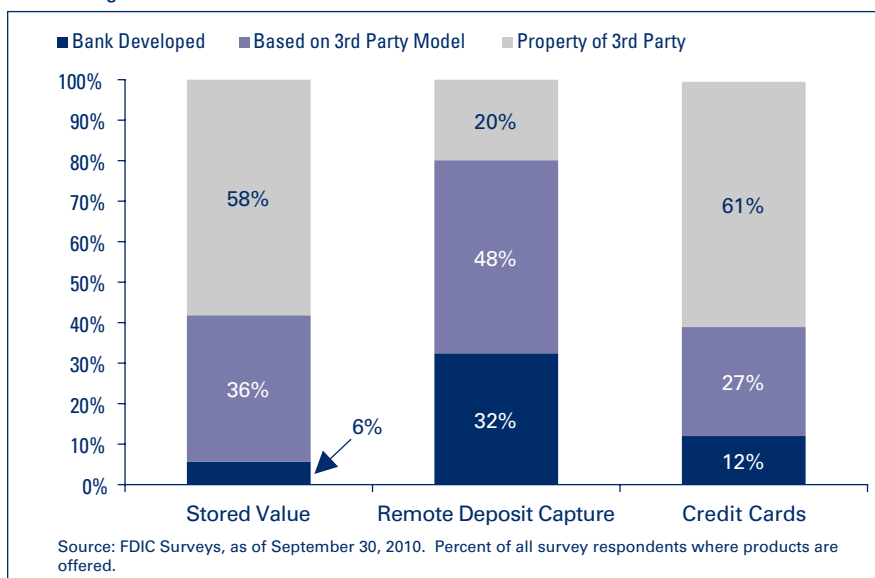
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Third-Party Risk

Compliance-related Survey data show a relatively high use of third parties to deliver consumer products and services. For example, the Survey shows that 40 percent of institutions offer credit cards, of which more than half (61 percent) are the asset of a third party, and another 27 percent are based on third-party models or programs (see Chart 8). Third parties also are prevalent in the delivery of stored value cards; 19 percent of institutions surveyed offer these products, of which 94 percent involve a third party. Remote deposit capture frequently involves third parties; in fact, 68 percent of institutions that offer this service report the use of a third party.

The use of third parties can provide a cost-effective way for institutions to offer a variety of products and services. However, these relationships must be managed to ensure consumers are protected from practices that may be deemed unfair or deceptive. Recent public enforcement cases involving Unfair or Deceptive Acts and Practices (UDAP) concern institutions' failure to properly manage third-party risk which can create significant financial liabilities and increase reputation risk. In 2008, the FDIC published guidance containing principles that institutions should consider when managing significant third-party risk exposure. The guidance encourages institutions to implement controls that consider such factors as the complexity, magnitude, and nature of the third-party arrangements.⁶

Chart 8: High Use of Third Parties in Consumer Products



Reverse Mortgages

An increasing number of institutions are considering entering the reverse mortgage market, becoming involved as a direct lender or through participation in some stage of the lending process, such as referring applications to specialized lenders. Currently, the market is dominated by the Home Equity Conversion Mortgage (HECM) program – a federal government loan program operated by the U.S. Department of Housing and Urban Development (HUD). Some lenders also offer “proprietary” reverse mortgage programs which have different requirements and cost structures.

The recent downturn in the housing market has impacted the reverse

⁶ “Guidance for Managing Third-Party Risk,” FIL-44-2008, June 6, 2008. <http://www.fdic.gov/news/news/financial/2008/fil08044.html>.

mortgage market, primarily due to declining property values. As of August 31, 2010, HECM activity is down approximately 30 percent from a year ago.⁷ However, as housing markets begin to stabilize, reverse mortgage lending may rebound. For smaller institutions, entry into this market could involve relationships with third parties, particularly reverse mortgage lending specialists operating on a regional or national level. Anecdotal comments from Survey respondents suggest many institutions are investigating relationships with third parties as a means of offering these products to their customers.

Regardless of how an institution is involved in this type of lending, a range of consumer protection and regulatory compliance issues must be managed; these include, among others, the cross-selling of other financial products, equity-sharing agreements, and aggressive marketing. In addition, compliance with consumer regulations, such as Truth-in-Lending, fair lending, etc., must be ensured.⁸ The Federal Financial Institutions Examination Council (FFIEC) recently released guidance to help institutions identify and manage these risks.⁹

Remote Deposit Capture Services

In addition to lending activities, the Survey results show that other non-credit products and services are evolving. As of September 30, 2010, approximately 38 percent of compliance-related Surveys indicate that institutions offer remote deposit capture (RDC) services. Anecdotally, many smaller institutions have begun to offer this service only for business customers. Many cost-effective RDC technologies, including smart phone applications, are now in the marketplace and poised to gain ground in the consumer market. Institutions' compliance management systems will need to manage risks relating to Check 21 (Regulation CC) compliance, UDAP (clear fee and program disclosures) as well as risk management, information technology, and Anti-Money Laundering/fraud. Due to expected growth in this product line, the FFIEC issued RDC guidance in January 2009 to outline appropriate risk management processes to measure and monitor risks with this service, including oversight of third parties.¹⁰

⁷ U.S. Department of Housing and Urban Development, "HECM Endorsement Summary Reports," September 1, 2010. <http://www.hud.gov/pub/chums/f17fvc/hecm.cfm>.

⁸ David P. Lafleur, "Reverse Mortgages: What Consumers and Lenders Should Know," *Supervisory Insights*, Winter 2008, p. 14. http://www.fdic.gov/regulations/examinations/supervisory/insights/siwin08/si_win08.pdf.

⁹ Federal Financial Institutions Examination Council, "Reverse Mortgage Products: Guidance for Managing Compliance and Reputation Risks," August 16, 2010. <http://www.ffiec.gov/press/pr081610.htm>.

¹⁰ "Risk Management of Remote Deposit Capture," FIL-4-2009, January 14, 2009. <http://www.fdic.gov/news/news/financial/2009/fil09004.html>.

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Conclusion

Overall, Survey results show that banks are responding to ongoing economic and competitive challenges in a variety of ways, for example, by tightening underwriting standards and making use of third-party service providers to offer new and innovative products. These operational changes can affect an individual institution's risk profile and its ability to effectively manage the resulting consumer compliance risks. The analysis of data gathered through this Survey will continue to help the FDIC understand how effectively bank safety-and-soundness and compliance risk management systems are keeping pace with these changes.

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Senior Life Settlements: A Cautionary Tale

In recent years, Wall Street firms, brokers and financial advisors have stepped up efforts to interest consumers and investors in a unique market segment - Senior Life Settlements (SLS), which when packaged into securities are sometimes known as “death bonds.” As outlined in this article, while these products may offer brokers and other middlemen the opportunity for high commissions, they carry significant risks to consumers and investors. Bankers should be aware of the substantial risks associated with any involvement with these products, and that absent specific authorization from their primary federal regulator any investment in them would be impermissible.

An SLS is a transaction in which an individual, generally between 65 and 79 years of age (Senior), sells his or her life insurance policy to a third-party investor, usually through a broker, for an amount less than the policy’s face value, but greater than the net cash surrender value. The investor becomes responsible for paying the future premiums and, upon the death of the Senior, receives the policy’s death benefits.

An SLS may appeal to a consumer who can no longer afford the premiums or is strapped for cash. For an investor, the potential profit depends on the purchase price and the amount of future premiums paid to keep the policy in force. If the death benefit exceeds the sum of the purchase price plus the aggregate future premiums and any other fees (all appropriately adjusted for the time value of money), the investor will profit; if not, the investor will suffer a loss. Essentially,

the investor is betting on mortality by taking a financial interest in another person’s demise. As morbid as this may sound, life settlements are a growing market and have garnered considerable interest on Wall Street.

This article provides an overview of the development of the SLS market and discusses the risks associated with these transactions to financial institutions, investors, and consumers, including the potential for fraud. In addition, a case study highlights an example where an FDIC insured institution’s involvement in SLS transactions contributed to its failure.

Development of the SLS Market

In 1911, the United States Supreme Court case of *Grigsby v. Russell*¹ established that it was a policy owner’s right to transfer an insurance policy, thus opening the door to life settlements. Transfers of insurance policies grew significantly during the 1980s, when AIDS patients and other terminally ill policyholders sold their life insurance policies to obtain cash to offset mounting medical bills and improve the quality of life in their final days. These transactions were known as viatical settlements, from the Latin word *viaticum* or “provisions for a journey.” However, over time, viaticals became less profitable due to medical advances that extended the life expectancy of AIDS patients. In addition, allegations of fraud relating to the sale and marketing of these products were widespread. Life settlement providers then turned to a new group of policyholders – Seniors.

¹ *Grigsby v. Russell*, 222 U.S. 149 at 156 (1911).

