

**UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA**

VERN MCKINLEY,	)	
	)	
Plaintiff,	)	
	)	
vs.	)	Case No. 10-00420 (EGS)
	)	
FEDERAL DEPOSIT INSURANCE	)	
CORPORATION,	)	
	)	
Defendant.	)	
_____	)	

**PLAINTIFF’S REPLY TO THE FDIC’S OPPOSITION
TO CROSS-MOTION FOR SUMMARY JUDGMENT**

Plaintiff Vern McKinley, by counsel and pursuant to Rule 56(c) of the Federal Rules of Civil Procedure, respectfully submits this reply to the opposition of Defendant Federal Deposit Insurance Corporation (“FDIC”) to Plaintiff’s cross-motion for summary judgment. As grounds therefor, Plaintiff states as follows:

MEMORANDUM OF LAW

I. Introduction.

The U.S. Government Accountability Office (“GAO”) recently reported, “In late 2008, the federal government took unprecedented steps to stabilize the financial services sector by committing trillions of dollars of taxpayer funds to assist financial institutions and restore order to credit markets.” United States Government Accountability Office, Report to Congressional Committees, *Federal Deposit Insurance Corporation: Regulators’ Use of Systemic Risk Exception Raises Moral Hazard Concerns and Opportunities Exist to Clarify the Provision* (GAO 10-100, April 2010) (“GAO Report”) (Exhibit A) at 1. One of these steps, the one relevant to the matter at issue, “was the use of the ‘systemic risk’ exception contained in the

Federal Deposit Insurance Act (FDI Act), which Congress enacted as part of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).” *Id.* Under the FDICIA when the FDIC takes action to minimize or prevent losses to the deposit insurance fund, the FDIC must “follow the least costly approach when resolving an insured depository institution.” *Id.* at 5. However, the FDIC may provide certain emergency assistance to a troubled insured depository institution if the Secretary of the U.S. Department of the Treasury (“Treasury”) “determines that compliance with certain cost limitations would result in serious adverse effects on economic conditions or financial stability and that such assistance could mitigate these systemic effects.” *Id.* at 1, 5. This provision allowing the FDIC to provide assistance is known as “the systemic risk exception.”

The systemic risk exception can only be invoked under the process specified by the FDICIA. *Id.* at 6. First, “the FDIC Board of Directors and the Board of Governors of the Federal Reserve System each must recommend use of the exception by a vote of not less than two-thirds of their respective members and deliver a written recommendation to the Secretary of the Treasury.” *Id.* Before making its recommendation, the FDIC performs its own analysis and determines whether the assistance is necessary to avoid or mitigate “serious adverse effects on economic conditions or financial stability.” *See* 12 U.S.C. § 1823(c)(4)(G). Second, based on the recommendations, “the Secretary of the Treasury, in consultation with the President, may make a systemic risk determination authorizing [the] FDIC to take action or provide assistance that does not meet the least-cost requirements.” GAO Report at 6. The systemic risk exception was invoked for the first time since the passage of the statute, in September 2008, when the Treasury

made a systemic risk determination which authorized the FDIC to provide assistance to facilitate the sale of Wachovia Corporation's banking operations to Citigroup Inc.¹ *Id.* at 1-2.

The second time the FDIC recommended and the Treasury made a systemic risk determination was to allow the FDIC to create the Temporary Liquidity Guarantee Program ("TLG Program"). *Id.* at 2, 16. On October 14, 2008, the FDIC announced the creation of the TLG program. Press Release, *FDIC Announces Plan to Free Up Bank Liquidity*, available at <http://www.fdic.gov/news/news/press/2008/pr08100.html> (October 14, 2008) ("TLG Press Release"). The goal of this new program was "to strengthen confidence and encourage liquidity in the banking system by guaranteeing newly issued senior unsecured debt of banks, thrifts, and certain holding companies, and by providing full coverage of non-interest bearing deposit transaction accounts, regardless of dollar amount." TLG Press Release. The FDIC was concerned that "the threat to the market for bank debt was a systemic problem that threatened the stability of a significant number of institutions, thereby increasing the potential for failures of these institutions and losses to the Deposit Insurance Fund." GAO Report at 17. The announcement that the FDIC was recommending a systemic risk determination followed a meeting of the FDIC's Board of Directors, at which the FDIC invoked its authority under section 13(c) of the Federal Deposit Insurance Act ("FDI Act") in determining that the TLG Program was necessary to avoid or mitigate "serious adverse effects on economic conditions or financial stability." See 12 U.S.C. § 1823(c)(4)(G).

The third and fourth times that the FDIC recommended a systemic risk determination were to allow the FDIC to provide assistance to Citigroup Inc. ("Citigroup") and Bank of

¹ The records related to the invocation of the systemic risk exception with respect to Wachovia Corporation are not at issue in this case. Plaintiff filed a separate FOIA request concerning Wachovia Corporation, which is currently being litigated in this Court. *McKinley v. FDIC*, No. 09-1263 (D.D.C. filed July 9, 2009).

America Corp. (“BofA”). GAO Report at 2. On November 23, 2008, the FDIC announced that, along with Treasury and the Federal Reserve, it would provide “a package of guarantees, liquidity access and capital” to Citigroup. Press Release, *Joint Statement by Treasury, Federal Reserve and the FDIC on Citigroup*, available at <http://www.federalreserve.gov/newsevents/press/bcreg/20081123a.htm> (November 23, 2008). According to the FDIC, “As part of the Agreement, Treasury and the [FDIC] will provide protection against the possibility of unusually large losses on an asset pool of approximately \$306 billion of loans and securities backed by residential and commercial real estate and other such assets, which will remain on Citigroup’s balance sheet.” *Id.* “By providing protection against large losses on these assets, [the FDIC] hoped to promote confidence among creditors and depositors providing liquidity to the firm to avert a least-cost resolution with potential systemic risk consequences.” GAO Report at 26.

On January 16, 2009, the FDIC similarly announced that, along with Treasury and the Federal Reserve, it would provide BofA with “a package of guarantees, liquidity access and capital as part of its commitment to support financial market stability.” Press Release, *Treasury, Federal Reserve and the FDIC Provide Assistance to Bank of America*, available at <http://www.federalreserve.gov/newsevents/press/bcreg/20090116a.htm> (January 16, 2009). According to the FDIC, “Treasury and the [FDIC] will provide protection against the possibility of unusually large losses on an asset pool of approximately \$118 billion of loans, securities backed by residential and commercial real estate loans and other such assets, all of which have been marked to current market value.” *Id.*

As with the TLG Program determination, both the agreements with Citigroup and BofA followed meetings of the FDIC’s Board of Directors at which it determined that the aid packages

were necessary to avoid or mitigate “serious adverse effects on economic conditions or financial stability.” See 12 U.S.C. § 1823(c)(4)(G).

After receiving the FDIC’s Board of Director’s recommendations for the TLG Program and the Citigroup assistance, the U.S. Department of the Treasury (“Treasury”) made determinations to invoke the systemic risk exception. GAO Report at 2, 9-10. However, after receiving the FDIC’s recommendation to invoke the systemic risk exception with respect to assistance to BofA, the Treasury did not make such a determination. GAO Report at 10 (“Although [the] FDIC and the Federal Reserve provided written recommendations in support of a determination, according to Treasury and FDIC officials, the Secretary of the Treasury did not make a determination at the time because the terms of the agreement had not been finalized.”).

In its report to Congress, GAO concluded:

The recent financial crisis underscored how quickly liquidity can deteriorate at a financial institution. As a result, regulators’ deliberations about whether to invoke the systemic risk exception often occurred under severe time constraints. Treasury, FDIC, and the Federal Reserve collaborated prior to making announcements intended to reassure the markets, but the lack of a determination after two of these announcements of planned FDIC assistance under the systemic risk exception [including that related to BofA] heightened the risk that such actions will be undertaken without appropriate transparency and accountability.

GAO Report at 36.

Because of the unprecedented nature of the FDIC’s response to the financial crisis and the general concern of the lack of transparency and accountability, Plaintiff served three Freedom of Information Act (“FOIA”) requests on the FDIC in December 2009 in an effort to discover “what the Government is up to.” *U.S. DOJ v. Reporters Comm. for Freedom of Press*, 489 U.S. 749, 800 (1989). Plaintiff’s requests sought information regarding the FDIC’s October 2008 decision to create the TLG Program, the FDIC’s November 2008 decision to extend

assistance to Citigroup, and the FDIC's January 2009 decision to extend assistance to BofA. Plaintiff subsequently initiated this lawsuit on March 15, 2010 after the FDIC failed to timely respond to the three FOIA requests.

One month after Plaintiff filed suit, the FDIC produced 102 pages of heavily redacted meeting minutes and memoranda purportedly responsive to the three requests. See Exhibits A, B, C to FDIC's Memorandum in Support of Motion to Dismiss. The FDIC attempts to justify its redactions by referencing various exemptions under FOIA and the Government in the Sunshine Act, 5 U.S.C. § 552b ("Sunshine Act"). In its motion to dismiss and, now, in its opposition to Plaintiff's motion for partial summary judgment, the FDIC claims that it has satisfied its statutory obligations and that Plaintiff is "demanding that the FDIC jump through [] hoops." FDIC's Opposition to "Cross-Motion" for Summary Judgment ("FDIC's Opp.") at 6. It also asserts that Plaintiff's efforts to secure this vital information about "what the government is up to" is "a regrettable waste of time and resources." *Id.*

The FDIC is wrong. Plaintiff has not asked the FDIC to jump through any unnecessary hoops. To the contrary, Plaintiff has properly requested that the FDIC demonstrate that it has satisfied its statutory obligations under the law. Because FOIA and the Sunshine Act create a strong presumption in favor of disclosure, it is the FDIC's burden to prove that it conducted an adequate search for responsive records and that it produced all responsive records not excepted from production by a specific exemption. Yet, the FDIC has not demonstrated that the searches it conducted for responsive records were reasonably calculated to uncover all responsive materials. Nor has the FDIC shown that its claims of exemption are proper. The FDIC's declaration and *Vaughn* index contain nothing more than conclusory statements and recitations of legal standards. Because the FDIC has not satisfied its obligations under FOIA and the

Sunshine Act demonstrating that its searches were reasonable and that its claims of exemptions are proper, Plaintiff should be granted partial summary judgment with respect to the FDIC's unsubstantiated claims of exemption.

II. Argument.

A. The FDIC Has Failed to Conduct an Adequate Search

When analyzing whether a search was adequate, courts do not assess “whether any further documents might conceivably exist.” *Weisberg v. U.S. Dep’t of Justice*, 705 F.2d 1344, 1351 (D.C. Cir. 1983) (quoting *Perry v. Block*, 684 F.2d 121, 128 (D.C. Cir. 1982)). Instead, courts generally evaluate “whether the government’s search for responsive documents was adequate.” *Weisberg*, 705 F.2d at 1351. “‘The adequacy of an agency’s search is measured by a standard of reasonableness’ and is ‘dependent upon the circumstances of the case.’” *Id.* (quoting *McGehee v. CIA*, 697 F.2d 1095, 1100-01 (D.C. Cir. 1983) and *Founding Church of Scientology v. Nat’l Security Agency*, 610 F.2d 824, 834 (D.C. Cir. 1979)). To satisfy its burden, an agency typically submits “[a]ffidavits that include search methods, locations of specific files searched, descriptions of searches of all files likely to contain responsive documents and names of agency personnel conducting the search.” *Ferranti v. Bureau of Alcohol, Tobacco and Firearms*, 177 F. Supp. 2d 41, 47 (D.D.C. 2001); *Perry*, 684 F.2d at 126 (“[A]ffidavits setting forth the record procurement efforts of an agency should provide some detailing of the scope of the examination conducted.”).

The FDIC does nothing more than assert that the Court and Plaintiff should trust that the FDIC conducted an adequate search for all records responsive to Plaintiff’s FOIA requests. *Id.* (“Reliance on affidavits to demonstrate agency compliance with the mandate of the FOIA does not, however, require courts to accept glib government assertions of complete disclosure or

retrieval.”). The FDIC does not show that its search was adequate. Instead of providing a “relatively detailed and nonconclusory” declaration (*Weisberg*, 705 F.2d at 1351), the FDIC’s declaration merely states that the FOIA/Privacy Group determined that the Executive Secretary Section would be the office most likely to have responsive records, that the Executive Secretary Section located and forwarded responsive documents to the FOIA/Privacy Group, and that “[t]he FOIA/Privacy Group reviewed the search conducted by the Executive Secretary Section and determined that it was thorough and appropriate and designed to locate all responsive documents.” Declaration of Gary Jackson (“Jackson Decl.”) (attached as Exhibit 1 to FDIC’s Opp.) at ¶¶ 18-19. The FDIC does not testify as to why the Executive Secretary Section was believed to be the office most likely to have responsive records; the search methods used; descriptions of searches performed; or the names of agency personnel who conducted the searches. Nor does the FDIC provide a declaration from an employee with firsthand knowledge of the searches performed. The FDIC simply ignored its burden required by FOIA and submitted an affidavit of an employee who was only told that the searches were adequate.

Moreover, Plaintiff asserts that the searches were inadequate because the FDIC did not search for records and did not produce such records or state that the records were being withheld under claims of exemption. Plaintiff requested any and all information available on the three recommendations made by the FDIC. In response to the requests, the FDIC only provided a single set of minutes and a single supporting memorandum for each of the recommendations. The FDIC did not produce any email correspondence, meeting notes, or memoranda. The GAO report specifically indicated that such records exist. According to the GAO, “over a period of a few days, through e-mail, memorandums, telephone calls, and emergency meetings” FDIC

officials had discussions among themselves, Federal Reserve officials, and Department of the Treasury officials “about whether to invoke the systemic risk exception.” GAO Report at 7.

The few records that the FDIC did produce to Plaintiff also show the inadequacy of the search. For example, with respect to the TLG Program, the produced Meeting Minutes refer to a study performed by FDIC staff:

Mr. Brown then stated that *a recent study by [FDIC] staff* on the effect of a run on uninsured deposits on economic activity indicates that a 5 percent run would reduce GDP growth by 1.16 percent per annum in a normal economy while the same run on a stressed economy could decrease GDP growth by as much as 1.96 percent per annum.

Minutes of the Meeting of the Board of Directors of the FDIC, October 13, 2008, Bates No. 56470 (Exhibit B) (emphasis added). This study is responsive to Plaintiff’s request and should have been produced or identified in the *Vaughn* index if the FDIC seeks to withhold it. Moreover since the study is mentioned in a record produced by the FDIC, the FDIC cannot claim to be unaware of the study’s existence and should be able to locate it easily.

Because other records exist that are responsive to Plaintiff’s requests, the FDIC has not produced all responsive records. The FDIC moreover has not shown that its search was reasonable in light of these other documents. *Perry*, 684 F.2d at 128 (“Perhaps most troublesome in gauging the adequacy of the agency’s search is the fact that additional documents were found and released after affidavits were executed by federal officials stating that no further records responsive to appellant’s request remained in agency control.”). The FDIC has failed to satisfy its burden and should re-search for all responsive records.