Senior Life Settlements

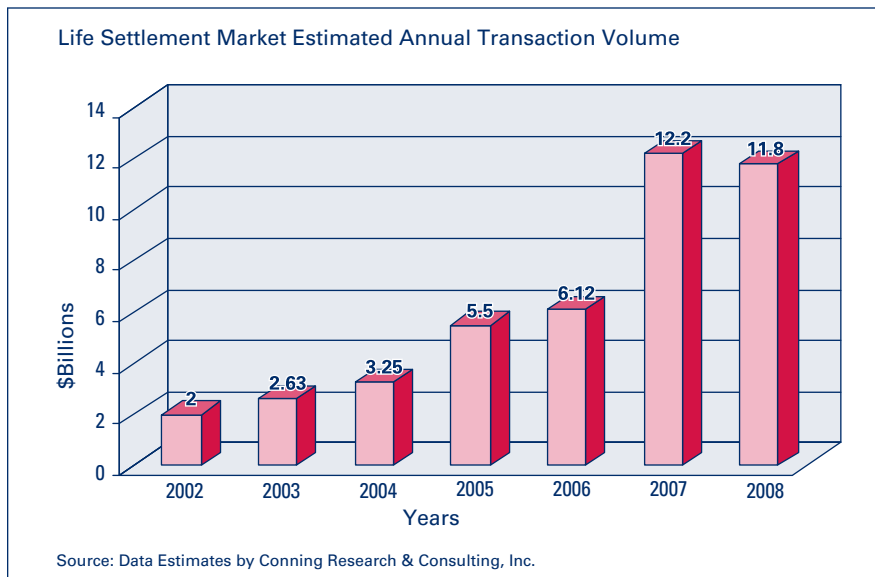
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As shown in Chart 1, the estimated annual volume of life settlement transactions (policies changing hands) in the United States rose from \$2 billion in 2002 to almost \$12 billion in 2008, bringing the total outstanding to \$31 billion at the end of that year.² The rate of growth leveled in 2007, as the recession constrained cash available to fund policy purchases. Also, the major life expectancy underwriters revised their methodologies and assumptions, which resulted in longer life expectancies, casting doubt on

the valuation of existing portfolios and further reducing investor interest. However, life settlement providers and trade groups predict a return of capital to the SLS market in 2010, although investment banks may be playing a smaller role.³ According to a *National Underwriter* article, more regulatory scrutiny, heightened consumer awareness, and a return of buyers to the market are likely developments for the settlement business in 2010.⁴

As an investment tool, securitized SLS are touted as offering an attractive investment feature: they are *uncorrelated assets*, meaning their performance is not directly tied to typical market influences. After all, death rates do not rise or fall based on the stock market. By purchasing a securitized pool, the argument goes, an investor can spread the risk over a large and diversified group of SLS contracts. However, critics question their investment viability due to the financial risks, lack of transparency, and limited number of successful transactions. Also, some industry observers believe significant growth in the securitization market can only be achieved with a favorable rating from a credit rating agency. However, rating life settlement securitizations presents many challenges, and in fact very few have been rated.⁵

Chart 1: Annual Volume of Life Settlement Transactions Grew Rapidly from 2002 to 2007 / Declined Slightly in 2008



² Data obtained from Conning Research & Consulting, an independent insurance industry analysis firm in Hartford, Connecticut.

³ In January 2010, Goldman Sachs shut down its life settlements provider (Longmore Capital) approximately one month after discontinuing its tradable mortality index (QxX). Credit Suisse downsized its Life Finance Group in February 2010.

⁴ "Feature: Experts See A Happy Year for Settlements," by Trevor Thomas, published on the *National Underwriter* Web site only on January 11, 2010. *National Underwriter* is available at <http://www.lifeandhealthinsurancenews.com/Exclusives/2010/1/Pages/Feature-Experts-see-a-happy-year-for-settlements.aspx?k=Life+Settlements>. The Aite Group, LLC, Boston, MA, also has forecast a rebound in the life settlement business as noted by Trevor Thomas in a January 29, 2010 *National Underwriter* item available at <http://www.lifeandhealthinsurancenews.com/News/2010/1/Pages/Aite-Group-Life-Settlement-Business-Will-Rebound.aspx?k=Life+Settlements>.

⁵ News and industry reports show that only one life settlement securitization has been rated in recent years. In early 2009, American International Group (AIG) securitized a pool of life settlement policies with a face value of approximately \$8.4 billion; this was an internal transaction between two units of AIG. A.M. Best Company, a credit rating organization serving the financial services industries, rated the securitization but did not publicly release the rating as this was a private transaction.

In February 2010, the American Council of Life Insurers issued a policy statement recommending that the securitization of life settlements be banned, largely because securitizations could heighten fraudulent activity associated with Stranger Originated Life Insurance (STOLI). STOLI is the initiation of a life insurance policy for the benefit of a person who, at the time of the policy's creation, has no insurable interest.

Although SLS transactions present a number of legal issues, insurable interest is paramount. In its simplest terms, an insurable interest means that anyone who takes out a policy must have an interest in the insured person staying alive (rather than hoping to cash in on the insured's death). The principle of insurable interest is a matter of state law. A high-profile case in New York federal court frames the question as follows: Does state law prohibit an insured from procuring a policy on his own life and immediately transferring the policy to a person *without* an insurable interest, if the insured never intended to provide insurance for a person *with* an insurable interest? On November 17, 2010, in a 5-2 decision, the court ruled that nothing in state law prevented such a practice at the time the policies were sold.⁶ It is important to note that this decision applies only in New York and, effective May 18, 2010, New York changed its insurance laws regulating permissible life settlement contracts to prohibit STOLI. The new laws also prohibit, with certain exceptions, anyone from entering into a

life settlement contract for two years after the issuance of a policy. As a result, the application of the *Kramer* decision is limited to policies in existence before May 18, 2010.

Regulation of the SLS Market

SLS are complex financial transactions that involve both insurance and securities elements, and most states have enacted regulations governing these products through their insurance or securities regulatory entities. The National Association of Insurance Commissioners developed a model uniform law that has been adopted in one form or another by at least 44 states.⁷ The law addresses licensing requirements, requires annual reporting, sets standards for a reasonable return to the person selling an insurance policy, and prohibits certain practices such as paying finders fees to an insured's physician. However, although it provides sample informational brochures for consumers and investors, the model regulation does not prescribe their use. The Life Insurance Settlement Association (LISA) provides an overview of state laws on its Web site at www.thevoiceoftheindustry.com.

Some SLS transactions fall under the purview of federal securities laws enforced by the U.S. Securities and Exchange Commission (SEC). If the life insurance policy being sold is a security (typically, a variable life insurance policy) or if the policy will be securitized, the SEC has jurisdiction. In July 2009, the Financial Industry Regulatory Authority,

⁶ *Kramer v. Lockwood Pension Services, Inc., et al.*, 653 F.Supp2d 354, S.D.N.Y. September 1, 2009. (Question certified to the New York Court of Appeals by the U. S. Court of Appeals for the Second Circuit, January 21, 2010.) The New York Court of Appeals heard oral arguments in the case on October 12, 2010.

⁷ *Viatical Settlements Model Act and Viatical Settlements Model Regulation*. Copies of the model laws are available from National Association of Insurance Commissioners: http://www.naic.org/store_pub_legal.htm#model_laws. A copy of the Viatical Settlements Model Regulation is available on the LISA Web site.

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Inc. (FINRA)⁸ published Regulatory Notice 09-42 reminding investment firms that variable life settlements are securities transactions subject to federal securities laws and all applicable FINRA rules.⁹ However, whether *other* SLS transactions fall under federal securities laws is unclear, and the courts have not reached a uniform answer.

Growth in the life settlement market and the potential dangers posed to consumers has resulted in additional regulatory and legislative scrutiny. In 2009, the life settlement market was the subject of congressional hearings and an investigation by the U.S. Senate Special Committee on Aging.¹⁰ In addition, a Life Settlement Task Force was established by the SEC in September 2009 to understand the range of issues presented by the life settlements market and to partner with other regulators to ensure the existence of adequate regulatory oversight and identify potential regulatory gaps.¹¹

Risks to Investors

SLS transactions, when considered purely as investments, present a number of financial risks that must be understood by investors and consumers considering selling their policies (see Table 1).

Special Risks to Financial Institutions

A number of financial institutions report receiving loan applications from investors wanting to finance SLS transactions. Bankers also have reported a few instances where they have been approached with proposals to either hold SLS directly as securities or as part of a “troubled loans for securitized SLS swap” transaction. Investments in SLS are speculative and have not been approved as permissible by either the Federal Deposit Insurance Corporation or the Office of the Comptroller of the Currency. Any bank considering such an investment must apply for permission prior to doing so¹² and should expect significant questions about whether the risks could be sufficiently mitigated to warrant granting such permission.

⁸ The FINRA, formed in 2007 as successor to the National Association of Securities Dealers, is the largest independent regulator for securities firms doing business in the United States.

⁹ The FINRA’s Regulatory Notice 09-42 is available at www.finra.org/Industry/Regulation/Notices/2009/P119547.

¹⁰ In April 2009, the U.S. Senate Special Committee on Aging held a hearing entitled, “Bet on Death in the Life Settlement Market – What’s at Stake for Seniors?” Details of this hearing can be found at www.aging.senate.gov/hearing_detail.cfm?id=312228&, and details of the related Committee investigation are available at www.aging.senate.gov/letters/lifeselementfindings.pdf. In September 2009, the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held a hearing entitled, “Recent Innovations in Securitization.” Details of this hearing are available at www.house.gov/apps/list/hearing/financialsvcs_dem/cmhr_092409.shtml.

¹¹ The Life Settlement Task Force is discussed in SEC Chairman Mary L. Schapiro’s address before the Solutions Forum on Fraud, October 22, 2009, at <http://www.sec.gov/news/speech/2009/spch102209mls.htm>.

¹² See Section 24 of the Federal Deposit Insurance Act; 12 C.F.R. Part 362 (Activities of Insured State Banks and Insured Savings Associations); 12 C.F.R. Part 1 (Investment Securities).

Table 1

Risks to Investors in SLS Transactions

Longevity Risk – The risk that the insured’s actual life span exceeds the projected life span. Longevity risk is affected by medical advances in the treatment of serious illnesses. The longer the life of the insured individual, the lower the investor’s return.

Legal Risk – SLS transactions often involve complex legal structures and incorporate numerous documents that impact the legal validity of the underlying assets and appropriate conveyance of the death benefit to an investor. These structures also may require appropriate perfection of security interests in several state jurisdictions.