B. The FDIC Has Failed to Meet its Burden of Withholding Records Under FOIA and the Sunshine Act.

1. The Defendant, Not the Plaintiff, has the Burden.

The primary purpose behind both FOIA and the Sunshine Act is to “make the government more fully accountable to the people.” *Common Cause v. Nuclear Regulatory Comm.*, 674 F.2d 921, 928 (D.C. Cir. 1982). To that end, Congress established legal mechanisms to assist the public in gaining access to agency records. Where a plaintiff in most civil litigation cases has the same factual information as the defendant, the typical FOIA case “distorts the traditional adversary nature of our legal system’s form of dispute resolution.” *Judicial Watch, Inc. v. Food and Drug Admin.*, 449 F.3d 141, 145 (D.C. Cir. 2006) (quoting *King v. U.S. Dep’t of Justice*, 830 F.2d 210, 218 (D.C. Cir. 1987)). “When a party submits a FOIA request, it faces an ‘asymmetrical distribution of knowledge’ where the agency alone possesses, reviews, discloses, and withholds the subject matter of the request.” *Judicial Watch, Inc.*, 449 F.3d at 145. Because of this lopsided relationship, the burden in litigation is on the agency to establish its right to withhold information from the public. *Coastal States Gas Corp. v. Dep’t of Energy*, 617 F.2d 854, 861 (D.C. Cir. 1980). To establish its right and enable “the adversary system to operate by giving the requester as much information as possible, on the basis of which he can present his case to the trial court,” the agency may rely on *Vaughn* indexes and agency declarations. *Gallant v. NLRB*, 26 F.3d 168, 172-173 (D.C. Cir. 1994).

The burden similarly is placed on the agency because of “the strong presumption in favor of disclosure.” *United States Dep’t of State v. Ray*, 502 U.S. 164, 173 (1991). FOIA generally requires complete disclosure of requested agency information unless the information falls into one of nine clearly delineated exemptions. 5 U.S.C. § 552(b); see also *Department of Air Force v. Rose*, 425 U.S. 352, 360-61 (1976) (discussing the history and purpose of FOIA and the

structure of FOIA exemptions). Consequently, it is the agency's burden to "prove that each document that falls within the class requested either has been produced, is unidentifiable, or is wholly exempt from the Act's inspection requirements." *Goland v. CIA*, 607 F.2d 339, 352 (D.C. Cir. 1978).

To provide the requester with as much information as possible and to sustain its burden of proof on a claim of exemption, an agency must provide a "relatively detailed justification, specifically identifying the reasons why a particular exemption is relevant and correlating those claims with the particular part of a withheld document to which they apply." *King*, 830 F.2d at 219; *see also Mead Data Central, Inc. v. U.S. Dep't of the Air Force*, 566 F.2d 242, 251 (D.C. Cir. 1977). An agency cannot satisfy its burden under FOIA by submitting affidavits or declarations that contain conclusory statements or merely recite legal standards. *Oglesby v. U.S. Dep't of the Army*, 79 F.3d 1172, 1176 (D.C. Cir. 1996); *Washington Post Co. v. Dep't of Health and Human Services*, 690 F.2d 252, 257 (D.C. Cir. 1982); *Founding Church of Scientology v. Bell*, 603 F.2d 945, 947 (D.C. Cir. 1979) (holding that, without the requisite specificity, "neither reviewing courts nor individuals seeking agency records can evaluate an agency's response to a request for government records").

Moreover, "barren assertions that an exemption statute has been met cannot suffice to establish the fact." *Banks v. Dep't of Justice*, 2010 U.S. Dist. LEXIS 29823, *12 (D.D.C. March 29, 2010) (quoting *Founding Church of Scientology*, 610 F.2d at 831). "Nor can an agency meet its obligation simply by quoting the statutory language of an exemption." *Id.* (citing *Army Times Pub. Co. v. Dep't of the Air Force*, 998 F.2d 1067, 1070 (D.C. Cir. 1993)) (remarking that affidavits "[p]arrot[ing] the case law" were insufficient); *Voinche v. Federal Bureau of*

Investigation, 412 F. Supp.2d 60, 69 (D.D.C. 2006) (agency failed to satisfy its burden where declaration “merely quote[d] the statutory language” of an exemption).

2. The FDIC’s Declaration and Vaughn Index are Inadequate.

As the FDIC correctly asserts, “Agency declarations in FOIA lawsuits should be clear, specific, and reasonably detailed, and describe the withheld information in a factual and nonconclusory manner.” FDIC’s Opp. at 4 (citing *Pickering-George v. Registration Unit, DEA/DOJ*, 553 F. Supp. 2d 3, 5 (D.D.C. 2008)). The FDIC’s declaration, however, fails to do just that. Mr. Jackson does not testify with any degree of specificity. Instead, Mr. Jackson testifies, “FDIC responded ... with a two-page cover letter [for each request] explaining the exemptions claimed for certain material that was withheld from disclosure.” Jackson Decl. at ¶¶ 27, 28, and 29. Mr. Jackson does not testify as to which records are being withheld. Nor does he testify to why the records are being withheld. He simply references the two-page cover letters that accompany the FDIC’s productions. The cover letters are basic, standard FOIA responses that could apply to any FOIA request sent to the FDIC: they inform Plaintiff that a search was performed, state in generic terms the claims of exemptions, and notify Plaintiff of his right to an administrative appeal. They do not provide Plaintiff or the Court with any additional, meaningful information. Even if these documents were verified or declared under the penalty of perjury, their content would fail to satisfy the burden placed on the FDIC.

The *Vaughn* index is similarly inadequate. As will be addressed below, the FDIC does not justify its decisions to withhold information under any of the exemptions. The FDIC provides only cursory descriptions of the redacted records and fails to elaborate on its basis for claiming that the records are exempt from production. *Banks v. Department of Justice*, 2010 U.S. Dist. LEXIS 29823 at *12 (D.D.C. Mar. 29, 2010) (“[A]n agency [cannot] meet its

obligation simply by quoting the statutory language of an exemption.”). The FDIC simply repeats the statutory language of the exemptions, but, in some instances, even fails to do that properly. *See infra* pp. 17-18, 19.

3. The FDIC Has Improperly Withheld Information Pursuant to Exemption 4 of FOIA and the Sunshine Act.

FOIA’s Exemption 4 and the Sunshine Act’s Exemption 4 (collectively referred to as “Exemption 4”) are identical: both exempt from disclosure “trade secrets and commercial or financial information obtained from a person that is privileged or confidential.” 5 U.S.C. § 552(b)(4); 5 U.S.C § 552b(c)(4).

The FDIC has failed to show that the withheld information was “obtained from a person.” Although the definition of a person is broadly construed, it does retain significance. *Board of Trade v. Commodity Futures Trading Commission*, 627 F.2d 392, 405 (D.C. Cir. 1980). The withheld information cannot come from or be generated by the agency or even another government agency. *Id.* at 404 (“Lacking any legislative history ... courts ... have read the requirement that information be ‘obtained from a person’ to restrict the exemption's application to data which have not been generated within the Government.”); *see also Bloomberg v. Board of Governors of the Federal Reserve System*, 601 F.3d 143, 148 (2nd Cir. 2010). The withheld information must be obtained from an entity outside the government. Yet, the FDIC fails to show from which banks it received information or how it obtained the information. The FDIC could have obtained the withheld information directly from the banks, from a third party, or from another government agency. The FDIC does not address such questions; it only provides the conclusory statement that the withheld information was “obtained from banks.”

Similarly, the FDIC fails to satisfy its burden of demonstrating that the withheld information is confidential; the FDIC merely claims that this is the case. For a court to

determine whether information is confidential, however, the court must first be informed of whether the agency's receipt of the records from the "person" was compulsory or whether the agency received the records voluntarily from the "person." If the production was compulsory, "it will not be considered confidential unless the submitter can show that disclosure will (1) 'impair the government's ability to obtain necessary information in the future; or (2) cause substantial harm to the competitive position of the person from whom the information was obtained.'" *Defenders of Wildlife v. U.S. Dep't of the Interior*, 314 F. Supp.2d 1, 7-8 (D.D.C. 2004) (citing *Nat'l Parks & Conservation Ass'n v. Morton*, 498 F.2d 765, 770 (D.C. Cir. 1974)). If the information was provided to the government voluntarily, it is considered confidential "if it is 'of a kind that would customarily not be released to the public by the person from whom it was obtained.'" *Defenders of Wildlife*, 314 F. Supp.2d at 7-8 (quoting *Critical Mass Energy Project v. Nuclear Regulatory Comm'n*, 975 F.2d 871, 879 (D.C. Cir. 1992) (*en banc*)). Yet, the FDIC has not stated whether the information withheld from Plaintiff was produced to the FDIC voluntarily or if its production was compulsory.

For purposes of the Exemption 4 withholdings, the FDIC has done nothing more than assert that the withheld information is "Confidential commercial and financial information obtained from banks." See *Vaughn* Index. The FDIC does not even attempt to show that the production of the information was compulsory or that it was provided voluntarily. Nor does the FDIC attempt to satisfy any of the tests required for information to be withheld as confidential. Again, such "barren assertions" fail to satisfy the FDIC's burden. *Banks*, 2010 U.S. Dist. LEXIS 29823 at *12. The FDIC has had ample opportunity to present all such evidence; yet it has chosen not to.

4. The FDIC Has Improperly Withheld Information Pursuant to Exemption 5 of FOIA.

Exemption 5 of FOIA allows an agency to withhold records that are “inter-agency or intra-agency memorandums or letters which would not be available by law to a party other than an agency in litigation with the agency.” 5 U.S.C. § 552 (b)(5). Courts have recognized three types of Exemption 5 withholdings: the deliberative process privilege, the attorney-client privilege, and the attorney work product doctrine. *See Coastal States Gas Corp.*, 617 F.2d at 862. The FDIC purportedly invokes the deliberative process privilege.

In order to withhold information pursuant to the deliberative process privilege, an agency must demonstrate that the information would “reveal ‘advisory opinions, recommendations and deliberations comprising part of a process by which governmental decisions and policies are formulated.’” *In re Sealed Case*, 121 F.3d 729, 737 (D.C. Cir. 1997) (quoting *Carl Zeiss Stiftung v. V.E.B. Carl Zeiss, Jena*, 40 F.R.D. 318, 324 (D.D.C. 1966)). Further, the information must be “predecisional and it must be deliberative” and “not shield documents that simply state or explain a decision the government has already made or protect material that is purely factual.” *In re Sealed Case*, 121 F.3d at 737.

The purpose of the deliberative process privilege is to protect the “quality of administrative decision-making [which] would be seriously undermined if agencies were forced to ‘operate in a fishbowl’ because the full and frank exchange of ideas on legal or policy matters would be impossible.” *Mead Data Central, Inc.*, 556 F.2d at 256; *Dudman Comm. Corp. v. Dep’t of the Air Force*, 815 F.2d 1563, 1567 (D.C. Cir. 1987) (“[W]ere agencies forced to operate in a fishbowl, the frank exchange of ideas and opinions would cease and the quality of administrative decisions would consequently suffer.”); *Petroleum Information Corp v. U.S. Dep’t of the Interior*, 976 F.2d 1429, 1433-1434 (D.C. Cir. 1992) (“While the deliberative

process privilege serves a number of related purposes, its ‘ultimate aim’ is to ‘prevent injury to the quality of agency decisions.’” (*citing* NLRB v. Sears Roebuck & Co. 421 U.S. 132, 151 (1975)). As the Court in *Dudman Comm. Corp.*, explained:

Congress enacted Exemption 5 to protect the executive’s deliberative processes – not to protect specific materials. Although courts focusing merely on the nature of the material sought will usually act consistently with the congressional purpose, they will in some instances reach plainly inappropriate results . . . Courts therefore began to focus less on the nature of the materials sought and more on the effect of the materials’ release: the key question in Exemption 5 cases became whether the disclosure of materials would expose an agency’s decision making process in such a way as to discourage candid discussion within the agency and thereby undermine the agency’s ability to perform its functions.

Dudman Comm. Corp., 815 F.2d at 1568. Therefore, in order to succeed on a deliberative process privilege claim under Exemption 5, an agency must demonstrate that the withheld information at issue “would actually inhibit candor in the decision making process if available to the public.” *Army Times Pub. Co.*, 998 F.2d at 1072. “An agency cannot meet its statutory burden of justification by conclusory allegations of possible harm.” *Mead Data Central, Inc.*, 556 F.2d at 258. “It must show by specific and detailed proof that disclosure would defeat, rather than further, the purposes of the FOIA.” *Id.*

The FDIC has withheld information that does not consist of deliberations comprising part of the decision-making process regarding the three recommendations. Rather, the FDIC has withheld information that details the actions to be taken and explains the FDIC’s decisions. *In re Sealed Case*, 121 F.3d at 737. For example, the FDIC has withheld in entirety five pages of information identified as “Summary” and “Conclusion.” Memorandum of the Board of Directors regarding FDIC Guarantee of Bank Debt, dated October 13, 2008, at 9-14 (Exhibit C). The purpose of a summary and conclusion is to describe the end result. They do not lay out “the full and frank exchange of ideas” that Exemption 5 aims to protect. *Dudman Comm. Corp.*, 815

F.2d at 1567. For that reason, records that summarize the three recommendations made by the FDIC should be released in their entirety. *See also* Memorandum of the Board of Directors regarding Bank of America, dated January 15, 2009, at 16-18 (Exhibit D); Memorandum of the Board of Directors regarding Citibank, dated November 23, 2008, at 12-18 (Exhibit E).

Generally, the FDIC does not even attempt to satisfy the requirements of Exemption 5. The FDIC merely alleges that the withheld information is “Deliberative and predecisional.” *See Vaughn Index*. Again, such “barren assertions” that do nothing more than repeat the language of the statute fail to satisfy the FDIC’s burden. *Banks*, 2010 U.S. Dist. LEXIS 29823 at *12. Nowhere does the FDIC show that the withheld information is either deliberative or predecisional. Nor has the FDIC demonstrated that disclosure of the withheld information “would actually inhibit candor” or otherwise harm its decision making process. The FDIC’s Exemption 5 claim should be rejected.

5. The FDIC Has Improperly Withheld Information Pursuant to Exemption 8 of FOIA and the Sunshine Act.

FOIA’s Exemption 8 and the Sunshine Act’s Exemption 8 (collectively referred to as “Exemption 8”) are identical: both exempt from disclosure information “contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.” 5 U.S.C. § 552(b)(8); 5 U.S.C § 552b(c)(8).

First, the FDIC does not even parrot the language of Exemption 8 in the *Vaughn Index*. The FDIC describes the withheld information as “Information derived from or related to financial institution examination, operating, or condition reports.” *See Vaughn Index*. “Contained in” and “derived from” have very distinct meanings. Information “contained in” a financial institution’s examination, operating, or condition report is information actually found in

such a report. Information “derived from” a financial institution’s examination, operating, or condition report could be information drawn from such a report, but then revised, augmented, analyzed, or changed in some way. The phrase “derived from” is broader than the actual language of Exemption 8.

Second, the *Vaughn* Index makes no mention of any specific examination, operating, or condition reports in which the withheld information was contained or to which the information was related. It identifies no particular bank examiner’s report or condition or operating report to which the information relates. It does not state who prepared the report, when the report was prepared, or why the report was prepared. It also does not state pursuant to what specific authority the report was prepared. The FDIC does nothing more than *incorrectly* replicate the language of Exemption 8.

Third, in order for Exemption 8 to apply, the withheld information must be contained in or related to the reports at issue, and must have been “prepared by, or on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.” 5 U.S.C. § 552 (b)(8). The FDIC fails to provide any basis in fact for concluding that any particular piece of withheld information relates to a particular report “prepared by or on behalf of, or for the use of” the FDIC. Again, such “barren assertions” fail to satisfy the FDIC’s burden. *Banks*, 2010 U.S. Dist. LEXIS 29823 at *12. The FDIC fails to satisfy its burden of showing that its Exemption 8 claim is proper.

6. The FDIC Has Improperly Withheld Information Pursuant to Exemption 9 of the Sunshine Act.

Sunshine Act Exemption 9(A)(ii) allows an agency to withhold information if its “premature” disclosure would “significantly endanger the stability of any financial institution.” 5 U.S.C. §552b(c)(9)(A)(ii). As with its other claims of exemptions, the FDIC fails to

adequately show that the information was properly withheld. The FDIC baldly asserts, “Disclosure would endanger stability of a financial institution.” *See Vaughn* Index. First, the FDIC fails to address the temporal aspect of the exemption, completely ignoring the “premature” component of the test. Second, the FDIC does not even mimic the language of the exemption properly. Under Exemption 9, disclosure must “significantly endanger the stability of any financial institution.” Yet, the FDIC’s *Vaughn* index only asserts that disclosure of the information will “endanger stability.” Third, the FDIC does not even try to show that the stability of any financial institution would be endangered “significantly” by the disclosure of the withheld information. Again, such “barren assertions” fail to satisfy the FDIC’s burden. *Banks*, 2010 U.S. Dist. LEXIS 29823 at *12. The FDIC’s Exemption 9 claim should be rejected.

7. The FDIC Has Failed to Meet Its Segregability Burden.

Finally, an agency must demonstrate that, even where particular exemptions have been properly applied, all non-exempt information has been segregated and disclosed. *Sussman v. U.S. Marshals Service*, 494 F.3d 1106, 1116 (D.C. Cir. 2007); *Shurberg Broadcasting of Hartford v. Federal Communications Commission*, 617 F. Supp. 825, 828 (D.D.C. 1985). A segregability determination is absolutely essential to any FOIA decision. *See Summers v. Dep’t of Justice*, 140 F.3d 1077, 1081 (D.C. Cir. 1998). The segregability analysis required by FOIA and the Sunshine Act cannot be understated. Courts have held that “even where specific exemptions apply, the agency is required to conduct a segregability analysis and determine if any non-exempt portions of the record can be released.” *Mead Data Central*, 566 F.2d at 260. This requirement is so essential that, “before approving the application of a FOIA exemption, the district court must make specific findings of segregability regarding the documents to be withheld ... [and] [i]f the district court approves withholding without such a finding, remand is

required even if the requester did not raise the issue of segregability before the court.” *Sussman*, 494 F.3d at 1116 (citing *Johnson v. Exec. Office for United States Attys.*, 310 F.3d 771, 776 (D.C. Cir. 2002)). Nowhere does the FDIC show that it has segregated and disclosed all non-exempt information. It is the burden of the FDIC to do so, and, once again, the FDIC has failed to satisfy its burden.

C. The Responsive Records Should Be Produced.

If an agency fails to satisfy its burden, the presumption of disclosure requires that the requested information be produced. *Military Audit Project v. Casey*, 656 F.2d 724, 738 (D.C. Cir. 1981). *Id.* A requester may prevail on summary judgment simply by demonstrating that the agency has failed to satisfy its burden as a matter of law. *Id.* The FDIC has failed to establish as a matter of law that it is entitled to withhold the requested information. The FDIC’s assertion that Plaintiff failed to present evidence is irrelevant. Since the FDIC has had ample opportunity to satisfy its burden, and has chosen not to do so, the FDIC should release all responsive records.

III. Conclusion.

For the foregoing reasons, Plaintiff respectfully requests that Plaintiff’s cross-motion for partial summary judgment with respect to the FDIC’s unsubstantiated claims of exemption be granted.

Dated: June 4, 2010

Respectfully submitted,

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Exhibit A



Report to Congressional Committees

April 2010

FEDERAL DEPOSIT INSURANCE ACT

Regulators' Use of Systemic Risk Exception Raises Moral Hazard Concerns and Opportunities Exist to Clarify the Provision



April 2010



Highlights of [GAO-10-100](#), a report to congressional committees

Why GAO Did This Study

In 2008 and 2009, the Federal Deposit Insurance Corporation (FDIC) provided emergency assistance that required the Secretary of the Department of the Treasury (Treasury) to make a determination of systemic risk under the systemic risk exception of the Federal Deposit Insurance Act (FDI Act). The FDI Act requires GAO to review each determination made. For the three determinations made to date, this report examines (1) steps taken by FDIC, the Board of Governors of the Federal Reserve System (Federal Reserve), and Treasury to invoke the exception; (2) the basis of the determination and the purpose of resulting actions; and (3) the likely effects of the determination on the incentives and conduct of insured depository institutions and uninsured depositors. To do this work, GAO reviewed agency documentation, relevant laws, and academic studies; and interviewed regulators and market participants.

What GAO Recommends

To better ensure transparency and accountability, Congress should consider amending the FDI Act to require Treasury to document reasons for not making a determination for an announced action and to clarify the requirements and exception. As Congress considers financial regulatory reform, it should ensure greater regulatory oversight of systemically important institutions to mitigate the effects of weakened market discipline from use of the systemic risk exception. The Federal Reserve and Treasury generally agreed with our findings.

View [GAO-10-100](#) or [key components](#). For more information, contact Orice Williams Brown, (202) 512-8678, williamsob@gao.gov.

FEDERAL DEPOSIT INSURANCE ACT

Regulators' Use of Systemic Risk Exception Raises Moral Hazard Concerns and Opportunities Exist to Clarify the Provision

What GAO Found

Treasury, FDIC, and the Federal Reserve collaborated before the announcement of five potential emergency actions that would require a systemic risk determination. In each case, FDIC and the Federal Reserve recommended such actions to Treasury, but Treasury made a determination on only three of the announced actions. Although two recommendations have not resulted in FDIC actions to date, their announcement alone could have created the intended effect of increasing confidence in institutions, while similarly generating negative effects such as moral hazard. However, because announcements without a determination do not trigger FDI Act requirements for documentation and communication, such as Treasury consultation with the President and notification to Congress, such de facto determinations heightened the risk that the decisions were made without the level of transparency and accountability intended by Congress. Further, uncertainties can arise because there is no requirement for Treasury to communicate that it will not be invoking a systemic risk determination for an announced action.

Two of Treasury's systemic risk determinations—for Wachovia and Citigroup—were made to avert the failure of an institution that regulators determined could exacerbate liquidity strains in the banking system. A third determination was made to address disruptions to bank funding affecting all banks. Under this latter determination, FDIC established the Temporary Liquidity Guarantee Program (TLGP), which guaranteed certain debt issued through October 31, 2009, and certain uninsured deposits of participating institutions through December 31, 2010, to restore confidence and liquidity in the banking system. While there is some support for the agencies' position that the statute authorizes systemic risk assistance of some type under TLGP facts and that it permits assistance to the entities covered by the program, there are questions about these interpretations, under which FDIC created a broad-based program of direct assistance to institutions that had never before received such relief—"healthy" banks, bank holding companies, and other bank affiliates. Because these issues are matters of significant public interest and importance, the statutory requirements may require clarification.

Regulators' use of the systemic risk exception may weaken market participants' incentives to properly manage risk if they come to expect similar emergency actions in the future. The financial crisis revealed limits in the current regulatory framework to restrict excessive risk taking by financial institutions whose market discipline is likely to have been weakened by the recent use of the systemic risk exception. Congress and regulators are considering reforms to the current regulatory structure. It is important that such reforms subject systemically important financial institutions to stricter regulatory oversight. Further, legislation has been proposed for an orderly resolution of financial institutions not currently covered by the FDI Act. A credible resolution regime could help impose greater market discipline by forcing participants to face significant costs from their decisions and preclude a too-big-to-fail dilemma.

Contents

Letter		1
	Background	4
	Documentation Evidences Interagency Collaboration, but Announcements of FDIC Actions That Did Not Result in a Systemic Risk Determination Create Accountability and Transparency Concerns	7
	Systemic Risk Determinations Authorized FDIC Guarantees That Regulators Determined Were Needed to Avert Adverse Effects on Financial and Economic Conditions	12
	Systemic Risk Determinations and Related Federal Assistance Raise Concerns about Moral Hazard and Market Discipline That May Be Addressed by Potential Regulatory Reforms	28
	Conclusions	36
	Matters for Congressional Consideration	39
	Agency Comments and Our Evaluation	39
Appendix I	Objectives, Scope, and Methodology	41
Appendix II	Analysis of Legal Authority for the Temporary Liquidity Guarantee Program (TLGP)	43
Appendix III	Comments from the Board of Governors of the Federal Reserve System	61
Appendix IV	Comments from the Department of the Treasury	64
Appendix V	GAO Contact and Staff Acknowledgments	65
Table		
	Table 1: TLGP Eligibility and Fee Requirements	21

Figures

Figure 1: Overview of Steps Regulators Must Take to Invoke Systemic Risk Exception	9
Figure 2: Three-Month LIBOR and 3-Month Treasury Bill Yield, as of November 21, 2008	17

Abbreviations

AIG	American International Group, Inc.
ARM	adjustable-rate mortgage
DGP	Debt Guarantee Program
FDI Act	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
Federal Reserve	Board of Governors of the Federal Reserve System
LLP	Legacy Loans Program
OCC	Office of the Comptroller of the Currency
PDCF	Primary Dealer Credit Facility
PPIP	Public-Private Investment Program
SIGTARP	Special Inspector General for the Troubled Asset Relief Program
TAGP	Transaction Account Guarantee Program
TLGP	Temporary Liquidity Guarantee Program
TARP	Troubled Asset Relief Program
Treasury	Department of the Treasury

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United States Government Accountability Office
Washington, DC 20548

April 15, 2010

The Honorable Christopher J. Dodd
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Barney Frank
Chairman
The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
House of Representatives

In late 2008, the federal government took unprecedented steps to stabilize the financial services sector by committing trillions of dollars of taxpayer funds to assist financial institutions and restore order to credit markets. One of these steps was the use of the “systemic risk” exception contained in the Federal Deposit Insurance Act (FDI Act), which Congress enacted as part of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).¹ Under the systemic risk exception, the Federal Deposit Insurance Corporation (FDIC) can provide certain emergency assistance authorized in the provision if the Secretary of the Department of the Treasury (Treasury), in consultation with the President and upon written recommendation of FDIC and the Board of Governors of the Federal Reserve System (Federal Reserve), determines that compliance with certain cost limitations would result in serious adverse effects on economic conditions or financial stability and that such assistance could mitigate these systemic effects. Such a determination exempts FDIC from the FDI Act’s least-cost rule, which requires FDIC to use the least costly method when assisting an insured institution and prohibits FDIC from increasing losses to the Deposit Insurance Fund by protecting creditors and uninsured depositors of an insured institution.

On September 29, 2008, the Secretary of the Treasury invoked the systemic risk exception for the first time since the enactment of FDICIA. This first

¹Pub. L. No. 102-242, sec. 141 (1991), codified at 12 U.S.C. § 1823(c)(4)(G).

determination authorized FDIC to provide assistance to facilitate a sale of Wachovia Corporation's (Wachovia) banking operations to Citigroup Inc. (Citigroup). At the time, Wachovia was the fourth-largest banking organization in terms of assets in the United States. On October 14, 2008, the Secretary of the Treasury again invoked the systemic risk provision, in order to allow FDIC to provide certain assistance to insured depository institutions, their holding companies, and qualified affiliates under the Temporary Liquidity Guarantee Program (TLGP). Under TLGP, FDIC has guaranteed newly issued senior unsecured debt up to prescribed limits for insured institutions, their holding companies, and qualified affiliates and provided temporary unlimited coverage for certain non-interest-bearing transaction accounts at insured institutions. TLGP's debt guarantee program ceased issuing new guarantees on October 31, 2009, and TLGP's transaction account guarantees remain in effect for insured institutions participating in an extension expiring on December 31, 2010.² A third systemic risk determination, on January 15, 2009, permitted FDIC to provide assistance to Citigroup, the third-largest U.S. banking organization by asset size at the end of the third quarter of 2008. FDIC and the Federal Reserve also made two other recommendations to Treasury—to authorize FDIC to provide open bank assistance to Bank of America Corporation (Bank of America) and to support the Public-Private Investment Program's (PPIP) proposed Legacy Loans Program (LLP)—neither of which had resulted in a systemic risk determination as of this report's issuance date. Treasury is no longer considering making a systemic risk determination for the announced assistance to Bank of America as Treasury, FDIC, and the Federal Reserve agreed with Bank of America to terminate the term sheet with respect to this assistance. Under LLP, FDIC would provide certain guarantees on the financing used by public-private investment funds to purchase distressed loans and other troubled assets from financial institutions to help restore their balance sheets.

The FDI Act requires GAO to review and report to Congress on each systemic risk determination made by the Secretary of the Treasury.³ For the three systemic risk determinations made as of March 2010, this report examines (1) the steps taken by Treasury, the Federal Reserve, and FDIC to invoke the systemic risk exception; (2) the basis for each determination

²On April 13, 2010, FDIC's Board of Directors approved an interim rule to extend the program providing transaction account guarantees to December 31, 2010, and noting FDIC may further extend the deadline to December 31, 2011.

³12 U.S.C. § 1823(c)(4)(G)(iv).

and the purpose of actions taken pursuant to each determination; and (3) the likely effects of each determination on the incentives and conduct of insured depository institutions and uninsured depositors.

To address our objectives, we reviewed and analyzed documentation of Treasury's systemic risk determinations and the supporting recommendations that FDIC and the Federal Reserve made. We also reviewed FDI Act requirements for transparency and accountability with respect to the use of the systemic risk exception and analyzed the implications of announcements that are not followed by a Treasury determination that would trigger these requirements. In addition, we collected and analyzed various data to illustrate financial and economic conditions at the time of each determination and the actions taken pursuant to each determination. We reviewed and analyzed the research reports of one credit rating agency and studies identifying the likely effects of each determination and the actions taken on the incentives and conduct of insured depository institutions and uninsured depositors. We also reviewed prior GAO work on the financial regulatory system. In addition we interviewed three economists, one banking industry association, and a banking analyst as well as officials from Treasury, FDIC, the Federal Reserve and the Office of the Comptroller of the Currency (OCC) to gain an understanding of their collaboration prior to making systemic risk determinations, the basis and authority for each determination, and the purpose of the actions taken under each determination. To perform our review of whether the legal requirements for making determinations and providing assistance under the systemic risk exception were met with respect to TLGP, we reviewed applicable statutes, regulations, guidance, and agency materials and obtained the legal views of agency officials, practitioners, and academics.