Contestability Risk – The risk associated with the issuing insurance company’s right to rescind a policy within the two-year contestability period.

Rescission Risk – This risk relates to the doctrine of insurable interest. An insurance company may rescind a policy when it suspects a lack of insurable interest.

Funding Risk – The risk that the investor may have insufficient funding capacity to pay future premiums and other holding costs.

Liquidity Risk – The lack of transparency in the SLS market creates difficulty in determining the fair value of a life settlement asset. The uncertainty in the market may hamper the ability of an investor to dispose of the investment at a reasonable price, if needed.

Litigation Risk – The risk that the insured’s family members (heirs) or previous beneficiaries will file legal action and the potential financial impact to the investor.

Regulatory Risk – The risk that new limitations or restrictions will be placed on SLS transactions, negatively impacting their value or marketability.

A financial institution that acts as an investment advisor, whether through a networking arrangement, trust department or as a registered advisor,¹³ and recommends a SLS or any other financial product that performs below customer expectation or has an undisclosed risk could create customer dissatisfaction or harm and potentially damage the reputation of the institution. In our judgment, the reputational risks associated with this product are unquantifiable but severe. Bankers should also be cognizant of third-party

risk, which stems from a broker or settlement provider engaging in inappropriate sales practices, and compliance risk associated with consumer protection regulations, such as Privacy of Consumer Financial Information¹⁴ and The Health Insurance Portability and Accountability Act of 1996 (HIPAA) Privacy and Security Rules.¹⁵

The case study *Bank Financing of SLS Investments* that concludes this article demonstrates the gravity of risks faced by institutions that become involved in SLS transactions.

¹³ See Final Regulation R: Exceptions and Exemptions for Banks from the Definition of “Broker” (FIL-92-2007, Oct. 25, 2007), <http://www.fdic.gov/news/news/financial/2007/fil07092.html> and Securities Activities of Banks: Exceptions and Exemptions for Banks from the Definition of “Broker” (FIL-89-2008, Sept. 10, 2008), <http://www.fdic.gov/news/news/financial/2008/fil08089.html>

¹⁴ 12 C.F.R. Part 332.

¹⁵ See U.S. Department of Health and Human Services Summary of the HIPAA Privacy Rule: <http://www.hhs.gov/ocr/privacy/hipaa/understanding/summary/index.html>; see also FDIC Compliance Manual, VIII-6.8 – 6.11 (Fair Credit Reporting Act Examination Procedures, Section 604(g) Protection of Medical Information).

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Risks to Consumers

Financial institutions should be alert to the aggressive marketing tactics of some life settlement providers and brokers. As more life settlement providers enter the market, competition to find policyholders increases. As incentive, commissions paid in connection with life settlements can be quite high (up to 30 percent of the purchase price). This incentive has prompted some life settlement providers to aggressively encourage financial service providers to canvass their books of business for Seniors or other eligible customers who may be interested in selling their life insurance policies in the secondary market, regardless of whether they need to sell or have previously considered surrendering or allowing the policy to lapse. Accordingly, in its August 2006 Notice to Members,¹⁶ the National Association of Securities Dealers (NASD) noted its concern that aggressive marketing tactics, fueled by high commissions, may lead to inappropriate sales practices in connection with these transactions.

Against this backdrop, financial advisors should encourage consumers to carefully consider their ongoing life insurance needs before entering into SLS transactions, as their policy remains in force and may affect their ability to obtain additional life insurance. The FINRA has issued an investor alert¹⁷ that identifies questions a

consumer should ask when deciding to sell a life insurance policy, including:

- ***Is the life settlement broker or provider licensed?*** A growing number of states require that life settlement companies and brokers be licensed.¹⁸
- ***Is there pressure to make a quick decision?*** A legitimate investment professional will provide clear answers and allow ample time to make an informed decision.
- ***What are the transaction costs? What is a fair and competitive sales price?*** There is no transparent secondary market for life insurance policies, so it is difficult to determine if a fair price is being offered. Consumers should ensure bids are obtained from several SLS providers.
- ***How will personal information be protected?*** When a life insurance policy is sold, the insured is required to authorize the release of medical and other personal information. The consumer should ensure procedures are in place to protect the confidentiality of the data.
- ***What is the impact on your survivors?*** Carefully consider the need for current income against the financial needs of survivors now and in the future. Legitimate life settlement brokers/providers will require the beneficiary to acknowledge and consent to the transaction.¹⁹

¹⁶ The NASD August 2006 Notice to Members is available at www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p017131.pdf.

¹⁷ The FINRA investor alert is available at www.finra.org/Investors/ProtectYourself/InvestorAlerts/AnnuitiesAndInsurance/P018469.

¹⁸ The National Association of Insurance Commissioners Web site at http://www.naic.org/state_web_map.htm contains information for consumers and investors by state, including licensing information.

¹⁹ As a general rule, in the absence of a court order (usually arising out of a divorce proceeding), there is no legal right to be named as a beneficiary in a life insurance policy or trust. Some State laws allow former beneficiaries or heirs to challenge the validity of the sale of a policy following an insured's death, based on a variety of factors including lack of insurable interest, mental capacity of the insured, and applicable periods of contestability.

■ *What are the tax consequences?*

Before entering into a life settlement, a tax professional should be consulted.

Finally, given the risks involved, consumers should seek legal advice before signing any agreements to ensure a SLS transaction is in their best interest.

The Potential for Fraud in SLS Transactions

The North American Securities Administrators Association (NASAA), which represents state securities regulators, previously listed life settlements among the top 10 investor traps.²⁰ The NASAA specifically identifies Ponzi schemes, fraudulent life expectancy evaluations, inadequate premium reserves that increase investor costs, and false promises of large profits with minimal risk. Other types of fraud identified in the SLS industry are *clean-sheeting* (applying for a life insurance policy without disclosing a life-threatening illness) and *dirty-sheeting* (when a healthy person provides false medical information indicating he or she has a life threatening illness). In addition, in the case of *wet-ink policies* (new life insurance policies sold immediately after being issued – before the ink is dry), the applicant commits fraud on the application by claiming he or she needs life insurance for estate planning purposes. One type of wet ink policy is STOLI.²¹ STOLI has many variations but only one purpose: to allow an investor without an insurable interest to initiate and profit from a life insurance policy on a stranger. The mainstream insurance industry

strongly opposes STOLI, arguing it is fraud for a person to buy a policy with only a *profit* - and not *insurance* - motive. STOLI is prohibited or statutorily restricted in many states.

The Case Study discussed below demonstrates the negative impact that the legal and other risks discussed above can have on a financial institution.

Bank Financing of SLS Investments - A Case Study

This case study is based on actual events and involves a failed bank that granted loans secured by SLS contracts.²² Although SLS were not the sole cause of the institution's failure, this case study underscores the significant risks associated with these investments.

Big Venture Bank (Bank) was a \$100 million rural community bank. Bank officers and directors expanded the institution's business strategy to include a venture capital component. Management converted its parent company to a financial holding company and established several subsidiaries to engage in venture capital financing activities.

One target investment was a local manufacturing company, Big Mountain Manufacturing (Big Mountain). Big Mountain appeared to have a good product; however, it did not have funds to commence production, and the Bank previously had granted a loan to the company in an amount close to its legal lending limit. As concern mounted over Big Mountain's economic survival and the repayment

²⁰ NASAA's top 10 investor traps for 2009 are discussed on its Web site at http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/11129.cfm.

²¹ Also known as Speculator-Initiated Life Insurance (SPINLIFE).

²² All names in this case study have been changed.

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of its significant debt to the Bank, Bank management began searching for funding alternatives. They chose *Senior Life Settlements*.

The Bank's plan was two-fold. As a short-term solution, the Bank would extend a credit facility (aggregating 125 percent of the Bank's capital) secured by SLS contracts to five of Big Mountain's directors at \$3 million each. Twenty percent of the loan proceeds (aggregating \$3 million) were provided to the borrower group to inject into Big Mountain. As a long-term solution, Bank management, with the aid of Wall Street investment advisors, would underwrite and issue a \$600 million SLS securitization transaction (consisting of 500 policies with an aggregated death benefit of \$1.6 billion, including the underlying policies associated with the Bank's SLS loans). Once the deal closed, \$15 million of the sales proceeds from the securitization (part of the securitization's venture capital component) would be provided to Big Mountain for operating capital and debt restructure, including the Bank's direct loan. The plan was designed to make the Bank whole on its loans, recognize large fee income from the securitization process, and sufficiently capitalize the local manufacturing company.

The structure of the credit facility was a Series Limited Liability Company (LLC) arrangement whereby a separate LLC was established for each of the five borrowers. Each LLC owned seven trusts, and each trust owned one universal life insurance policy on a senior individual. The *owner and beneficiary* of the underlying policy was the trust. The *original beneficiary* of each trust was the insured's family member. After the interest was purchased by the investor, the *beneficial interest* in each trust was

transferred from the family member to the LLC. Each original trustee was then replaced by a common trustee engaged by the Bank. This structure was used in an attempt to preserve insurable interest and facilitate the transfer of interest to an investor. Each LLC granted the borrower an irrevocable security interest in all its assets (i.e., the beneficial interest in each trust), which the borrower pledged to the Bank as collateral.

The five LLCs purchased 35 trusts (and 35 policies) with an aggregate death benefit of \$32 million. The policies were issued by 17 insurance companies to seniors residing in 12 states. The LLCs, in an attempt to shelter their risks, subscribed to a master agreement which served as a profit-sharing mechanism. In the event any of the LLCs received death benefits on policies in a greater proportion than other LLCs, the contracts would be shifted among the LLCs to level the playing field.