The work upon which this report is based was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. This work was conducted between October 2008 and April 2010.

Background

The dramatic decline in the U.S. housing market that began in 2006 precipitated a decline in the price of mortgage-related assets, particularly mortgage assets based on subprime loans, in 2007. Some institutions found themselves so exposed that they were threatened with failure, and some failed because they were unable to raise capital or obtain liquidity as the value of their portfolios declined. Other institutions, ranging from government-sponsored enterprises such as Fannie Mae and Freddie Mac to large securities firms, were left holding “toxic” mortgages or mortgage-related assets that became increasingly difficult to value, were illiquid, and potentially had little worth. Moreover, investors not only stopped buying private-label securities backed by mortgages but also became reluctant to buy securities backed by other types of assets. Because of uncertainty about the liquidity and solvency of financial entities, the prices banks charged each other for funds rose dramatically, and interbank lending conditions deteriorated sharply. The resulting liquidity and credit crunch made the financing on which businesses and individuals depend increasingly difficult to obtain. By late summer of 2008, the ramifications of the financial crisis ranged from the continued failure of financial institutions to increased losses of individual savings and corporate investments and further tightening of credit that would exacerbate the emerging global economic slowdown.

Treasury and federal financial regulators play a role in regulating and monitoring the financial system. Historically, Treasury’s mission has been to act as steward of U.S. economic and financial systems. Among its many activities, Treasury has taken a leading role in addressing underlying issues such as those precipitating the recent financial crisis. The key federal banking regulators include the following:

- The Federal Reserve, an independent agency that is responsible for conducting the nation’s monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates; supervising and regulating bank holding companies and state-chartered banks that are members of the Federal Reserve System; and maintaining the stability of the financial system and containing systemic risk that may arise in financial markets through its role as lender of last resort;
- FDIC, an independent agency created to help maintain stability and public confidence in the nation’s financial system by insuring deposits, examining and supervising insured state-chartered banks that are not members of the Federal Reserve System, and resolving failed or failing banks;

-
- OCC, which charters and supervises national banks; and the
 - Office of Thrift Supervision, which supervises savings associations (thrifts) and savings and loan holding companies.

In 1991, Congress enacted FDICIA in response to the savings and loan crisis. FDICIA enacted a number of reforms, including some designed to address criticisms that federal regulators had not taken prompt and forceful actions to minimize or prevent losses to the deposit insurance funds caused by bank and thrift failures. Among other things, FDICIA amended the FDI Act by establishing a rule requiring FDIC to follow the least costly approach when resolving an insured depository institution. Specifically, under the least cost rule, FDIC must resolve a troubled insured depository institution using the method expected to have the least cost to the deposit insurance fund and cannot use the fund to protect uninsured depositors and creditors who are not insured depositors if such protection would increase losses to the fund.⁴ To make a least-cost determination, FDIC must (1) consider and evaluate all possible resolution alternatives by computing and comparing their costs on a present-value basis, and (2) select the least costly alternative on the basis of the evaluation. Under the least-cost requirements, FDIC generally has resolved failed or failing banks using three basic methods, which do not constitute open bank assistance. These are: (1) directly paying depositors the insured amount of their deposits and disposing of the failed bank's assets (deposit payoff and asset liquidation); (2) selling only the bank's insured deposits and certain other liabilities, and some of its assets, to an acquirer (insured deposit transfer); and (3) selling some or all of the failed bank's deposits, certain other liabilities, and some or all of its assets to an acquirer (purchase and assumption). According to FDIC officials, they have most commonly used purchase and assumption, as it is often the least costly and disruptive alternative.⁵

FDICIA also amended the FDI Act to create an exception to the least-cost requirements, known as the systemic risk exception, that allows FDIC assistance without complying with the least cost rule if compliance would

⁴12 U.S.C. § 1823(c)(4)(A)-(B), (E).

⁵In an open bank assistance transaction, FDIC provides assistance to an operating insured institution. Because of the restrictions imposed by the least cost rules and post-FDICIA statutory limitations on FDIC assistance, until its recent assistance under the systemic risk determinations, FDIC had not provided open bank assistance since 1992.

have “serious adverse effects on economic conditions and financial stability”—that is, would cause systemic risk—and if such assistance would “avoid or mitigate such adverse effects.” FDIC may act under the exception only under the process specified in the statute. The FDIC Board of Directors and the Board of Governors of the Federal Reserve System each must recommend use of the exception by a vote of not less than two-thirds of their respective members and deliver a written recommendation to the Secretary of the Treasury. Based on a review of the FDIC and Federal Reserve recommendations, the Secretary of the Treasury, in consultation with the President, may make a systemic risk determination authorizing FDIC to take action or provide assistance that does not meet the least-cost requirements.⁶ For example, under a systemic risk determination, FDIC is not bound to identify and follow the least-cost resolution strategy and may provide assistance (such as debt or deposit guarantees) that protects uninsured depositors and creditors, who otherwise might suffer losses under a least-cost method such as a purchase and assumption or depositor payoff. Until recently, the systemic risk exception required FDIC to recover any resulting losses to the insurance fund by levying one or more emergency special assessments on insured depository institutions. Congress amended this requirement in May 2009 to also authorize assessments on bank holding companies, and savings and loan holding companies. Finally, the systemic risk exception includes requirements that serve to ensure accountability for regulators’ use of this provision. The Secretary of the Treasury must notify Congress in writing of any systemic risk determination and must document each determination and retain the documentation for GAO review, and GAO must report its findings to Congress.

⁶As discussed below and in app. II, Treasury, FDIC, and the Federal Reserve believe a systemic risk determination waives all other restrictions on FDIC assistance and authorizes additional measures not otherwise allowed by the FDI Act, provided this would avoid or mitigate the systemic risk.

Documentation Evidences Interagency Collaboration, but Announcements of FDIC Actions That Did Not Result in a Systemic Risk Determination Create Accountability and Transparency Concerns

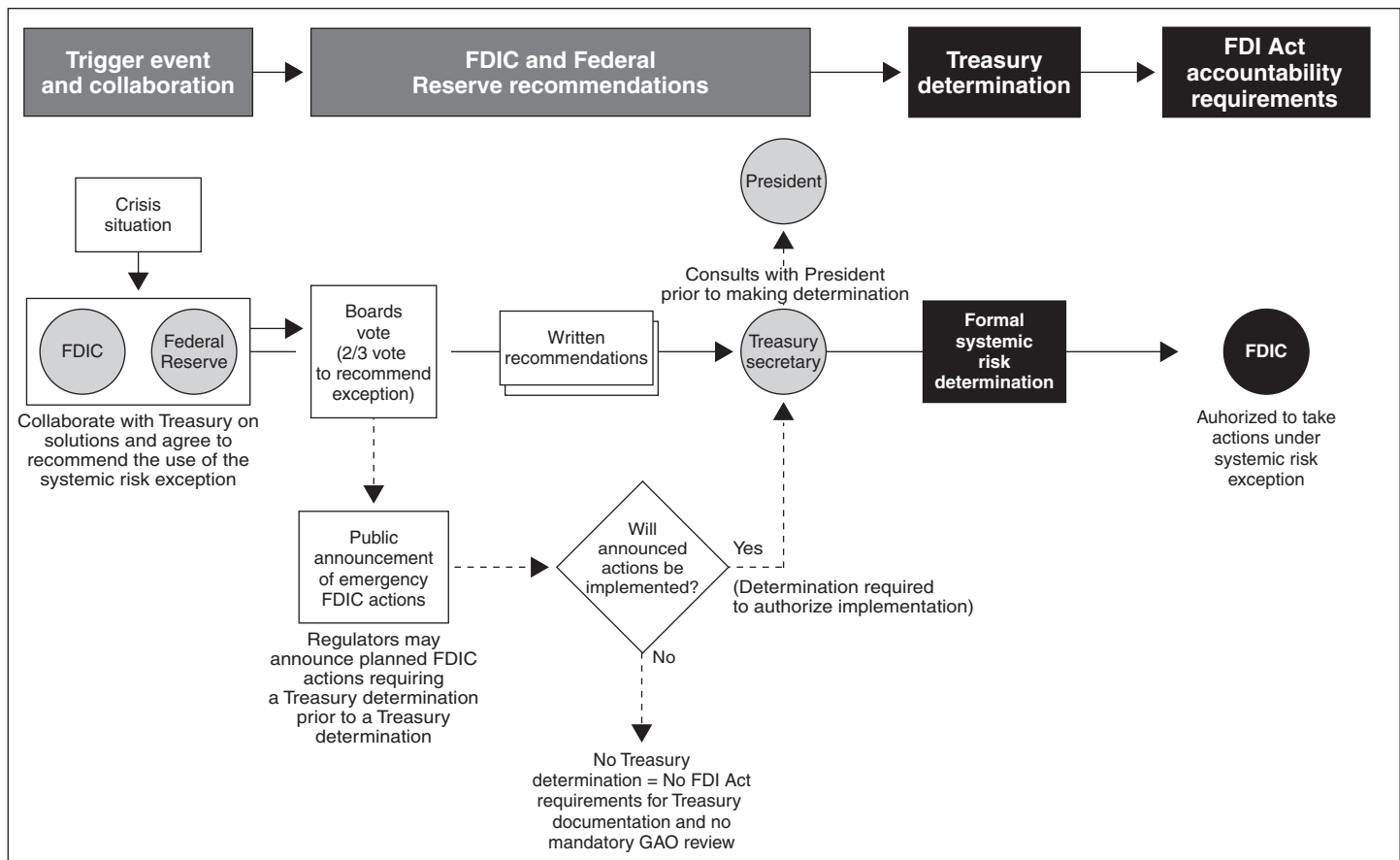
On five occasions, collaboration among high-level officials at Treasury, FDIC, and the Federal Reserve resulted in the announcement of emergency actions that would require a systemic risk exception. FDIC and the Federal Reserve provided written recommendations to the Secretary of the Treasury for all five announced actions, but the Secretary has made a determination on only three of these announcements. Treasury made the first two determinations concurrent with the initial announcements, and the third determination was made nearly 2 months after the announcement of action. Treasury has not made a determination on the remaining two announced actions which have not been implemented to date. Such announcements can affect market expectations and contribute to moral hazard, but the announcements alone—absent a Treasury determination—do not trigger requirements established by Congress for documentation and communication of the agencies' use of the systemic risk exception. Such requirements serve to ensure transparency and accountability related to the application of the systemic risk exception.

Treasury, FDIC, and the Federal Reserve Collaborated before Announcing Emergency Actions

On five occasions between late 2008 and early 2009, regulators announced potential emergency actions that would require a systemic risk determination before they could be implemented. In each case, a liquidity crisis—either at a single institution or across the banking industry—triggered discussions among FDIC, Federal Reserve, and Treasury officials about whether to invoke the systemic risk exception.⁷ According to regulators, these discussions generally occurred among high-level officials at the three agencies over a period of a few days, through e-mail, memorandums, telephone calls, and emergency meetings. The regulators shared and analyzed information, such as data describing the liquidity pressures facing financial institutions, to help them understand the financial condition of the troubled institutions and the potential systemic implications of complying with the least-cost resolution requirements. In the second section of this report, we discuss in detail publicly available information about the financial condition of the institutions that received emergency assistance, the basis for each decision to invoke the systemic risk exception, and the actions that FDIC took under the provision.

⁷OCC, the primary regulator for the national bank subsidiaries of two institutions involved in FDIC's emergency actions, provided information on the condition of these national banks.

Following these collaborations, FDIC and Federal Reserve staff submitted documentation of their analyses and recommendations to support invoking the systemic risk exception to their respective Boards. In each of the five cases, FDIC's Board of Directors and Federal Reserve Board members voted in favor of recommending a systemic risk determination, and FDIC and the Federal Reserve provided written recommendations to the Secretary of the Treasury (see fig. 1). On each occasion, the regulators issued public statements announcing planned FDIC actions that would require a systemic risk determination for implementation. The Secretary of the Treasury made a determination in response to three of the five recommendations (Wachovia, TLGP, and Citigroup); therefore, we reviewed, as provided by the mandate, documentation related to these three cases. Treasury documents that we reviewed indicate that the Secretary of the Treasury signed and approved the determinations (as required by the FDI Act) and authorized FDIC to take planned action after having reviewed the FDIC and the Federal Reserve's written recommendations and consulted with the President. Also as required by the FDI Act, Treasury sent letters to Congress to notify the relevant committees of all three determinations.

Figure 1: Overview of Steps Regulators Must Take to Invoke Systemic Risk Exception

 Treasury determination = statutory requirements for Treasury documentation and GAO review

Source: GAO.

Announcements of Emergency Actions without a Systemic Risk Determination Diminish the Level of Transparency and Accountability Intended by Congress

In all five cases, planned emergency actions were announced by regulators, but Treasury did not make an immediate determination for three of these announcements and still has not made a determination to date in two of them. In two cases, Wachovia and TLGP, Treasury made a determination before regulators finalized the terms of the assistance. According to Treasury, FDIC, and Federal Reserve officials, they publicly announced emergency assistance prior to a Treasury determination in these cases to reassure the markets that the government was committed to supporting financial market stability. In the Citigroup case, the public announcement preceded Treasury's determination by about 2 months.

Specifically, on November 23, 2008, Treasury, FDIC, and the Federal Reserve jointly announced an agreement-in-principle to assist Citigroup. FDIC and the Federal Reserve delivered written recommendations by early December 2008 and Treasury signed the determination in January 2009 when the finalized agreement was executed.

Since the Citigroup determination, Treasury has not made determinations following two announcements of emergency actions and those announced initiatives have not been implemented. On January 16, 2009, FDIC announced an agreement-in-principle with Bank of America to share losses on a fixed pool of Bank of America assets. Although FDIC and the Federal Reserve provided written recommendations in support of a determination, according to Treasury and FDIC officials, the Secretary of the Treasury did not make a determination at the time because the terms of the agreement had not been finalized. In May 2009, Bank of America requested a termination of the term sheet for the announced guarantee of up to \$118 billion in assets by the U.S. government and in September 2009, the parties to the agreement-in-principle executed a termination agreement in which Bank of America agreed to pay \$425 million to Treasury, the Federal Reserve, and FDIC. Similarly, on March 23, 2009, FDIC and Treasury announced the creation of the PPIP's LLP, but Treasury has not yet made a determination. According to a Treasury official with whom we spoke, Treasury has delayed making a determination while regulators considered how to structure the program.

While important to stabilizing markets, the public announcement of planned actions can serve as a de facto determination by implying that Treasury has made a systemic risk determination. An announcement alone could have given rise to some of the benefits of a systemic risk determination, while similarly generating the potential for negative incentives such as moral hazard. For example, although FDIC did not provide assistance to Bank of America, the announcement of the planned Bank of America guarantees signaled regulators' willingness to provide such assistance and may have achieved to some degree the intended effect of increasing market confidence in Bank of America. The agreement requiring Bank of America to pay a \$425 million termination fee recognized that although the parties never entered into a definitive documentation of the transaction, Bank of America received value from the announced term sheet, including benefits in terms of market confidence in the institution.

Although the effects of announcements and determinations can be similar, determinations must be conducted under procedural and documentation

requirements that do not apply to announcements. Under the determination process, Treasury must consider recommendations from FDIC and the Federal Reserve, consult with the President before making a determination, and document its reasons for making a determination and retain the documentation for later review.⁸ Treasury must also notify Congress in writing of each systemic risk determination. None of these requirements applies when a determination is not made.

We acknowledge that Treasury is not required to make a determination within a set period and recognize the need for some flexibility during crisis situations. However, absent a determination, the agency is not required to follow the formal process put in place by Congress to ensure transparency and accountability in the application of the systemic risk exception. Therefore, when a determination is not made along with the announced actions, Congress cannot be assured that Treasury's reasoning would be open to the same scrutiny required in connection with a formal systemic risk determination because Treasury does not have to act upon the FDI Act's documentation and accountability measures. For instance, Congress cannot be assured that the documentation required to support a determination will be or has been generated, even when the announcement by the agencies can have some of the same effects a systemic risk determination would have. Furthermore, uncertainty in de facto determination situations can arise because Treasury is not required to communicate that it will not make a systemic risk determination for an announced action. For example, since the announcement proposing the creation of the PPIP's LLP in March 2009, it has not been clear whether Treasury intends to make a systemic risk determination, raising questions about whether Treasury will make a determination to authorize the program.

⁸12 U.S.C. § 1823(c)(4)(G)(iii). GAO has discretionary authority under the Banking Agency Audit Act, 31 U.S.C. § 714, and GAO's organic statute, 31 U.S.C. §§ 712, 716, and 717, to obtain documentation of the agencies' recommendations to Treasury and Treasury's response, and to evaluate these actions. The systemic risk exception makes GAO review mandatory and specifies the areas to be covered and reported to Congress. In the absence of a formal Treasury determination, neither Congress nor the public can be assured that the agencies will create or maintain the information needed to conduct a meaningful review.

Systemic Risk Determinations Authorized FDIC Guarantees That Regulators Determined Were Needed to Avert Adverse Effects on Financial and Economic Conditions

The Secretary of the Treasury's three systemic risk determinations authorized FDIC guarantees that FDIC, the Federal Reserve, and Treasury determined were needed to avoid or mitigate further serious adverse effects on already deteriorating financial and economic conditions. Treasury invoked the exception so that FDIC could provide assistance to Wachovia and its insured institution subsidiaries, the banking industry as a whole (through TLGP), and Citigroup and its insured institution subsidiaries.

FDIC Protection against Large Losses on Wachovia Assets Was Intended to Facilitate an Orderly Sale to Citigroup and Avert a Resolution with Potentially Systemic Consequences

In describing the basis for the first systemic risk determination in September 2008, Treasury, FDIC, and the Federal Reserve noted that mounting problems at Wachovia could have led to a failure of the firm, which in turn could have exacerbated the disruption in the financial markets. At the time, the failures and near-failures of several large institutions had increased stress in key funding markets. As noted earlier, by late summer 2008, the potential ramifications of the financial crisis included the continued failure of financial institutions and further tightening of credit that would exacerbate the emerging global economic slowdown that was beginning to take shape. In this environment, many financial institutions, including Wachovia, were facing difficulties in raising capital and meeting their funding obligations. In its recommendation, FDIC said that the rapidly deteriorating financial condition of Wachovia Bank, N.A.—Wachovia's largest bank subsidiary—was due largely to its portfolio of payment-option adjustable-rate mortgage (ARM) products, commercial real-estate portfolio, and weakened liquidity position.⁹ Over the first half of 2008, Wachovia had suffered more than \$9 billion in losses due in part to mortgage-related asset losses and investors increasingly had become concerned about the firm's prospects, given the worsening outlook for home prices and mortgage credit quality. In addition, during the week preceding Treasury's determination, Wachovia's

⁹Payment option ARMs allow borrowers to make payments lower than what would be needed to cover any of the principal or all of the accrued interest.

Treasury, FDIC, and the
Federal Reserve Determined a
Least-Cost Resolution of
Wachovia Would Likely
Exacerbate Market Strains

stock price declined precipitously and the spreads on credit default swaps that provide protection against losses on Wachovia's debt widened, indicating that investors considered a Wachovia default increasingly likely.¹⁰ FDIC consulted with Treasury and the Federal Reserve in conducting an analysis of Wachovia's liquidity and determined that Wachovia would soon be unable to meet its funding obligations as a result of strains on its liquidity, particularly from projected outflows of deposits and retail brokerage accounts.

In considering actions to avert a Wachovia failure, Treasury determined that a least-cost resolution of Wachovia's bank and thrift subsidiaries, without protecting creditors and uninsured depositors, could—in light of conditions in the financial markets and the economy at the time—weaken confidence and exacerbate liquidity strains in the banking system.¹¹ FDIC could have effected a least-cost resolution of Wachovia Bank, N.A. through a depositor payoff or purchase and assumption transaction following appointment of FDIC as the receiver of the bank's assets. FDIC and the Federal Reserve projected that either of these least-cost resolution options would have resulted in no cost to the deposit insurance fund, but that either option likely would have imposed significant losses on subordinated debtholders and possibly senior note holders.¹² In addition, Treasury, the Federal Reserve, and FDIC expected these resolution options to impose losses on foreign depositors, a significant funding source for several large U.S. institutions. Their concerns over the possible significant losses to creditors holding Wachovia subordinated debt and senior debt were reinforced by the recent failure of Washington Mutual, a large thrift holding company. According to Treasury's determination, under the least-cost resolution of Washington Mutual, senior and subordinated debtholders of the holding company and its insured depository subsidiaries suffered large losses. Treasury, FDIC, and the Federal Reserve expressed concern that imposing similarly large losses on Wachovia's creditors and foreign depositors could intensify liquidity pressures on

¹⁰ Credit default swaps provide protection to the buyer of the credit default swap contract if the assets covered by the contract go into default.

¹¹ The four insured depository institution affiliates of Wachovia Bank, N.A. are the following: Wachovia Mortgage, F.S.B.; Wachovia, F.S.B.; Wachovia Bank of Delaware, N.A.; and Wachovia Card Services, N.A.

¹² FDIC concluded that Wachovia Bank, NA, in the event of its failure, would have sufficient uninsured obligations (such as foreign deposits and senior and subordinated debt) to absorb expected losses without requiring payments from the Deposit Insurance Fund to protect insured depositors.

other U.S. banks, which were vulnerable to a loss of confidence by creditors and uninsured depositors (including foreign depositors), given the stresses already present in the financial markets at that time. According to FDIC and Federal Reserve documents, Wachovia's sudden failure would have led to investor concern about direct exposures of other financial institutions to Wachovia. Furthermore, a Wachovia failure also could have led investors and other market participants to doubt the financial strength of other institutions that might be seen as similarly situated. In particular, the agencies noted that a Wachovia failure could intensify pressures on other large banking organizations that, like Wachovia, reported they were well capitalized but continued to face investor concerns about deteriorating asset quality. At the time of the Wachovia determination, the Emergency Economic Stabilization Act had not yet been passed and, thus, the authorities under that law to create the Troubled Asset Relief Program (TARP) were not available to help mitigate these effects.¹³ Furthermore, a least-cost resolution of Wachovia, N.A. could have negatively affected the broader economy, because with banks experiencing reduced liquidity and increased funding costs, they would be less willing to lend to businesses and households.

In recommending a systemic risk determination, the Federal Reserve and FDIC described the extent of Wachovia's interdependencies and the potential for disruptions to markets in which it played a significant role. The Federal Reserve listed the top financial entities exposed to Wachovia, noting that mutual funds were prominent among these counterparties. In addition, FDIC expressed concern that a Wachovia failure could result in losses for mutual funds holding its commercial paper, accelerating runs on those and other mutual funds.¹⁴ The Federal Reserve also noted that Wachovia was a major participant in the full range of major domestic and international clearing and settlement systems and that a least-cost resolution would likely have raised some payment and settlement concerns.

Treasury, FDIC, and the Federal Reserve concluded that FDIC assistance under the systemic risk exception could avert the potential systemic

¹³Pub. L. No. 110-343, Div. A, 122 Stat. 3765 (2008), codified at 12 U.S.C. §§ 5201 et seq.

¹⁴Following the bankruptcy filing of Lehman Brothers, 25 money market fund advisers had to act to protect their investors against losses arising from their investments in that company's debt, with at least one of these funds having to be liquidated with investors receiving less than \$1 dollar per share.

**FDIC Loss-Sharing Agreement
Intended to Avert Likely
Additional Market Strains from
a Least-Cost Resolution**

consequences of a least-cost resolution of Wachovia's bank and thrift subsidiaries. In particular, they determined that authorizing FDIC guarantees to protect against losses to Wachovia's uninsured creditors would avoid or mitigate the potential for serious adverse effects on the financial system and the economy by facilitating the acquisition of Wachovia's banking operations by Citigroup.

On September 29, 2008, pursuant to Treasury's systemic risk determination, FDIC announced that it had agreed to provide protection against large losses on a fixed pool of Wachovia assets to facilitate the orderly sale of Wachovia's banking operations to Citigroup and avert an imminent failure that might exacerbate the serious strains then affecting the financial markets, financial institutions, and the economy. On September 28, 2008, Citigroup and Wells Fargo both submitted bids to FDIC to acquire Wachovia's banking operations with FDIC open bank assistance in the form of loss sharing on Wachovia assets. The Citigroup and Wells Fargo bids differed in terms of the amount of losses each proposed to absorb and the result of the bidding process held by FDIC was the acceptance of Citigroup's bid.¹⁵ After agreeing with FDIC to a loss-sharing agreement on selected Wachovia assets, Citigroup announced that it would acquire Wachovia's banking operations for \$2.2 billion and assume the related liabilities, including senior and subordinated debt obligations and all of Wachovia's uninsured deposits.¹⁶ Under the agreement, Citigroup agreed to absorb the first \$42 billion of losses on a \$312 billion pool of loans and FDIC agreed to assume losses beyond that. To compensate FDIC for its assumption of this risk, Citigroup agreed to grant FDIC \$12 billion in preferred stock and warrants. A few days after the announcement of the proposed Citigroup acquisition, Wachovia announced that it would instead merge with Wells Fargo in a transaction that would include all of Wachovia's operations and, in contrast to the bids submitted days earlier by Citigroup and Wells Fargo, require no FDIC assistance. As a result, the FDIC loss-sharing agreement on Wachovia assets was not implemented and no assistance was provided under the systemic risk exception.

¹⁵ As part of the bidding process, FDIC also noted that Wachovia Corporation submitted its own proposal for FDIC credit protection on a fixed pool of the bank's loans.

¹⁶ Citigroup agreed to acquire Wachovia Bank, N.A. and four other depository institutions that together accounted for the bulk of the assets and liabilities of the holding company, Wachovia Corporation. Wachovia Corporation would continue to own Wachovia Securities, AG Edwards, and Evergreen.

Although the loss-sharing agreement never took effect, the announcement of the Citigroup acquisition and loss-sharing agreement may have helped to avert a Wachovia failure with potential systemic consequences. While acknowledging that isolating the impact of FDIC's assistance from other factors is difficult, Treasury and FDIC officials with whom we spoke said that one measure of the success of the loss-sharing agreement was that Wachovia was able to remain open and meet its funding obligations on Monday, September 29, 2008. In particular, the determination and the announcement of Citigroup's assumption of debt and deposit liabilities of Wachovia and its insured bank and thrift subsidiaries may have helped to allay the concerns of creditors and depositors that might otherwise have withdrawn liquidity support. As Wachovia did not fail, the extent to which a Wachovia failure would have had adverse effects on financial stability is not known.

TLGP Determination Was Intended to Help Restore Confidence and Liquidity to the Banking System, but Highlights Need for Clarification of the Systemic Risk Exception

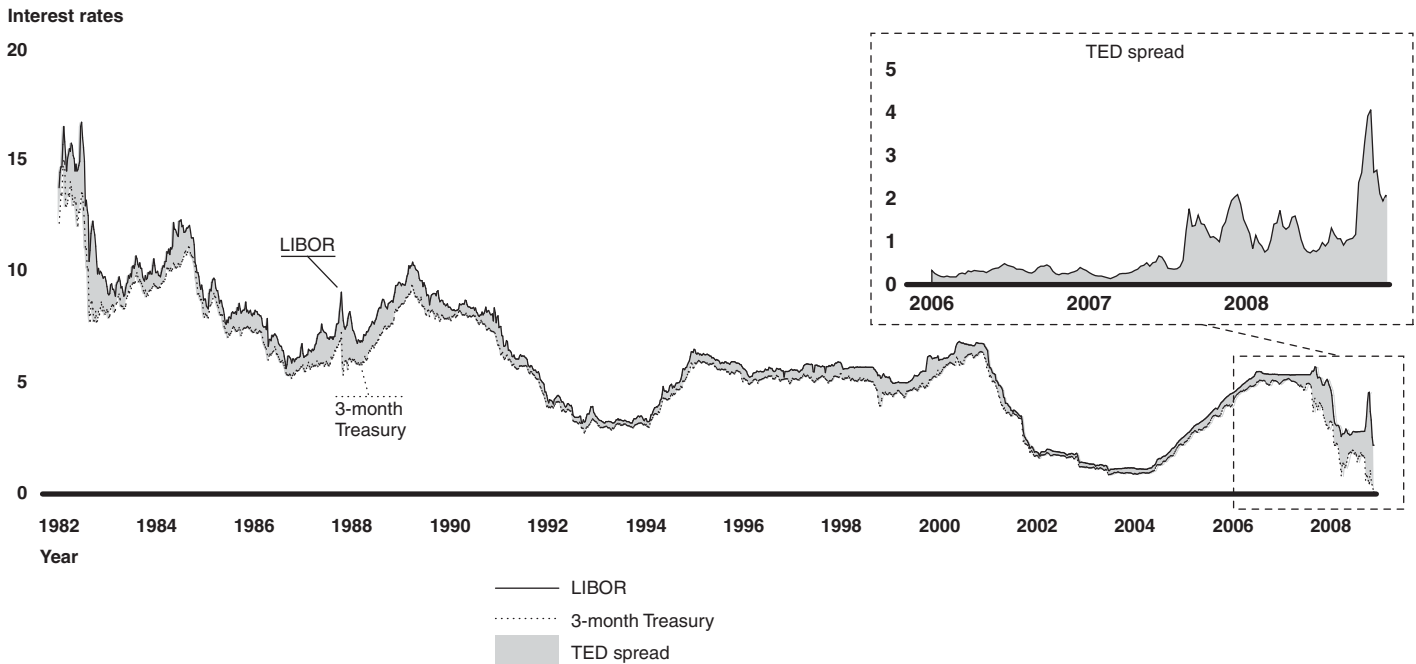
In describing the basis for the second systemic risk determination, which authorized TLGP, Treasury, FDIC, and the Federal Reserve said that disruptions in credit markets posed a threat to the ability of many institutions to fund themselves and lend to consumers and businesses. In a memorandum provided to Treasury, FDIC noted that the reluctance of banks and investment managers to lend to other banks and their holding companies made finding replacement funding at a reasonable cost difficult for these financial institutions. The TED spread—a key indicator of credit risk that gauges the willingness of banks to lend to other banks—peaked at more than 400 basis points in October 2008, likely indicating an increase in both perceived risk and in risk aversion among investors (see fig. 2).¹⁷ In addition to disruptions in interbank lending, financial institutions also faced difficulties raising funds through commercial paper and asset-backed securitization markets.¹⁸ The resulting credit crunch made the financing on which businesses and individuals depend increasingly difficult to obtain. In addition, FDIC was concerned that large outflows of uninsured deposits could strain many banks' liquidity. According to FDIC officials with whom we spoke, they were not tracking outflows of these

¹⁷ A basis point is a common measure used in quoting yield on bills, notes, and bonds and represents 1/100 of a percent of yield. It should be noted that while the spread is large, the actual LIBOR rate is lower than the average rate for 2005 through mid-2007.