The proceeds of the Bank's loans were used to purchase the underlying insurance policies, pay fees, inject capital into Big Mountain, and establish a three-year reserve for interest payments, fees, and future insurance premiums. Table 2 summarizes the use of proceeds, including the sizable unfunded commitment. The loans were set up with seven-year maturities, with quarterly interest payments during the first three years followed by quarterly principal and interest payments until maturity.

In SLS transactions, active administration of the collateral and continued payment of policy premiums is critical and requires a number of administrative services.²³ In this instance, these services were provided by a Bank affiliate (Service Company) for an initial

²³ These administrative services include a tracking agent, collections manager, policy custodian, premium and claims administrator, and accounting services.

Table 2

Big Venture Bank – SLS Loan Proceeds		
Purpose	Amount	Percent of Total
Funded Portion		
Purchase Beneficial Interest of Trusts (Cost of Policies)	\$3,000,000	20.0
Fees Associated with the Purchase	60,000	0.4
Up Front Fees to Service Company under Servicing Agreement	625,000	4.2
Advance to Pay Current Premiums Due on Policies	325,000	2.1
Venture Capital Component for Investment in Big Mountain	3,000,000	20.0
Total Funded Portion	\$7,010,000	46.7
Unfunded Commitment		
Future Premium Payments on Underlying Policies (3 year reserve)	\$5,415,000	36.1
Interest Reserve on Credit Facility (3 year reserve)	2,025,000	13.5
Fees to Service Company under Servicing Agreement (3 year reserve)	550,000	3.7
Total Unfunded Portion	\$7,990,000	53.3
Total Credit Facility	\$15,000,000	100

up front fee and quarterly servicing fees, all of which were to be funded by the loan proceeds.

Loan Underwriting Deficiencies

The Bank's SLS credit facility was selected for review by FDIC examiners due to its size and the unique characteristics of the loan structure and underlying collateral. Examiners criticized Bank management for failing to perform the pre-funding due diligence necessary to understand the significant risks inherent in these transactions. The following loan underwriting deficiencies were identified, all of which impacted credit quality:

- **Inadequate Due Diligence of Legal Issues** - Management did not confirm that all transactions complied with state and federal regulations. Several critical documents tracing the transactions from inception were missing or unavailable. Management did not obtain

independent legal opinions related to the structure of these transactions, perfection of the Bank's collateral position in the various state jurisdictions, the *contestability risk* associated with the underlying policies (each policy was within the two-year contestability period), or the *rescission risk* related to insurable interest. Refer to Table 1 for information regarding these risks.

- **Unpredictable Cash Flow** - Cash flow in SLS transactions depends on the amount of the policy's death benefits and can be impacted by various risks, including *longevity risk* (the risk the insured individual will outlive the life expectancy in the actuarial model). Management did not consider whether the 35 insured individuals comprised a sufficiently large pool to correlate with the actuarial tables and assumptions used in its actuarial model.

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- **Lack of Independent Mortality Analysis** - Management did not perform a loan-level analysis that considered the specific characteristics of each underlying policy, including age of the insured, medical history, and condition. A mortality profile that included a summary of the pertinent medical conditions and a determination of life expectancy should have been conducted by a medical underwriter. The analysis also should have included assumptions for medical advances that could impact mortality rates. Moreover, cash flow should have been stressed under a number of reasonable mortality scenarios to analyze longevity risk.
- **Funding Risk** – The carrying costs (interest, premiums, and fees) associated with this structure is significant. If cash flow was impacted by longevity risk, carrying costs would have significantly increased. Further, many of the underlying policies had premium structures that escalated as the insured aged. The unfunded portion of the credit facility was sufficient to accommodate the projected carrying cost for only three years.
- **Borrowers Lacked Equity and Financial Capacity** - Each borrower was essentially a passive participant with no equity in the structure. Repayment terms were extremely liberal, as the borrowers were not required to make any out-of-pocket payments for three years. Interest payments, administrative fees, and premiums were all advanced on the line of credit. Moreover, the loans were primarily funded on the *projected* cash flow from the deaths of the seniors with little consideration given to the borrowers' financial strength or cash flow, which was nominal. The borrowers did not establish cash reserves to fund the cost of holding the investment, and no additional collateral was pledged.
- **Liquidity Risk** - Management did not adequately analyze the availability of a secondary market before engaging in these transactions. The SLS market is still emerging, with a limited secondary market (especially for contestable contracts) and a lack of transparency, which posed significant *liquidity risk* for the institution and the borrowers should they want to dispose of the collateral. The lack of transparency in the pricing of life settlements and the fees earned by intermediaries, coupled with the lack of standardization of the general methods for predicting life expectancies, contribute to capital markets uncertainties relative to the value of life settlement transactions. Bank management should have engaged independent, licensed life settlement providers to determine an estimated market value based on the specific characteristics of the individual transaction. Management also should have ascertained the financial strength of each insurance company.
- **Unrealistic Exit Strategy** - The Bank's ultimate repayment source - the proposed \$600 million SLS securitization – never materialized. The unique structure of the bond caused the underwriting process to become severely protracted and subject to continual delays and legal setbacks.

Regulatory Treatment and Impact on the Bank

The Bank failed to obtain regulatory approval before establishing its SLS credit facility. Given the highly speculative nature of these investments, legal risk, unpredictable cash flow, funding risk, questionable collateral position, liquidity risk, and numerous other unmitigated risks, the SLS credit facility did not meet the test of a prudent extension of credit. Consequently, once examiners became aware of the activity, they adversely classified the credit facility, placed each loan on nonaccrual, required a significant allocation to the allowance for loan and lease losses (ALLL), and instructed that any future advances, which were previously contracted, be immediately charged-off through the ALLL.

Within an 18 month period, the write-downs associated with this credit facility and other loan losses exhausted the Bank's capital and resulted in its failure. The FDIC as receiver of the Bank holds these assets and is attempting to liquidate them.

Conclusion

Substantial financial risks, aggressive and deceptive sales practices fueled by the opportunity for promoters to collect high commissions,

STOLI deals, and fraud cast a dark cloud over the SLS industry. Accordingly, bank and securities regulators continue to consider the application of additional federal and state laws to life settlements and market intermediaries. Bankers, investors, and consumers being approached with proposals to enter into life settlement transactions should exercise caution and carefully consider all risks associated with these transactions. Bankers should also consider whether such activity is likely to be permitted by their supervisor, regardless of potential mitigating actions.

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From the Examiner's Desk: Managing Agricultural Credit Concentrations

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.

Managing Agricultural Credit Concentrations

The more than 1,500 farm banks remain a viable and important part of the U.S. banking industry, representing 1 of every 5 insured institutions.¹ These institutions are heavily concentrated in the nation's heartland, including the Corn Belt and Great Plains.² This is not unexpected given the importance of the agricultural economy in these geographic areas. The vast majority of farm banks are small institutions with limited geographic footprints in areas that are heavily dependent on agriculture; therefore, extensive diversification within the loan portfolio may not be realistic or feasible. Instead, these institutions must engage in sound oversight of their agricultural credit concentrations.

Although the agricultural sector is healthy, and the outlook remains favorable, the industry is cyclical and subject to substantial inherent volatility. Moreover, agricultural land values currently are experiencing a boom of historic proportions based in part on strong agricultural conditions. Similar episodes in the past ended with a sharp contraction of agricultural land values. Importantly, the credit structure underlying U.S. farmland does

not appear to involve excessive leverage on the part of farmers, which was present in past episodes.

Vigilance and adherence to safe-and-sound banking practices now will help ensure farm banks are well positioned to weather any challenges on the horizon. This article highlights best practices relating to agricultural lending and effective management of agricultural credit concentrations that can help agricultural banks manage the uncertainties inherent in this industry.

State of the U.S. Agricultural Industry

The agricultural sector has performed well during much of the past decade and has been one of the few bright spots amid the economic downturn and nascent recovery. On balance, the agricultural industry has benefited from solid production, strong demand and prices, and favorable financing costs. As a result, annual net farm income has been strong, with 6 of the past 8 years ranking among the top 10 since 1980. This solid performance is reflected in strong agricultural credit quality reported by the nation's farm banks. Median agricultural loan delinquencies and charge-offs remain near the lowest levels since data collection began in 1984 (see Chart 1).

Of some concern is that the current prosperity in the agricultural sector has not been shared across the sector's industries. Crop producers have done well while cattle, hog, and dairy producers struggled greatly during 2008

¹ As of September 30, 2010, there are 1,583 farm banks operating in the United States. The FDIC defines a farm bank as an insured institution with at least 25 percent of its loans concentrated in agricultural production or farmland-secured lending. Thrift Financial Reports do not show these data; therefore, FDIC data on farm banks are limited to Call Report filing institutions, which are primarily commercial banks.

² Eighty-four percent of farm banks are concentrated in 10 states (percentages are of U.S. total): Iowa (15.9%), Nebraska (10.9%), Kansas (10.7%), Illinois (10.5%), Minnesota (9.8%), Texas (7.1%), Missouri (6.4%), North Dakota (4.6%), Oklahoma (4.3%), and South Dakota (3.9%).

and 2009. As a result, net farm incomes among livestock producers did not keep pace with that of crop producers. Although all major livestock segments – beef, pork, dairy, and poultry – have struggled to varying degrees, conditions appear to have improved across the board during 2010, and the forecast is for continued strengthening into 2011.

Moreover, even though agricultural loan quality remains favorable, the credit quality of farm bank nonagricultural loan portfolios has slipped. Earnings have declined as these institutions increased loan loss provisions in response to rising delinquencies and charge-offs. However, farm bank earnings and capital have held up much better than those at metro-based nonfarm banks during the past few years (see Chart 2).

Five Perennial “Health Hazards” for the Agricultural Economy

The agricultural sector appears poised to continue its years of prosperity in the near term. Crop prices remain high, and 2010 production of wheat, corn, and soybeans is projected to be strong. Moreover, hog prices have rebounded sharply from 2009 lows; cattle prices are moving up on tight inventories; and dairy prices have recovered moderately from 2009 lows. Meanwhile, an improving global economy is expected to bolster export demand.

However, the agricultural industry is inherently susceptible to shocks from a variety of sources, such as environmental pressures, market volatility, changes in interest rates, geopolitical issues, and the potential for declining farmland values.

Environmental Risk

The massive fires that raged across much of the former Soviet Union during the summer of 2010 and

Chart 1: Delinquent Agricultural Loans Remain at Historically Low Levels

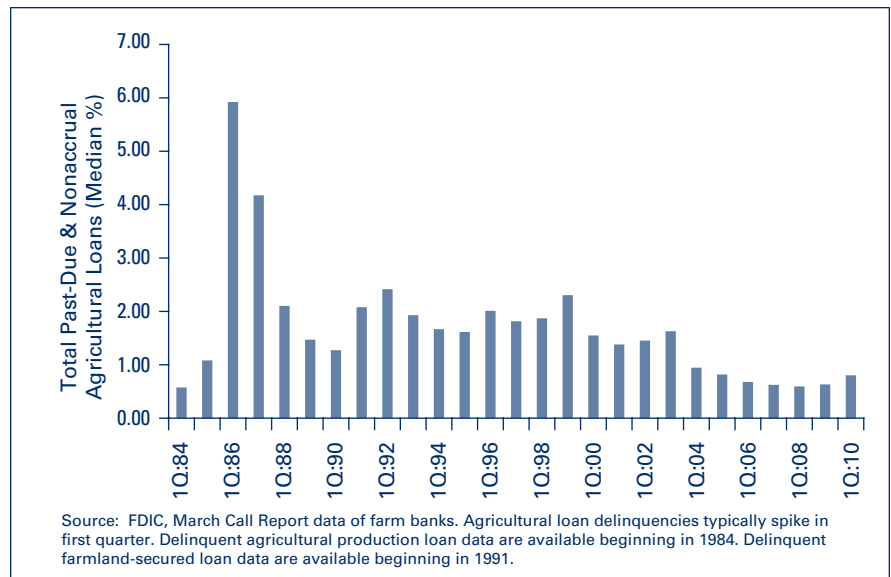
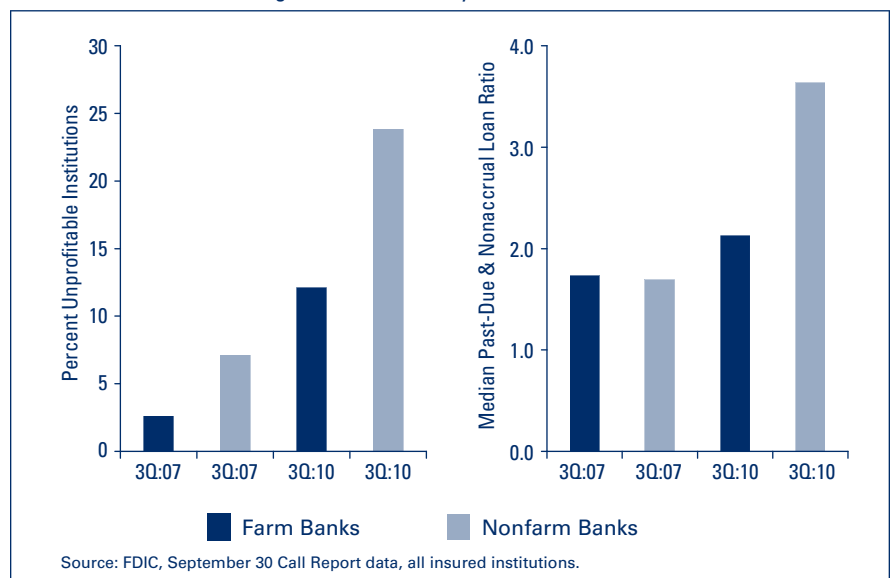


Chart 2: Farm Banks' Earnings and Asset Quality Remain Better Than Nonfarm Banks



the resulting ban on Russian wheat exports (because of the significant failure of its wheat crop) are stark reminders of the potential impact of adverse weather conditions. This development echoes the 1970s when the Soviet Union imported U.S. wheat because of severe drought.

Weather is the major uncontrollable risk in agriculture, with drought topping

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the list of widespread, yield-limiting factors. The United States currently is 22 years removed from its last major drought in 1988, and many experts believe another major drought event is overdue. For example, climatologists note that serious droughts tend to follow a 19-year cycle.³

Market Volatility

Market volatility for commodity prices and input costs can be extreme. For example, the price of fertilizer, the largest input cost, increased more than 250 percent between Spring 2007 and Spring 2008. Similarly, corn and wheat prices roughly doubled between the first half of 2007 and the first half of 2008 before retreating in the second half of the year (see Chart 3).

Rising Interest Rates

Typically, farming is a low-margin operation, and rising interest rates can constrain farmers' debt-servicing capacity. Interest rates have been at

decades-lows for much of the past decade, and low financing costs sometimes cloud the determination as to whether good performance results from strong operations or lower debt costs. Moreover, rising interest rates exert downward pressure on farmland values, which is the most significant asset of many farming operations.

Geopolitical Risks

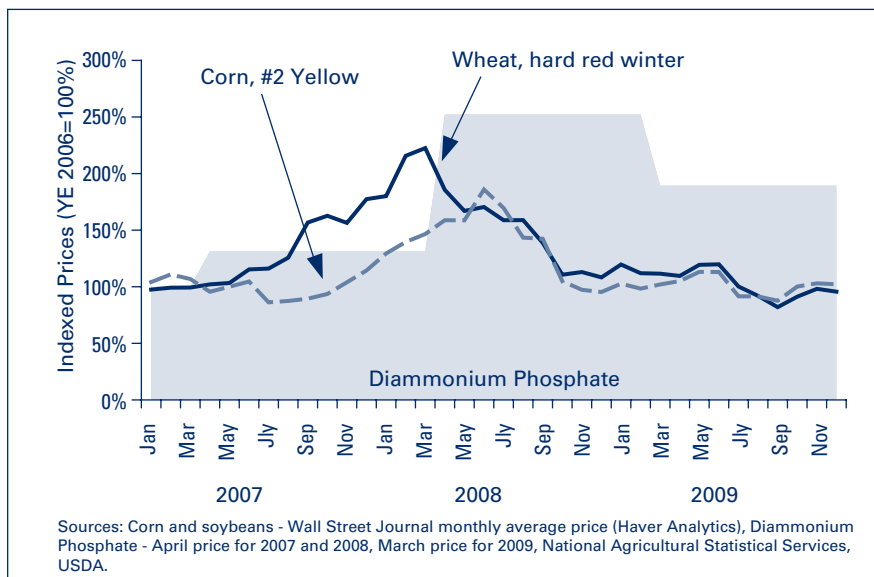
Domestically, the agricultural sector faces "stroke of the pen" uncertainties involving several federal programs, including the potential for a reduction in the United States Department of Agriculture's Farm Program payments, an increase in capital gains taxes, and a reduction or elimination of federal supports to the ethanol industry. Other sources of uncertainty for agriculture include the effects of environmental regulations, water allocation, and pressure from animal activist groups.

Looking beyond U.S. borders, this sector must be prepared to deal with the uncertainties surrounding global market conditions and international trade issues, such as free trade and bio-security. Since 2003, less than a handful of U.S. cases of Bovine Spongiform Encephalopathy, or "Mad Cow" Disease, have resulted in significant foreign bans on U.S. beef imports, adversely affecting the U.S. cattle industry. Similarly, concerns about H1N1 Influenza, or "Swine Flu," hurt pork producers during 2009.

Decline in Farmland Values

When farmland is owned, it is the principal farm asset on an agricultural producer's balance sheet. However, when rented, it represents a significant expense. Nationally, farmland values have risen more than 50 percent since

Chart 3: Crop Prices and Fertilizer Costs Diverged Widely in 2008



³ Elwynn Taylor, Professor/Climatologist, Department of Agronomy, Iowa State University. Based on the results of long-term tree-ring studies, the longest drought-free period in central/eastern North America is 23 years. See www.extension.iastate.edu and click on "Weather."

2000 (in inflation-adjusted dollars) and are at historic highs (see Chart 4).

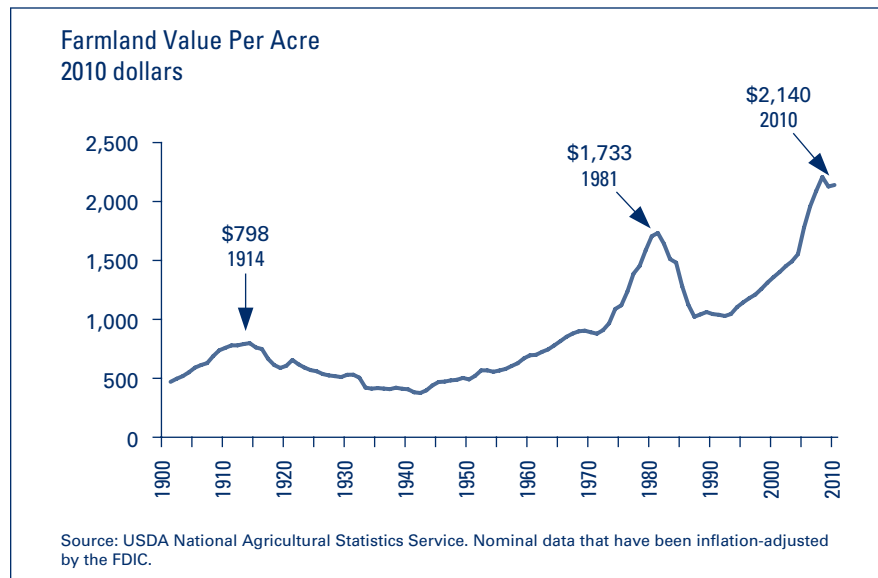
During the twentieth century, there were only two other periods of similar increases in farmland values, and both were followed by declines of more than 40 percent. A drop in farmland values likely would accompany any significant decline in farm income, causing collateral margins to tighten at the same time repayment capacity falls. Depending on how much collateral margins tighten relative to underwriting standards, lenders could view farmland's collateral protection as an insufficient secondary repayment source.