¹⁸ Commercial paper is an unsecured, short-term debt instrument issued by a corporation, typically for the financing of accounts receivable, inventories, and meeting short-term liabilities. Maturities on commercial paper rarely range any longer than 270 days.

deposits, but relied on anecdotal reports from institutions and the regulators serving as their primary supervisors.

Figure 2: Three-Month LIBOR and 3-Month Treasury Bill Yield, as of November 21, 2008



Source: Global Insight and Federal Reserve Bank of St. Louis.

Treasury, FDIC, and the Federal Reserve Determined That Resolving Institutions on a Bank-by-Bank Basis Could Result in Adverse Impacts

In light of the liquidity strains many institutions faced, Treasury, FDIC, and the Federal Reserve determined that resolving institutions on a bank-by-bank basis in compliance with least-cost requirements would result in adverse impacts on financial stability and the broader economy. In its recommendation letter, FDIC concluded that the threat to the market for bank debt was a systemic problem that threatened the stability of a significant number of institutions, thereby increasing the potential for failures of these institutions and losses to the Deposit Insurance Fund. The Federal Reserve reasoned, among other things, that the failures and least-cost resolutions of a number of institutions could impose unexpected losses on investors and further undermine confidence in the banking system, which already was under extreme stress. Treasury concurred with FDIC and the Federal Reserve in determining that relying on the least-cost resolution process would not sufficiently address the systemic threat to bank funding and the broader economy.

Treasury concluded that FDIC actions under a systemic risk exception would avoid or mitigate adverse effects that would have resulted if assistance were provided subject to the least cost rules. Specifically, Treasury, FDIC, and the Federal Reserve advised that certain FDIC debt and deposit guarantees—otherwise subject to the prohibition against use of the Deposit Insurance Fund to protect uninsured depositors and creditors who are not insured depositors—could address risk aversion among institutions and investors that had become reluctant to provide liquidity to financial institutions and their holding companies. In a memorandum describing the basis for TLGP determination, Treasury explained the need for emergency actions in the context of a recent agreement among the United States and its G7 colleagues to implement a comprehensive action plan to provide liquidity to markets and prevent the failure of any systemically important institution, among other objectives.¹⁹ To implement the G7 plan, several countries had already announced programs to guarantee retail deposits and new debt issued by financial institutions. Treasury noted that if the United States did not take similar actions, global market participants might turn to institutions and markets in countries where the perceived protections were the greatest.

TLGP Determination Highlights the Need for Clarification of Requirements and Authorized Assistance under the Systemic Risk Exception

Some have noted that under a possible reading of the exception, the statute may authorize assistance only to particular institutions, based on those institutions' specific problems, not, as was done in creating TLGP, systemic risk assistance based on problems affecting the banking industry as a whole. Treasury, FDIC, and the Federal Reserve considered this and other legal issues in recommending and making TLGP determination. The agencies believe the statute could have been drafted more clearly and that it can be interpreted in different ways. They concluded, however, that under a permissible interpretation, assistance may be based on industry-wide concerns. They also concluded that a systemic risk determination waives all of the normal statutory restrictions on FDIC assistance and then creates new authority to provide assistance, both as to the types of aid that may be provided and the entities that may receive it. Under this reading, the agencies believe the statutory criteria were met in the case of TLGP and that the assistance was authorized.

We examined these issues as part of our review of the basis of the systemic risk determinations made to date. As detailed in appendix II, the

¹⁹The G7 is an informal forum of coordination among Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

recent financial crisis is the first time the agencies have relied on the systemic risk exception since its enactment in 1991, and no court to date has ruled on when or how it may be used. We found there is some support for the agencies' position that the exception authorizes assistance of some type under TLGP facts, as well as for their position that the exception permits assistance to the entities covered by this program. There are a number of questions concerning these interpretations, however. In the agencies' view, for example, some of the statutory provisions are ambiguous. What is clear, however, that the systemic risk exception overrides important statutory restrictions designed to minimize costs to the Deposit Insurance Fund, and in the case of TLGP, that the agencies used it to create a broad-based program of direct FDIC assistance to institutions that had never before received such relief—"healthy" banks, bank holding companies, and other bank affiliates. Because application of the systemic risk exception raises novel legal and policy issues of significant public interest and importance, and because of the need for clear direction to the agencies in a time of financial crisis, the requirements and the assistance authorized under the systemic risk exception may require clarification by Congress.

FDIC Established TLGP to Promote Confidence and Liquidity in the Banking System

In October 2008, FDIC created TLGP to complement the TARP Capital Purchase Program and the Federal Reserve's Commercial Paper Funding Facility and other liquidity facilities in restoring confidence in financial institutions and repairing their capacity to meet the credit needs of American households and businesses.²⁰ TLGP's Debt Guarantee Program (DGP) was designed to improve liquidity in term-funding markets by guaranteeing certain newly issued senior unsecured debt of financial institutions and their holding companies. According to FDIC officials, by guaranteeing payment of these debt obligations, DGP was intended to address the difficulty that creditworthy institutions were facing in replacing maturing debt because of risk aversion in the markets. TLGP's Transaction Account Guarantee Program (TAGP) also was created to stabilize an important source of liquidity for many financial institutions. TAGP temporarily extended an unlimited deposit guarantee to certain non-interest-bearing transaction accounts to assure holders of the safety of these deposits and limit further outflows. By facilitating access to

²⁰The Capital Purchase Program was created in October 2008 to stabilize the financial system by providing capital to viable banks through the purchase of preferred shares and subordinated debentures. The Commercial Paper Funding Facility provided a broad backstop to the commercial paper market by funding purchases of 3-month commercial paper from high-quality issuers.

TLGP Requirements Were Structured to Prevent Costs to the Insurance Fund

borrowed funds at lower rates, Treasury, FDIC, and the Federal Reserve expected TLGP to free up funding for banks to make loans to creditworthy businesses and consumers. Furthermore, by promoting stable funding sources for financial institutions, they intended TLGP to help avert bank and thrift failures that would impose costs on the insurance fund and taxpayers and potentially contribute to a worsening of the crisis.

FDIC structured TLGP requirements to provide needed assistance to insured banks while avoiding costs to the deposit insurance fund. According to FDIC officials, in designing TLGP, FDIC sought to achieve broad participation to avoid the perception that only weak institutions participated and to help ensure collection of fees needed to cover potential losses. Initially, all eligible institutions, which included insured depository institutions, their holding companies, and qualified affiliates, were enrolled in TLGP for 30 days at no cost and only those that participated in DGP or TAGP (or both) after the opt-out date became subject to fee assessments. Table 1 provides additional details related to TLGP features and requirements. As of March 31, 2009, among depository institutions with assets over \$10 billion, 92 percent and 94 percent had opted into DGP and TAGP, respectively. According to one regulatory official, this high participation rate indicated that many large institutions judged the benefits of the program to outweigh fee and other costs. However, while seeking to encourage broad participation, TLGP was not intended to prop up nonviable institutions, according to FDIC officials. The TLGP rule allowed FDIC to prospectively cancel eligibility for DGP if an institution had weak supervisory ratings.²¹ According to FDIC officials, some financial institutions were privately notified by their regulatory supervisors that they were not eligible to issue TLGP-guaranteed debt. In addition, FDIC required all parts of a holding company to make the same decision about TLGP participation to prevent an entity from issuing guaranteed debt through its weakest subsidiary.

²¹U.S. insured depository institutions were automatically enrolled in the TAGP as of October 14, 2008. TLGP rule did not permit FDIC to prospectively cancel eligibility for the TAGP, which was intended to assure holders of covered deposits of the safety of these deposits until the end of the program. On April 13, 2010, FDIC approved an interim rule extending the TAGP to December 31, 2010, and reserving FDIC's "discretion to extend the program to the end of 2011, without additional rulemaking, if it determines that economic conditions warrant such an extension." FDIC Press Release, April 13, 2010, [available at www.fdic.gov/news/news/press/2010/pr10075.html](http://www.fdic.gov/news/news/press/2010/pr10075.html).

Table 1: TLGP Eligibility and Fee Requirements

Program	Initial eligibility and coverage rules	Fees and surcharges	Extensions
TLGP (both programs)	All eligible institutions were automatically enrolled at no cost for 1 month starting Oct. 14, 2008. Eligible institutions include FDIC insured depository institutions (IDIs); U.S. bank and financial holding companies and certain savings and loan holding companies; and affiliates of IDIs upon application.	Eligible institutions that remained in one or both programs after the opt-out date (Dec. 5, 2008) became subject to fees assessments as of Nov. 13, 2008.	Mar. 17, 2009: FDIC announcement of DGP extension. Aug. 26, 2009: FDIC announcement of first TAGP extension to June 30, 2010. Apr. 13, 2010: FDIC announcement of second TAGP extension by interim rule to December 31, 2010, and potentially to the end of 2011.
DGP	Guarantee on newly issued senior unsecured debt issued on Oct. 14, 2008, through June 30, 2009. Covered debt included, but was not limited to • federal funds, • promissory notes, • commercial paper, and • unsubordinated unsecured notes. Guarantees generally limited to 125 percent of senior unsecured debt outstanding on Sept. 30, 2008, scheduled to mature before June 30, 2009. All eligible new debt issued up to this limit was required to carry the FDIC guarantee.^a	Fees assessed on each TLGP-guaranteed debt issuance by IDIs based on time to maturity (basis points per annum): 31-180 days: 50 181-364 days: 75 ≥365 days: 100	Terms of DGP extension: - Ability to issue guaranteed debt extended from June 30, 2009, to Oct. 31, 2009. - Guarantee expiration extended from June 30, 2012 to Dec. 31, 2012 for new debt. Surcharges starting 4/1/09^b (basis points per annum = bps) 10 bps if issued (20 bps for other participating entities) before June 30, 2009, and maturing in 1 year or more. 25 bps if issued (50 bps for other participating entities) under extension (after June 30, 2009, or maturing after June 30, 2012)
TAGP	Extended deposit insurance to non-interest-bearing transaction accounts until Dec. 31, 2009, for amounts exceeding deposit insurance limit of \$250,000.	10 basis points on quarter end balance of eligible deposits over \$250,000.	Terms of first TAGP extension: Extended coverage until June 30, 2010, if IDI did not opt out by Nov. 2, 2009. Risk-based fees Starting on Jan. 1, 2010, risk-based assessment of 15, 20, or 25 basis points.

Source: GAO analysis of TLGP regulations.

^aFDIC has allowed institutions participating in DGP to issue nonguaranteed debt under certain conditions.

^bSurcharges collected under DGP extension are added to the deposit insurance fund. Non-insured depository institutions have been required to pay twice the surcharges shown for IDIs (that is, 20 basis points or 50 basis points).

As of December 31, 2009, FDIC had collected \$11.0 billion in TLGP fees and surcharges and incurred claims of \$6.6 billion on TLGP guarantees. All of the claims to date, except for one \$2 million claim under DGP, have

FDIC Guarantees Lowered Certain Funding Costs and Some Indicators Suggest Improvements in the Credit Markets

come from TAGP, under which FDIC has collected \$639 million in fees. Since the creation of TLGP, bank failures have been concentrated among small banks (assets under \$10 billion), which as a group have not been significant participants in DGP. Although the high number of small bank failures has resulted in higher-than-expected costs under TAGP, FDIC officials still expect total TLGP fees collected to exceed the costs of the program.²² At the end of the program, FDIC will be permitted to account for any excess TLGP fees as income to the deposit insurance fund.²³ If a supportable and documented analysis demonstrates that TLGP assets exceed projected losses, FDIC may recognize income to the deposit insurance fund prior to the end of the program. As noted earlier, in the event that TLGP results in losses to the deposit insurance fund, FDIC would be required to recover these losses through one or more special assessments.

Although isolating the impacts of TLGP on credit markets is difficult, FDIC officials and some market participants have attributed positive developments to the program. While being credited with helping to improve market confidence in participating banks and other beneficial effects, several factors complicate efforts to measure the impact of this program on credit markets. For example, any changes in market conditions attributed to TLGP could be changes that (1) would have occurred without the program; (2) could be attributed to other policy interventions, such as the actions of Treasury, the Federal Reserve, or other financial regulators; or (3) have been enhanced or counteracted by other market forces, such as the correction in housing markets and revaluation of mortgage-related assets. Certain credit market indicators, although imperfect, suggest general improvements in credit market conditions since TLGP was launched in mid-October 2008. For example, from October 13, 2008, to September 30, 2009, the cost of interbank credit (LIBOR) declined by 446 basis points, and the TED spread declined by 443 basis points. While these changes cannot be attributed exclusively to TLGP, FDIC officials and other market observers have attributed some benefits specifically to the debt and deposit guarantees provided under TLGP. In March 2009, the FDIC Chairman said that TLGP had been

²²Furthermore, FDIC estimates that it will recover about \$4.9 billion of the TAGP claims from its claims on the receiverships of the failed institutions.

²³In addition, surcharges assessed on debt issued under the extension of TLGP are added directly to the deposit insurance fund. As of November 30, 2009, FDIC has collected \$872 million in such surcharges.

TLGP Extensions

Since TLGP was created in October 2008, FDIC has extended both components of the program. In March 2009, FDIC extended the final date for new debt issuance under DGP from June 30, 2009, to October 31, 2009, and in August 2009, extended the TAGP for 6 months, through June 30, 2010. FDIC officials with whom we spoke said they consulted with other regulators in determining that a separate systemic risk determination was not required for these extensions. These officials noted that economic conditions had improved at the time of the extensions, but had not yet returned to precrisis conditions. FDIC noted the need to ensure an orderly phase-out of TLGP assistance and outlined certain higher fee requirements for institutions choosing to continue participation past the original end dates. As part of the DGP extension, FDIC established new surcharges beginning on April 1, 2009, for certain debt issued prior to the original June 2009 deadline and for all debt issued under the extension. In extending TAGP, FDIC announced that eligible institutions not opting out of the 6-month extension would be subject to higher fees based on the institution's risk category as determined by regulator assessments.