These health hazards have the potential to negatively affect much of the agricultural sector and, by extension, the operations of a large number of farm banks. As it is not feasible in many instances for farm banks to diversify away their concentrated agricultural risk, careful management of that risk is necessary.

Management focus on best practices can help mitigate these risks⁴

Robust credit concentration risk management begins at the bank level, includes sound agricultural lending practices, and considers any associated third-party risks. The strong practices described below are not a list of formal supervisory requirements. They reflect the authors' observations about the factors successful agricultural lenders consider in managing their agricultural credit exposure. The application of these practices should be commensu-

Chart 4: In 2010 Dollars, Present Farmland Values Exceed the Two Price Booms of the 20th Century



rate with the scope and complexity of a bank's operations.

Agricultural Credit Underwriting and Administration

Management should establish prudent, time-tested lending policies and reporting mechanisms. Robust credit portfolio reporting systems should provide timely, detailed information about agricultural concentrations; for example, reports should be created that stratify the agricultural portfolio by crop production versus livestock production, cow/calf versus feeder program, etc.

The credit review process and risk-rating system should allow for the early identification of problem signals, for example, weakening profitability,

⁴ Information included in this section is based on existing supervisory guidance and the authors' informed perspective. Refer to Part 364, Appendix A, "Standards for Safety and Soundness." Additional guidance is available in these FDIC publications: "Analysis and Classification of Agricultural Credits," FIL-61-96, <http://www.fdic.gov/news/news/financial/1996/fil9661.html>; **FDIC Risk Management Manual of Examination Policies**, Section 3.2, http://www.fdic.gov/regulations/safety/manual/section3-2_toc.html; *2001 FDIC Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions*, <http://www.fdic.gov/regulations/laws/rules/5000-4650.html#fdic5000psall>; and *2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses*, <http://www.fdic.gov/regulations/laws/rules/5000-4700.html#fdic5000interagencycpso>.

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increasing leverage, and declining collateral margins, and the credit department should perform appropriate financial analysis and collateral inspections. Institutions should ensure experienced personnel are available to effectively manage any increase in problem loans and loan workouts.

In addition, credit officers should perform appropriate cash flow analysis, including stress testing; require and understand marketing programs, hedging activities, and insurance programs; and appropriately structure loan terms. The following best practices will help ensure a robust and effective agricultural credit underwriting and administration function.

- For significant borrowers, develop a baseline cash-flow scenario predicated on realistic production estimates, attainable commodity prices, and most likely input costs. Shock or stress test the baseline cash flow by substituting price extremes for commodity prices, input costs, and interest rates.
- Segment the loan portfolio based on the stress test results, for example: (1) producers who are profitable under almost any realistic scenario; (2) producers who may experience negative cash flows under difficult circumstances but can service resulting carryover debt when prices or expenses normalize; and (3) producers who only cash flow under a best-case scenario.
- Implement mitigation strategies where needed. For example, for borrowers falling into group 3 above, develop timely exit strategies. Place borrowers in category 2 on an internal loan watch list and determine if credit enhancements, such as Farm Service Agency (FSA) guarantees, are available to manage risk. According to information appearing on the USDA/FSAWeb site “FSA-guaranteed loans provide lenders (e.g., banks, Farm Credit System institutions, credit unions) with a guarantee of up to 95 percent of the loss of principal and interest on a loan. Farmers and ranchers apply to an agricultural lender, which then arranges for the guarantee. The FSA guarantee permits lenders to make agricultural credit available to farmers who do not meet the lender’s normal underwriting criteria.”⁵
- Establish and enforce reasonable repayment terms and do not lend beyond a borrower’s capacity to service debt structured under appropriate terms. Control loan disbursements and review loan disbursements against borrower-prepared budgets and cash-flow projections. Review incoming borrower deposits and compare them to borrower-prepared budgets and cash-flow projections. Discuss any major deviations in income or expenses with the borrower and take appropriate remedial actions if necessary.
- When taking collateral, maintain prudent collateral margins to provide appropriate protection and a secondary source of repayment. Sound, documented valuation of collateral values should accompany collateral margin analysis. Collateral valuation should consider the sustainability of current market values over the term of the loan and, when in question, valuations should be appropriately discounted.
- Require borrowers to carry levels of insurance appropriate to their risk profiles. Crop Revenue Coverage and Revenue Assurance products provide price-floor protection and minimize risks of not being able to deliver crops as contracted. These

⁵See <http://www.fsa.usda.gov/FSA/webapp?area=home&subject=fmlp&topic=gfl>.

types of insurance coverage are important components of a viable marketing strategy.

- Encourage borrowers to protect their profits using sound sales marketing programs and hedging tools to lock in crop and livestock prices and favorable input costs. The bank should evaluate the program's appropriateness, monitor hedging account activities to ensure consistency with the original marketing plan, and develop sufficient funding sources to meet margin demands.
- Meet with financially distressed borrowers during the operating season and revisit the initial cash-flow projections, and perform on-site collateral inspections. Document these meetings and inspections and consider the risk that financially troubled borrowers might sell or transfer portable collateral, such as grain, livestock, and machinery, without the bank's approval.
- Hold borrowers accountable for discretionary spending, such as family living expenditures and capital purchases that exceed budgeted limits.
- Do not advance funds or release sales proceeds to pay other creditors without first determining the borrower can service his debt. Do not advance funds for a new production cycle until reasonable assurance exists that current operating season debt will be repaid or a determination is made that the level of new carryover debt is an acceptable risk. The lender should document this analysis and decision-making process in the credit file.

Mitigating Third-Party Risk

Finally, agricultural credit concentrations require prudent oversight of borrowers' third-party risk. Agricultural

producers typically prepay for inputs before the beginning of the operating season and then market production to a relatively small number of entities, such as grain elevators, feedlots, and ethanol plants. Therefore, farmers routinely face substantial third-party risk regarding the delivery of prepaid inputs and the sale of product. As an example, during 2008, ethanol producer VeraSun entered bankruptcy and repudiated contracts for delivery of millions of bushels of corn from local corn growers, forcing growers to sell their crops on the open market at much lower market prices.

Third-party risk has the potential to jeopardize the viability of agricultural borrowers. To help mitigate this risk, banks should:

- specify acceptable concentration limits in the Loan Policy for exposure stemming from related repayment sources, whether it is a direct loan customer, a third party, or a combination of the two.
- develop appropriate strategies for managing agricultural concentration levels, including a contingency plan to reduce or mitigate concentrations when adverse market conditions emerge.
- review borrower credit files to identify all significant third parties that provide services to or purchase products from the borrower including, but not limited to, an elevator, ethanol plant, or feedlot that purchases large quantities of grain; or a supplier that provides a large volume of prepaid operating inputs to local farmers.
- determine the volume and nature of business conducted with third parties and perform due diligence of these third parties. Whenever possible, due diligence should include a financial statement review.

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- determine the existing aggregate exposure. For example, if the bank loans \$1 million to a local supply dealer that has also taken on \$10 million in prepaid expenses from farmers financed by that institution, \$11 million of direct and indirect exposure should be assigned to that dealer.

Capital and the Allowance for Loan and Lease Losses

In any given agricultural operating season, geographic pockets typically will experience some type of stress – most often weather related. However, as indicated by the previous discussion of health hazards, the potential exists for widespread stress in the agricultural lending sector. Capital exists to absorb unexpected losses. Given the relatively undiversified loan portfolios of farm banks, these institutions typically operate with capital ratios that well exceed regulatory minimums.

When managing agricultural credit concentrations, the Allowance for Loan and Lease Losses (ALLL) levels should be evaluated in light of these potential hazards. As the first line of defense against expected losses associated with problem credits and loans and leases more generally, a properly funded and managed ALLL is critical. Institutions should ensure:

- consistency with Generally Accepted Accounting Principles (GAAP) and relevant supervisory guidance, such as the December 13, 2006 *Interagency Policy Statement on the ALLL*.
- a review of the adequacy of the ALLL is conducted at least quarterly, including an analysis of the collectability of the agricultural loan portfolio and other exposures.
- the ALLL level covers estimated credit losses on individual impaired loans and estimated credit losses in the remaining loan portfolio.

- that as the volume of noncurrent loans and internally criticized credits becomes elevated, a commensurate increase in the ALLL level is considered.

Conclusion

The FDIC recognizes the importance of the agricultural sector to a large segment of the U.S. banking industry, particularly in the nation's heartland, where one of every two institutions is considered a farm bank. Agricultural credit concentrations among these banks and thrifts are common. Although agricultural conditions have been strong for many years, and the outlook remains favorable, the industry is cyclical and faces potential health hazards.

Reviewing lending processes and strengthening them as appropriate will help insulate farm banks against any problems in the agricultural sector. The best practices discussed in this article relating to agricultural credit underwriting and administration, strategies for mitigating third-party risk, and maintaining appropriate levels of the ALLL are policies and procedures that farm banks can incorporate now into their operations to mitigate concentration risk in the agricultural loan portfolio.

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Overview of Selected Regulations and Supervisory Guidance

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

ACRONYMS and DEFINITIONS

FDIC	Federal Deposit Insurance Corporation
FRB	Federal Reserve Board
FFIEC	Federal Financial Institutions Examination Council
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
Notice of Proposed Rulemaking on Assessments (PR-248-2010, November 9, 2010, FIL-78-2010, November 10, 2010)	On November 9, 2010, the FDIC adopted the Notice of Proposed Rulemaking on Assessments which would define the assessment base as “average consolidated total assets minus average tangible equity,” as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act); permit certain reductions for banker’s banks and “custodial” banks, as allowed by the Act; revise existing adjustments to assessment rates, eliminate one adjustment, and add another; and revise deposit insurance assessment rate schedules in light of the changes to the assessment base. The proposed rate schedule and other revisions to the assessment rules would become effective April 1, 2011, and would be used to calculate the June 30, 2011 invoices for assessments, which will be due September 30, 2011. Comments are due 45 days following publication in the <i>Federal Register</i> . See http://www.fdic.gov/news/news/financial/2010/fil10078.html
Notice of Proposed Rulemaking on Assessments (PR-248-2010, November 9, 2010, FIL-77-2010, November 10, 2010)	On November 9, 2010, the FDIC adopted the Notice of Proposed Rulemaking on Assessments which would revise the risk-based assessment system for all large insured depository institutions, generally those institutions with at least \$10 billion in total assets. The proposed changes would be effective April 1, 2011. Comments are due 45 days following publication in the <i>Federal Register</i> . See http://www.fdic.gov/news/news/financial/2010/fil10077.html
Final Rule: Temporary Unlimited Coverage for Noninterest - Bearing Transaction Accounts (PR-247-2010, November 9, 2010, FIL-76-2010, November 9, 2010, <i>Federal Register</i>, Vol. 75, No. 219, p. 69577, November 15, 2010)	The FDIC Board of Directors has issued a final rule to implement the section of the Dodd-Frank Wall Street Reform and Consumer Protection Act that provides temporary unlimited coverage for noninterest-bearing transaction accounts at all FDIC-insured depository institutions. The separate coverage for noninterest-bearing transaction accounts becomes effective on December 31, 2010, and terminates on December 31, 2012. See http://www.fdic.gov/news/news/financial/2010/fil10076.html

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Subject	Summary
Teleconference on Fair Lending Issues (FIL-74-2010, November 3, 2010)	FDIC Fair Lending Examination Specialists hosted a Fair Lending Teleconference on Tuesday, November 16, 2010. This call discussed how the FDIC reviews institutions flagged for disparities based on the Corporation's analysis of Home Mortgage Disclosure Act data. The call also assisted bankers in identifying areas of fair lending risk within their institutions' programs and processes. See http://www.fdic.gov/news/news/financial/2010/fil10074.html
Proposed Revisions to Consolidated Reports of Condition and Income (Call Report) for 2011 (FIL-70-2010, October 25, 2010)	The banking agencies are requesting comment on several proposed revisions to the Call Report that would take effect March 31, 2011. Comments were due by November 29, 2010, and will be shared among the agencies. See http://www.fdic.gov/news/news/financial/2010/fil10070.html
Notice of Proposed Rulemaking on Assessments (PR-229-2010, October 19, 2010, FIL-68-2010, October 20, 2010, Federal Register, Vol. 75, No. 207, p. 66272, October 27, 2010)	On October 19, 2010, the FDIC proposed a comprehensive, long-range plan for Deposit Insurance Fund management with the goals of maintaining a positive fund balance, even during a period of large fund losses, and steady, predictable assessment rates throughout economic and credit cycles. The FDIC adopted the Restoration Plan and Notice of Proposed Rulemaking on assessment rates, dividends, and the designated reserve ratio. Comments were due November 26, 2010. See http://www.fdic.gov/news/news/financial/2010/fil10068.html
Guidance on Golden Parachute Applications (FIL-66-2010, October 14, 2010)	As part of supervisory efforts to address executive compensation in the financial services industry, the FDIC issued guidance on handling applications to make permissible golden parachute payments. This guidance clarifies the golden parachute application process for troubled institutions, specifies the type of information necessary to satisfy the certification requirements, and highlights factors considered by supervisory staff when determining whether to approve a golden parachute payment. See http://www.fdic.gov/news/news/financial/2010/fil10066.html
Joint Final Rule on Community Reinvestment Act (PR-219-2010, September 29, 2010, FIL-65-2010, October 12, 2010)	The federal bank and thrift regulatory agencies are publishing revisions to the Community Reinvestment Act regulations. This rule change implements two statutory changes. One requires the agencies, when assessing a financial institution's record of meeting community credit needs, to consider low-cost education loans to low-income borrowers. The other allows the agencies to consider various activities undertaken with minority- and women-owned financial institutions and low-income credit unions. The final rule took effect November 3, 2010. See http://www.fdic.gov/news/news/financial/2010/fil10065.html
Temporary Registration of Municipal Advisors (FIL-63-2010, October 1, 2010)	Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Act), Pub. L. 111-203 amended Section 15B(a) of the Securities Exchange Act of 1934 to make it unlawful for "municipal advisors," as defined in the Act, to provide certain advice to or solicit municipal entities or certain other persons without registering with the U.S. Securities and Exchange Commission (SEC). On September 8, 2010, the SEC issued an interim final temporary rule, 17 C.F.R. § 240.15Ba2-6T, requiring all municipal advisors to register with the SEC by October 1, 2010. Municipal advisors must register by submitting Form MA-T through the SEC's Web site, http://www.sec.gov . See http://www.fdic.gov/news/news/financial/2010/fil10063.html

Subject	Summary
<p>Model Privacy Notice Form Compliance Guide (FIL-60-2010, September 27, 2010)</p>	<p>On December 1, 2009, the FDIC issued amendments to Part 332 of the FDIC's Rules and Regulations which implement the privacy provisions of the Gramm-Leach-Bliley Act and adopted the model privacy notice form. Part 332 requires state nonmember banks to notify consumers of their information-sharing practices and inform consumers of the right to opt out of certain sharing practices. The FDIC now is issuing a compliance guide for state nonmember banks wishing to use the model form to comply with these requirements. See http://www.fdic.gov/news/news/financial/2010/fil10060.html</p>
<p>Notice of Proposed Rule: Temporary Unlimited Coverage for Noninterest-Bearing Transaction Accounts (PR-217-2010, September 27, 2010, FIL-59-2010, September 27, 2010)</p>	<p>The FDIC Board of Directors has issued a proposed rule to implement the section of the Dodd-Frank Wall Street Reform and Consumer Protection Act that provides temporary unlimited coverage for noninterest-bearing transaction accounts. The separate coverage for noninterest-bearing transaction accounts becomes effective on December 31, 2010, and terminates on December 31, 2012. The proposed rule is also a vehicle to announce that the FDIC will not be extending its Transaction Account Guarantee Program beyond its scheduled expiration date of December 31, 2010. Comments were due October 15, 2010. See http://www.fdic.gov/news/news/financial/2010/fil10059.html</p>
<p>FDIC Extends Application Period for Safe Account Pilot (PR-203-2010, September 2, 2010)</p>	<p>The FDIC extended for 30 days the application period for a pilot program to evaluate the feasibility of insured depository institutions offering safe, low-cost transactional and savings accounts that meet the needs of underserved consumers. Applications were due October 15, 2010. See http://www.fdic.gov/news/news/press/2010/pr10203.html</p>
<p>Guidance on Mitigating Risk Posed by Information Stored on Photocopiers, Fax Machines, and Printers (FIL-56-2010, September 15, 2010)</p>	<p>The FDIC has issued guidance which describes the risk posed by sensitive information stored on certain electronic devices and how institutions should mitigate that risk. The guidance encourages financial institutions to implement written policies and procedures to ensure that a hard drive or flash memory containing sensitive information is erased, encrypted, or destroyed. See http://www.fdic.gov/news/news/financial/2010/fil10056.html</p>
<p>Free Nationwide Seminars for Bank Officers and Employees on Deposit Insurance Coverage (FIL-55-2010, September 2, 2010)</p>	<p>The FDIC hosted six telephone seminars on deposit insurance coverage for bank representatives between September 23 and November 2, 2010. Four sessions provided a basic overview of deposit insurance coverage, and two focused on advanced deposit insurance coverage issues. The seminars were free to officers and employees of FDIC-insured banks and savings associations. See http://www.fdic.gov/news/news/financial/2010/fil10055.html</p>
<p>Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of External Credit Ratings in Risk-Based Capital Guidelines of the Federal Banking Agencies (PR-185-2010, August 10, 2010, FIL-52-2010, August 16, 2010)</p>	<p>The banking agencies requested comment on alternative standards of creditworthiness to replace the use of credit ratings in the risk-based capital requirements. The advance notice was issued in response to Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act which requires the agencies to review regulations that (1) require an assessment of the creditworthiness of a security or money market instrument and (2) contain references to or requirements regarding credit ratings. In addition, the agencies are required to remove such references and requirements and substitute uniform standards of creditworthiness, where feasible. Comments for the Advance Notice of Proposed Rulemaking were due on October 25, 2010. See http://www.fdic.gov/news/news/financial/2010/fil10052.html</p>