DGP concluded on October 31, 2009, for most entities participating in the program. To further ensure an orderly phase-out of the program, FDIC established a limited emergency guarantee facility through which eligible entities (upon application and FDIC approval) could issue guaranteed debt through April 30, 2010, subject to a minimum annualized assessment of 300 basis points. In April 2010, FDIC's Board of Directors approved an interim rule to extend the TAGP until December 31, 2010, and give the Board discretion to extend the program to the end of 2011, if necessary.

effective in improving short-term and intermediate-term funding markets.²⁴ In addition, FDIC officials with whom we spoke said that although they do not track outflows of deposits of transaction accounts covered under TAGP, several institutions have told them that TAGP was helpful in stemming such outflows.

Moreover, some market observers have commented that FDIC's assumption of risk through the debt guarantees enabled many institutions to obtain needed funding at significantly lower costs. Eligible financial institutions and their holding companies raised more than \$600 billion under DGP, which concluded on October 31, 2009, for most participating entities. Notably, several large financial holding companies each issued tens of billions of dollars of TLGP-guaranteed debt and most did not issue senior unsecured debt outside DGP before April 2009.²⁵ Although determining the extent to which FDIC guarantees lowered debt costs is difficult, a U.S. government guarantee significantly reduces the risk of loss and accordingly, and would be expected to substantially reduce the interest rate lenders charge for TLGP-guaranteed funds. By comparing yields on TLGP-guaranteed debt to yields on similar debt issued without FDIC guarantees, some market observers have estimated that FDIC guarantees lowered the cost of certain debt issues by more than 140 basis points. To the extent that TLGP helped banking organizations to raise funds during a very difficult period and to do so at substantially lower cost than would otherwise be available, it may have helped improve confidence in institutions and their ability to lend. However, some market observers have expressed concern that the large volume of issuance under TLGP could create difficulties associated with rolling over this debt in a few years when much of this debt matures in a short time frame. According to one financial analyst with whom we spoke, potential difficulties associated with rolling over this debt could be mitigated by any improvements in other funding markets, such as asset-backed securitization markets.

²⁴FDIC press release, March 17, 2009.

²⁵According to regulatory officials, advantages of issuing debt outside TLGP included sending a positive signal to the market that government assistance is no longer needed and issuing debt at longer and varying maturities (to avoid having too much debt mature at once).

FDIC Protection against Large Losses on Citigroup Assets Was Part of a Package of Government Assistance Intended to Forestall a Resolution with Potential Systemic Consequences

In describing the basis for the third systemic risk determination, Treasury, FDIC, and the Federal Reserve cited concerns similar to those discussed in connection with the Wachovia determination. During November 2008, severe economic conditions persisted despite new Federal Reserve liquidity programs and the announcements of the Treasury's Capital Purchase Program and FDIC's TLGP. Similar to Wachovia, Citigroup had suffered substantial losses on mortgage-related assets and faced increasing pressures on its liquidity as investor confidence in the firm's prospects and the outlook for the economy declined. On Friday, November 21, 2008, Citigroup's stock price fell below \$4, down from over \$14 earlier that month. In their memoranda supporting their recommendations for a systemic risk determination, FDIC and the Federal Reserve expressed concern that Citigroup soon would be unable to meet its funding obligations and expected deposit outflows. FDIC concluded that the government funding support otherwise available to Citigroup through the Federal Reserve's lending programs such as the Commercial Paper Funding Facility and the Primary Dealer Credit Facility and TLGP provided the firm with short-term funding relief but would not be sufficient to help Citigroup withstand the large deposit outflows regulators expected if confidence in the firm continued to deteriorate.²⁶

Treasury, FDIC, and the Federal Reserve Concluded That a Least-Cost Resolution of Citigroup's Insured Depository Institution Subsidiaries Would Likely Exacerbate Market Strains

As was the case with Wachovia, Treasury, FDIC, and the Federal Reserve were concerned that the failure of a firm of Citigroup's size and interconnectedness would have systemic implications. They determined that resolving the company's insured institutions under the least-cost requirements likely would have imposed significant losses on Citigroup's creditors and on uninsured depositors, thus threatening to further undermine confidence in the banking system. According to Treasury, a least-cost resolution would have led to investor concern about the direct exposures of other financial firms to Citigroup and the willingness of U.S. policymakers to support systemically important institutions, despite Treasury's recent investments in Citigroup and other major U.S. banking institutions. In its recommendation to Treasury, the Federal Reserve listed the banking organizations with the largest direct exposures to Citigroup and estimated that the most exposed institution could suffer a loss equal

²⁶The Primary Dealer Credit Facility (PDCF) was an overnight loan facility through which the Federal Reserve provided funding to primary dealers in exchange for a specified range of eligible collateral and was intended to foster the orderly functioning of financial markets more generally. The PDCF began operations on March 17, 2008, and was closed on February 1, 2010.

to about 2.6 percent of its Tier 1 regulatory capital.²⁷ Furthermore, Treasury, FDIC, and the Federal Reserve were concerned that a failure of Citigroup, which reported that it was well-capitalized (as did Wachovia at the time of the first systemic risk determination), could lead investors to reassess the riskiness of U.S. commercial banks more broadly. In comparison to Wachovia, Citigroup had a much larger international presence, including more than \$500 billion of foreign deposits—compared to approximately \$30 billion for Wachovia. Given Citigroup’s substantial international presence, imposing losses on uninsured foreign depositors under a least-cost framework could have intensified global liquidity pressures and increased funding pressures on other institutions with significant amounts of foreign deposits. For example, this could have caused investors to raise sharply their assessment of risks of investing in U.S. banking organizations, making raising capital and other funding more difficult.

In addition to the potential serious adverse effects on credit markets, Treasury, FDIC, and the Federal Reserve expressed concern that a Citigroup failure could disrupt other markets in which Citigroup was a major participant. Citigroup participated in a large number of payment, settlement, and counterparty arrangements within and outside the United States. The Federal Reserve expressed concern that Citigroup’s inability to fulfill its obligations in these markets and systems could lead to widespread disruptions in payment and settlement systems worldwide, with important spillover effects back to U.S. institutions and other markets. Citigroup was a major player in a wide range of derivatives markets, both as a counterparty for over-the-counter trades and as a broker and clearing firm for trades on exchanges. If Citigroup had failed, many of the firm’s counterparties might have faced difficulties replacing existing contracts with Citigroup, particularly given concerns about counterparty credit risk at the time.

²⁷ Banks and thrifts are required to meet two risk-based capital ratios, which are calculated by dividing their qualifying capital (numerator) by their risk-weighted assets (denominator). Total capital consists of core capital, called Tier 1 capital, and supplementary capital, called Tier 2 capital. Tier 1 capital can include common stockholders’ equity, noncumulative perpetual preferred stock, and minority equity investments in consolidated subsidiaries. To be well-capitalized under Federal Reserve definitions, a bank holding company must have a Tier 1 capital ratio of at least 6 percent. A 2.6 percent reduction in the Tier 1 regulatory capital would represent a significant loss, even for a banking organization holding an amount of Tier 1 capital in excess of the minimum 6 percent requirement.

Assistance to Citigroup
Included a Loss-Sharing
Agreement and Capital
Infusion Intended to Restore
Confidence and Promote
Financial Stability

Treasury, FDIC, and the Federal Reserve determined that FDIC assistance under the systemic risk exception, which would complement other U.S. federal assistance and TARP programs, would promote confidence in Citigroup. Specifically, they determined that if the systemic risk exception were invoked, FDIC could provide guarantees that would help protect Citigroup from outside losses on certain assets and thus reduce investor uncertainty regarding the potential for additional losses to weaken Citigroup. In addition, such actions could help to reassure depositors and investors that the U.S. government would take necessary actions to stabilize systemically important U.S. banking institutions.

On November 23, 2008, Treasury, FDIC, and the Federal Reserve announced a package of assistance to Citigroup, including a loss-sharing agreement on a fixed pool of Citigroup's assets, to help restore confidence in the firm and maintain financial stability.²⁸ By providing protection against large losses on these assets, regulators hoped to promote confidence among creditors and depositors providing liquidity to the firm to avert a least-cost resolution with potential systemic risk consequences. In particular, the loss-sharing agreement limited the potential losses Citigroup might suffer on a fixed pool of approximately \$300 billion of loans and securities backed by residential and commercial real estate and other such assets. Under the final agreement executed on January 15, 2009, Citigroup agreed to absorb the first \$39.5 billion in losses plus 10 percent of any remaining losses incurred. Ninety percent of covered asset losses exceeding \$39.5 billion would be borne by Treasury and FDIC, with maximum guarantee payments capped at \$5 billion and \$10 billion, respectively. In addition, if all of these loss protections were exhausted, the Federal Reserve Bank of New York committed to allow Citigroup to obtain a nonrecourse loan equal to the aggregate value of the remaining covered asset pool, subject to a continuing 10 percent loss-sharing obligation of Citigroup. Citigroup issued FDIC and Treasury approximately \$3 billion and \$4 billion of preferred stock, respectively, for bearing the risk associated with the guarantees.²⁹ The Federal Reserve loan, if extended, would have borne interest at the overnight index swap rate plus 300 basis points. Citigroup also received a \$20 billion capital infusion from

²⁸The fixed pool of assets is the pool of assets protected by Treasury and FDIC guarantees and a residual financing arrangement from the Federal Reserve.

²⁹In June 2009, Treasury and FDIC exchanged this preferred stock for an equal value of trust preferred securities as part of a series of transactions designed to realign Citigroup Inc.'s capital structure and increase its tangible common equity.

FDIC Assistance May Have
Helped to Ensure Continued
Access to Funding for
Citigroup

the TARP's Targeted Investment Program, in addition to the initial \$25 billion capital infusion received from TARP's Capital Purchase Program in October 2008. In addition, the agreement subjected Citigroup to specific limitations on executive compensation and dividends during the loss share period.³⁰

Isolating the impact of FDIC assistance to Citigroup is difficult, but according to Treasury and FDIC, the package of assistance provided by regulators may have helped to allow Citigroup to continue operating by encouraging private sector sources to continue to provide liquidity to Citigroup during the crisis. According to one FDIC official, one measure of success was that Citigroup could do business in Asia the business day following the announcement. With the package of assistance, regulators hoped to improve the confidence of creditors and certain depositors, facilitating Citigroup's funding. Changes in the market's pricing of Citigroup's stock and its default risk, as measured by credit default swap spreads, indicate that the November 23, 2008, announcement boosted market confidence in the firm, at least temporarily. From a closing price of \$3.77 on Friday, November 21, 2008, Citigroup's common stock price rose 58 percent on Monday, November 24 and more than doubled by the end of the week. However, market confidence in Citigroup fell sharply again in early 2009 before the company's stock price recovered and stabilized in spring 2009.

On December 23, 2009, Citigroup announced that it had reached an agreement with FDIC, the Federal Reserve Bank of New York, and Treasury to terminate the loss-sharing and residual financing agreement.³¹ As part of the termination agreement, Citigroup agreed to pay a \$50 million termination fee to the Federal Reserve. As of September 30, 2009,

³⁰The loss-sharing arrangements were put in effect for 10 years for residential assets and 5 years for nonresidential assets. Treasury's Targeted Investment Program was designed to prevent a loss of confidence in financial institutions that could result in significant market disruptions, threaten the financial strength of similarly situated financial institutions, impair broader financial markets, and undermine the overall economy.

³¹As part of the termination, Treasury and FDIC are exchanging \$1.8 billion of the trust preferred securities that were issued under the agreement. Citigroup is reducing the aggregate liquidation amount of the trust preferred securities issued to Treasury by \$1.8 billion and FDIC initially is retaining all of its trust preferred securities until the expiration date of all guarantees of debt of Citigroup and its affiliates under TLGP. When no Citigroup TLGP guaranteed debt remains outstanding, FDIC will transfer \$800 million of the trust preferred securities to Treasury along with accumulated dividends and less any payments it makes under TLGP guarantees on the Citigroup debt.

Citigroup reported that it had recognized \$5.3 billion of losses on the pool of assets covered by the loss-sharing agreement. These losses did not reach the thresholds that would trigger payments by Treasury or FDIC. In July 2009, the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) announced plans to audit the asset guarantees provided to Citigroup. According to SIGTARP, this audit is to examine why the guarantees were provided, how the guaranteed assets were structured, and whether Citigroup's risk controls were adequate to prevent government losses. At the close of this review, the SIGTARP review was ongoing.

Systemic Risk Determinations and Related Federal Assistance Raise Concerns about Moral Hazard and Market Discipline That May Be Addressed by Potential Regulatory Reforms

While the systemic risk determinations and associated federal assistance may have helped to contain the crisis by mitigating potential systemic adverse effects, they may have induced moral hazard—encouraging market participants to expect similar emergency actions in future crises, thereby weakening their incentives to properly manage risks and also creating the perception that some firms are too big to fail. Federal assistance required for large and important institutions, such as non-bank holding companies, whose activities could affect the financial system, also highlighted gaps in the current regulatory regime, including inconsistent supervision and regulatory standards and lack of resolution authority for these institutions. Regulators, the Administration and Congress currently are considering financial regulatory reform proposals that could help address these concerns. Reforms that would enhance the supervision of financial institutions—particularly large financial holding companies—whose market discipline is likely to have been weakened by the recent exercises of the systemic risk exceptions are essential.

Federal Assistance Could Exacerbate Moral Hazard and Reduce Potential for Market Discipline Particularly for the Largest U.S. Financial Institutions

While the federal assistance authorized by the systemic risk determinations may have helped to contain the financial crisis by mitigating potential adverse systemic effects that would have resulted from traditional FDIC assistance, they may have exacerbated moral hazard, particularly for large financial institutions. According to regulators and some economists, the expansion of deposit insurance under TAGP, in which most insured depository institutions of all sizes participated, could weaken incentives for newly protected, larger depositors to monitor their banks, and in turn banks may be more able to engage in riskier activities. According to some economists, the higher the deposit insurance guarantee, the greater the risk of moral hazard. In principle, deposit insurance helps prevent bank runs by small depositors, while lack of

insurance encourages (presumably better informed) large depositors to protect their deposits by exerting discipline on risk taking by banks.

Unlike the broad participation in TAGP, the majority of institutions that participate in DGP are large financial institutions. In addition, according to FDIC data, most of the senior unsecured debt under DGP has been issued by the largest U.S. financial institutions. Market observers with whom we spoke said that small banks did not participate in DGP as generally they primarily rely on deposits for funding. The bank debt guarantees, according to some economists, allow large financial institutions to issue debt without regard for differences in their risk profiles and can weaken the incentives for creditors to monitor bank performance and exert discipline against excessive risk taking for these institutions. In general, some economists said that to help mitigate moral hazard, it is important to specify when the extra deposit insurance and debt guarantee programs will end. Further, while recognizing that uncertainty about the duration of the crisis makes it difficult to specify timetables for phasing out guarantees, some economists said it is important to provide a credible “exit strategy” to prevent further disruption in the financial markets when withdrawing government guarantees. In addition, some economists noted that while government guarantees can be withdrawn once the crisis abates, a general perception may persist that a government guarantee always will be made available during a crisis—thus perpetuating the risk for moral hazard.