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Subject	Summary
Final Rule Conforming FDIC Regulations on Deposit Insurance Coverage and Advertisement of Membership to Permanent Standard Maximum Deposit Insurance Amount of \$250,000 (FIL-49-2010, August 12, 2010)	On August 10, 2010, the FDIC Board of Directors adopted a final rule amending its insurance regulations (12 C.F.R. Part 330) and advertising regulations (12 C.F.R. Part 328) to conform with provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which permanently increases the standard maximum deposit insurance amount from \$100,000 to \$250,000. This permanent increase became effective July 22, 2010. See http://www.fdic.gov/news/news/financial/2010/fil10049.html
FDIC Board Approves Safe Accounts Pilot Program (PR-183-2010, August 10, 2010)	The FDIC Board of Directors approved a pilot program to evaluate the feasibility of insured depository institutions offering safe, low-cost transactional and savings accounts. Under the pilot, participating institutions will offer electronic deposit accounts with product features identified in the FDIC Model Safe Accounts Template. The pilot's Model Safe Accounts are designed to help meet the needs of the more than one-quarter of all U.S. households that are underserved, according to the <i>FDIC Survey of Unbanked and Underbanked Households</i> . Applications from insured institutions interested in participating in the pilot were due October 15, 2010. See http://www.fdic.gov/news/news/press/2010/pr10183.html
Letter from FDIC Chairman Sheila C. Bair on Retained Asset Accounts and FDIC Deposit Insurance Coverage (FIL-48-2010, August 11, 2010)	FDIC Chairman Bair sent a letter to the National Association of Insurance Commissioners addressing the FDIC's concerns about the adequacy of disclosures provided by insurance companies when distributing insurance proceeds to consumers through Retained Asset Accounts (RAAs). Insured depository institutions that participate in any function relating to RAAs (participating banks) must be vigilant in minimizing consumer confusion about FDIC insurance coverage. Participating banks should work with the insurance companies offering RAAs to ensure all documents provided to consumers appropriately reflect the participating banks' role in the transactions and disclose to policyholders and beneficiaries if the RAAs are insured by the FDIC. See http://www.fdic.gov/news/news/financial/2010/fil10048.html
FDIC Seeks Comments on Overdraft Payment Supervisory Guidance (PR-186-2010, August 11, 2010, FIL-47-2010, August 11, 2010)	The FDIC is seeking comments on how the banking institutions it supervises should implement and maintain robust oversight of automated overdraft payment programs. Such oversight should include appropriate measures to mitigate risks, incorporating best practices outlined in the 2005 <i>Joint Guidance on Overdraft Protection Programs</i> and effective management of third-party arrangements. Management should be particularly vigilant with respect to product over-use that may harm consumers, rather than providing them the protection against occasional errors or funds shortfalls for which the programs were intended. The FDIC sought comments on these supervisory expectations by September 27, 2010. See http://www.fdic.gov/news/news/financial/2010/fil10047.html
Notice of Joint Final Rule: Registration of Residential Mortgage Loan Originators (PR-170-2010, July 28, 2010, FIL-43-2010, July 30, 2010, <i>Federal Register</i>, Vol. 75, No. 144, p. 44656, July 28, 2010)	The federal financial institution regulatory agencies and the Farm Credit Administration published in the <i>Federal Register</i> the joint final rule implementing the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 on July 28, 2010. The rule took effect on October 1, 2010, and institutions are expected to implement appropriate policies, procedures, and management systems to ensure compliance. Applicable mortgage loan originators must register with the Nationwide Mortgage Licensing System and Registry (NMLSR) within 180 days of the date the NMLSR can begin accepting registrations, which could be as soon as January 28, 2011. The FDIC will provide advance notice of the exact date. See http://www.fdic.gov/news/news/financial/2010/fil10043.html

Subject	Summary
<p>Standard Deposit Insurance Coverage Amount of \$250,000 Made Permanent (PR-161-2010, July 21, 2010, FIL-40-2010, July 22, 2010)</p>	<p>The Dodd-Frank Wall Street Reform and Consumer Protection Act made permanent the current standard maximum deposit insurance amount of \$250,000. The FDIC coverage limit applies per depositor, per insured depository institution, for each account ownership category. See http://www.fdic.gov/news/news/financial/2010/fil10040.html</p>
<p>FDIC Board Votes to Revise MOU on Backup Supervision Authority (PR-153-2010, July 12, 2010)</p>	<p>The FDIC Board of Directors voted to revise its Memorandum of Understanding with the primary federal banking regulators to enhance the FDIC's existing backup authorities over insured depository institutions the FDIC does not directly supervise. The revised agreement will improve the FDIC's ability to access information necessary to understand, evaluate, and mitigate its exposure to insured depository institutions, especially the largest and most complex firms. See http://www.fdic.gov/news/news/press/2010/pr10153.html</p>
<p>Alert on FHFA Statement Relative to Concerns With Certain Energy Lending Programs (FIL-37-2010, July 6, 2010)</p>	<p>The Federal Housing Finance Agency issued a statement relative to concerns with certain energy retrofit lending programs. Insured institutions should be aware of such programs, as these programs could affect their residential mortgage lending activities and the ability to sell loans to Fannie Mae and Freddie Mac. See http://www.fdic.gov/news/news/financial/2010/fil10037.html</p>
<p>Examination Guidance and Procedures for the Unlawful Internet Gambling Enforcement Act (FIL-35-2010, June 30, 2010)</p>	<p>The federal financial institution regulatory agencies issued guidance and examination procedures related to the Unlawful Internet Gambling Enforcement Act of 2006 (UIGEA). The UIGEA was enacted to prohibit institutions from accepting payments from any person engaged in the business of betting or wagering with a business in unlawful Internet gambling. Compliance with the rule took effect June 1, 2010. See http://www.fdic.gov/news/news/financial/2010/fil10035.html</p>
<p>Small-Dollar Loan Pilot Results Released (PR-140-2010, June 24, 2010; FIL-31-2010, June 24, 2010)</p>	<p>The FDIC issued a report to summarize the final results of the FDIC's Small-Dollar Loan Pilot Program and outline lessons learned and potential strategies for expanding the availability of affordable small-dollar loans. The pilot was designed to illustrate the feasibility of banks offering alternatives to high-cost credit products, such as payday loans and fee-based overdraft programs, and resulted in the creation of a template for safe, affordable, and feasible small-dollar loans. See http://www.fdic.gov/news/news/financial/2010/fil10031.html</p>
<p>Final Guidance on Incentive Compensation (PR-138-2010, June 21, 2010, <i>Federal Register</i>, Vol. 75, No. 122, p. 36395, June 25, 2010)</p>	<p>The federal bank and thrift regulatory agencies issued final guidance to ensure incentive compensation arrangements at financial organizations take into account risk and are consistent with safe-and-sound practices. The guidance is designed to ensure that incentive compensation arrangements at banking organizations appropriately tie rewards to longer-term performance and do not undermine the safety and soundness of the firm or create undue risks to the financial system. The guidance applies not only to top-level managers, but also to other employees who have the ability to materially affect the risk profile of an organization, either individually or as part of a group. The guidance became effective on June 25, 2010. See http://www.fdic.gov/news/news/press/2010/pr10138.html</p>

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Subject	Summary
Agencies Propose to Expand Scope of Community Reinvestment Act Regulations to Encourage Depository Institution Support for HUD Neighborhood Stabilization Program Activities (PR-135-2010, June 17, 2010)	The federal financial institution regulatory agencies announced a proposed change to the Community Reinvestment Act regulations to support stabilization of communities affected by high foreclosure levels. The proposed change specifically would encourage depository institutions to support the Neighborhood Stabilization Program administered by the U.S. Department of Housing and Urban Development. See http://www.fdic.gov/news/news/press/2010/pr10135.html
Agencies Announce Public Hearings on Community Reinvestment Act Regulations (PR-134-2010, June 17, 2010)	The federal financial institution regulatory agencies announced a series of public hearings on modernizing the regulations that implement the Community Reinvestment Act (CRA). The hearings were held on the following dates: July 19, 2010, Arlington, Virginia; August 6, 2010, Atlanta, Georgia; August 12, 2010, Chicago, Illinois; and August 17, 2010, Los Angeles, California. The agencies will consider how to update the regulations to reflect changes in the financial services industry, changes in how banking services are delivered to consumers today, and current housing and community development needs. The agencies also want to ensure the CRA remains effective for encouraging institutions to meet the credit needs of communities. Interested parties were invited to provide testimony and written comments. See http://www.fdic.gov/news/news/press/2010/pr10134.html
Interagency Supervisory Guidance on Bargain Purchases and Assisted Acquisitions (FIL-30-2010, June 7, 2010)	The federal financial institution regulatory agencies issued Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions to address supervisory considerations related to business combinations resulting in bargain purchase gains and the impact such gains have on the acquisition approval process. Approval of an acquisition may be conditioned on the acquiring institution's commitment to maintain specified levels of capital to address the risk of significant retrospective adjustments to the bargain purchase gain or other risks. See http://www.fdic.gov/news/news/financial/2010/fil10030.html
Guidance on Deposit Placement and Collection Activities (FIL-29-2010, June 7, 2010)	The FDIC issued guidance on deposit placement and collection activities at FDIC-insured institutions and their affiliates. The guidance outlines steps depository institutions should take to avoid customer misunderstanding about deposit insurance coverage when the institutions enter into third-party arrangements to collect and place deposits. Failure to properly administer deposit collection practices in a manner that prevents customer confusion and complies with deposit insurance rules will be factored into the supervisory assessment of the institution and may result in enforcement actions and penalties pursuant to 12 U.S.C. 1828(a)(4). See http://www.fdic.gov/news/news/financial/2010/fil10029.html
Agencies Release List of Distressed or Underserved Nonmetropolitan Middle-Income Geographies (PR-128-2010, June 1, 2010)	The federal financial institution regulatory agencies announced the availability of the 2010 list of distressed or underserved nonmetropolitan middle-income geographies where revitalization or stabilization activities will receive Community Reinvestment Act consideration as "community development." See http://www.fdic.gov/news/news/press/2010/pr10128.html



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