Similarly, while the assistance to open banks authorized by the systemic risk determinations may have helped to contain the crisis by stabilizing the large and other financial institutions and mitigating potential systemic adverse effects, it also may have exacerbated moral hazard. According to regulators and market observers, assistance to open banks may weaken the incentives of large uninsured depositors, creditors, and investors to discipline large complex financial institutions deemed too big to fail. Federal Reserve Chairman Bernanke stated in March 2009 to the Council on Foreign Relations that the belief of market participants that a particular institution is considered too big to fail has many undesirable effects. He explained such perceptions reduce market discipline, encourage excessive risk taking by the firm, and provide artificial incentives for firms to grow. He also noted these beliefs can create an unlevel playing field, in which smaller firms may not be regarded as having implicit government support. Similarly, others have noted how such perceptions may encourage risk taking—for example, that large financial institutions are given access to the credit markets at favorable terms without consideration of the institutions’ risk profile because creditors and investors believe their

credit exposure is reduced since they believe the government will not allow these firms to fail.

Limitations in Financial Regulatory Framework Restrict Regulators' Ability to Mitigate Impact of Weakened Incentives but Some Reform Proposals May Help Address These Concerns

Although regulators' use of the systemic risk exception may weaken incentives of institutions to properly manage risk, the financial regulatory framework could serve an important role in restricting the extent to which they engage in excessive risk-taking activities as a result of weakened market discipline. Responding to the recent financial crisis, recent actions by the Federal Reserve as well as proposed regulatory reform and new FDIC resolution authority could help address concerns raised about the potential conduct (to monitor and control risks) of institutions receiving federal assistance or subject to the systemic risk determinations.

Enhanced Supervision of Systemically Important Institutions

In an effort to mitigate moral hazard and weakened market discipline for large complex financial institutions including those that received federal assistance, regulators, the administration, and Congress are considering regulatory reforms to enhance supervision of these institutions. These institutions not only include large banks but also nonbank institutions. In the recent crisis, according to a testimony by FDIC Chairman Bair, bank holding companies and large nonbank affiliates have come to depend on the banks within their organizations as a source of funding.³² Bank holding companies must, under Federal Reserve regulations, serve as the source of strength for their insured institution subsidiaries. Subject to the limits of sections 23A and 23B of the Federal Reserve Act, however, bank holding companies and their nonbank affiliates may rely on the depository institution for funding. Also, according to regulators, institutions that were not bank holding companies (such as large thrift holding companies, investment banks, and insurance organizations) were responsible for a disproportionate share of the financial stress in the markets in the past 2 years and the lack of a consistent and coherent regulatory regime for these institutions helped mask problems until they were systemic and gaps in

³²Sheila C. Bair, Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Washington, D.C.: Mar. 19, 2009). Transactions between a bank and an affiliate, such as loans, asset purchases, and other transactions that expose the bank to the risks of the affiliate, are subject to limitations imposed by sections 23A and 23B of the Federal Reserve Act, 12 U.S.C. §§ 371c, 371c-1, the Board's implementing Regulation W, 12 C.F.R. Part 223, and corresponding provisions of the Federal Deposit Insurance Act and the Home Owners Loan Act. *See* Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. 76560 (December 12, 2002); *see also*, Federal Reserve Supervisory Letter SR 03-2 (Jan. 9, 2003).

the regulatory regime constrained the government's ability to deal with them once they emerged.

Legislation has been proposed to create enhanced supervision and regulation for any systemically important financial institution, regardless of whether the institution owns an insured depository institution. The proposals would establish a council chaired by the Secretary of the Treasury with voting members comprising the chairs of the federal financial regulators which would oversee systemic risk and help identify systemically important companies. An institution could be designated "systemically important" if material financial distress at the firm could threaten financial stability or the economy. Systemically important institutions would be regulated by the Federal Reserve under enhanced supervisory and regulatory standards and stricter prudential standards.³³

Regulators and market observers generally agree that these systemically important financial institutions should be subject to progressively tougher regulatory standards to hold adequate capital and liquidity buffers to reflect the heightened risk they pose to the financial system. They also generally agree that systemically important firms should face additional capital charges based both on their size and complexity.³⁴ Such capital charges (and perhaps also restrictions on leverage and the imposition of risk-based insurance premiums on systemically important or weak insured depository institutions and risky activities) could help ensure that institutions bear the costs of growth and complexity that raise systemic concerns. Regulators and market observers believe that imposing systemic risk regulation and its associated safeguards will strengthen the ability of these firms to operate in stressed environments while the associated costs can provide incentives to firms to voluntarily take actions to reduce the risks they pose to the financial system. Under legislative proposals, these institutions also would be subject to a prompt corrective action regime

³³Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 1103 (2009); *see also* Restoring American Financial Stability Act of 2010, 111th Cong., § 113 (Senate Banking Committee, available at <http://banking.senate.gov/public/index.cfm>)

³⁴Basel II is an effort by international banking supervisors to update the original international bank capital accord (Basel I), which has been in effect since 1988. The Basel Committee on Banking Supervision on which the United States serves as a participating member, developed Basel II. The revised accord aims to improve the consistency of capital regulations internationally, make regulatory capital more risk sensitive, and promote enhanced risk management practices among large, internationally active banking organizations.

that would require the firm or its supervisors to take corrective actions as the institutions' regulatory capital level or other measures of financial strength declined, similar to the existing prompt corrective action regime for insured depository institutions under the FDI Act.

Regulators also are considering regulatory reforms to improve the overall risk management practices of systemically important institutions. The Federal Reserve has proposed standards for compensation practices across all banking organizations it supervises to encourage prudent risk taking by creating incentives focusing on long-term rather than short-term performance.³⁵ Regulators noted that compensation practices that create incentives for short-term gains may overwhelm the checks and balances meant to mitigate excessive risk taking.³⁶ In its proposal for financial regulatory reform, Treasury recommended that systemically important financial institutions be expected to put in place risk management practices commensurate with the risk, complexity, and scope of their operations and be able to identify firmwide risk concentrations (such as credit, business lines, liquidity) and establish appropriate limits and controls around these concentrations. Also, under Treasury's proposal, to measure and monitor risk concentrations, these institutions would be expected to be able to identify and report aggregate exposures quickly on a firmwide basis.

Regulators also have indicated the need for measures to improve their oversight of risk management practices by these institutions. In our prior work on regulatory oversight of risk management at selected large institutions, we found that oversight of institutions' risk management systems before the crisis illustrated some limitations of the current regulatory system.³⁷ For example, regulators were not looking across groups of institutions to effectively identify risks to overall financial stability. In addition, primary, functional, and holding company regulators faced challenges aggregating certain risk exposures within large, complex financial institutions. According to testimony by a Federal Reserve official, the recent crisis highlighted the need for a more comprehensive and integrated assessment of activities throughout bank holding companies—a

³⁵74 Fed. Reg. 55227 (Oct. 27, 2009).

³⁶*See, e.g., id.* at 55228, 55232.

³⁷GAO, *Financial Regulation: Review of Regulators' Oversight of Risk Management Systems at a Limited Number of Large, Complex Financial Institutions*, [GAO-09-499T](#) (Washington, D.C.: Mar. 18, 2009).

departure from the customary premise of functional regulation that risks within a diversified organization can be managed properly through supervision focused on individual subsidiaries within the firm.³⁸ Accordingly, the bank supervisors, led by the Federal Reserve, recently completed the Supervisory Capital Assessment Program, which reflects some of the anticipated changes in the Federal Reserve's approach to supervising the largest banking organizations. The Supervisory Capital Assessment Program involved aggregate analyses of the 19 largest bank holding companies, which according to Federal Reserve testimony, accounted for a majority of the assets and loans within the financial system.³⁹ Bank supervisors evaluated on a consistent basis the expected performance of these firms under baseline and more-adverse-than-expected scenarios, drawing on individual firm information and using independently estimated outcomes.⁴⁰ In addition, according to the agency's officials, the Federal Reserve is creating an enhanced quantitative surveillance program for the largest and most complex firms, that will use supervisory information, firm-specific data analysis, and market-based indicators to identify emerging systemic risks as well as risks to specific firms.

Some economists argue that a formal designation of systemically important institutions would have significant, negative competitive consequences for other firms and could encourage designated firms to take excessive risk because they would be perceived to be too big to fail. Instead some argue that a market stability regulator should be authorized to oversee all types of financial markets and all financial services firms, whether otherwise regulated or unregulated. Market observers also point out factors that complicate such determinations and make maintaining an accurate list of such institutions difficult. Aside from asset size and degree of leverage, they include degree of interconnectivity to other financial institutions, risks of activities in which they engage, nature of compensation practices, and degree of concentration of financial assets

³⁸Daniel K. Tarullo, Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs (Washington, D.C., Aug. 4, 2009).

³⁹Tarullo (2009).

⁴⁰We are currently reviewing the Supervisory Capital Assessment Program and assessing the process used to design and conduct the stress test, how the stress test methodology was developed and how the stress test economic assumptions and bank holding companies' performance have tracked actual results as well as describing bank officials' views on the stress test process. We plan on issuing a report in the summer of 2010.

and activities. Moreover, maintaining a list would require regular monitoring in order to ensure the list was kept up to date, and some risky institutions would likely go unidentified, at least for a time. Such designation also would likely depend on factors outside the firm, such as economic and financial conditions. However, supervisors would presumably be doing much of the monitoring activity regardless of the existence of a public list, and they would have to establish standards, including assumptions regarding the economic and financial circumstances assumed when making such designations. It is important for Congress and regulators to subject systemically important institutions to stricter regulatory requirements and oversight in order to restrict excessive risk-taking activities as a result of weakened market discipline particularly after the use of federal assistance during the crisis to stabilize such institutions.

Resolution Authority for Systemically Important Institutions

The recent crisis also highlighted how a lack of a resolution authority for failing bank holding companies including those subject to the systemic risk determinations as well as nonbank financial firms such as Bear Stearns, Lehman Brothers, and American International Group, Inc. (AIG), complicated federal government responses. For example, regulators invoked the systemic risk exception to assist bank holding companies and savings and loan holding companies to prevent systemic disruptions in the financial markets and provided emergency funding to AIG, and in doing so potentially contributed to a weakening of incentives at these institutions and similarly situated large financial institutions to properly manage risks.⁴¹ According to regulators, the lack of a resolution authority for systemically important institutions also contributes to a belief by market participants that the government will not allow these institutions to fail and thereby weakens market discipline. Proposals for consideration by Congress include providing federal resolution authority for large financial holding companies deemed systemically important. One purpose of this authority would be to encourage greater market discipline and limit moral hazard by forcing market participants to realize the full costs of their decisions. In order to achieve its intended purpose, the use of a new resolution authority must be perceived by the market to be credible. The authority would need to provide for a regime to resolve systemically important institutions in an orderly manner when the stability of the financial system is threatened. As noted in our prior work, a regulatory

⁴¹GAO: *Troubled Asset Relief Program: Status of Federal Assistance to AIG*, [GAO-09-975](#) (Washington, D.C.: Sept. 21, 2009).

system should have adequate safeguards that allow financial institution failures to occur while limiting taxpayers' exposure to financial risk while minimizing moral hazard.⁴²

Regulators and market observers generally agree that a credible resolution authority to resolve a distressed systemically important institution in an orderly manner would help to ensure that no bank or financial firm would be too big to fail. Such authority would encourage market discipline if it were to provide for the orderly allocation of losses to risk takers such as shareholders and unsecured creditors, and allow for the replacement of senior management. It also should help to maintain the liquidity and key activities of the organization so that the entity could be resolved in an orderly fashion without disrupting the functioning of the financial system. Unlike the statutory powers that exist for resolving insured depository institutions, the current bankruptcy framework available to resolve large complex nonbank financial entities and financial holding companies was not designed to protect the stability of the financial system. Without a mechanism to allow for an orderly resolution for a failure of a systemically important institution, failures of such firms could lead to a wider panic as indicated by the problems experienced after the failure of such large financial companies as Lehman Brothers, and near failures of Bear Stearns and AIG.

Proposed new authority for resolution of a systemically important failing institution would provide for a receiver to resolve the institution in an orderly way. Government assistance such as loans, guarantees, or asset purchases would be available only if the institution is in government receivership. The receiver would have authority to operate the institution, enforce or repudiate its contracts, and pay its claims as well as remove senior management. In addition, shareholders and creditors to the firm would absorb first losses in the resolution. However, imposing losses on unsecured debt investors of large, interconnected, and systemically important firms might be inconsistent with maintaining financial stability during a crisis. In particular, faced with the potential failures of Wachovia and Citigroup, Treasury, FDIC, and the Federal Reserve concluded that the exercise of authority under the systemic risk exception was necessary because the failure of these firms would have imposed large losses on

⁴²GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, [GAO-09-216](#) (Washington, D.C.: Jan. 8, 2009).

creditors and threatened to undermine confidence in the banking system. An effective resolution authority must properly balance the need to encourage market discipline with the need to maintain financial stability, in particular in a crisis scenario. One market observer argued that no such losses would be taken immediately by creditors because the objective of the resolution authority is to prevent a disorderly failure in which such creditors suffer immediate losses. Therefore an appropriate degree of flexibility would mean that some of an institution's creditors might be protected, at least to some extent, against losses where doing so would be necessary to protect the stability of the financial system. Other features of the resolution authority would continue to promote market discipline even if some credit obligations were honored, because shareholders and senior management would still suffer losses. A regulatory official stated that the intertwining of functions among an institution's affiliates can present significant issues when winding down the institution and recommended requirements that mandate greater functional autonomy of holding company affiliates.⁴³ In addition, some economists and market observers also have recommended that regulators break up large institutions in resolution to limit a continuation of too-big-to-fail problems. That is, when a regulator assumes control of a troubled important financial institution, it should make reasonable efforts to break up the institution before returning it to private hands or to avoid selling it to another institution when the result would create a new systemically important institution. It is important for Congress and regulators to establish a credible resolution process to allow for an orderly resolution of a failed systemically important institution thereby helping to ensure that no bank or financial firm would be too big to fail.

Conclusions

The recent financial crisis underscored how quickly liquidity can deteriorate at a financial institution. As a result, regulators' deliberations about whether to invoke the systemic risk exception often occurred under severe time constraints. Treasury, FDIC, and the Federal Reserve collaborated prior to making announcements intended to reassure the markets, but the lack of a determination after two of these announcements of planned FDIC assistance under the systemic risk exception heightened the risk that such actions will be undertaken without appropriate transparency and accountability. Specifically, such an announcement

⁴³Sheila C. Bair, Testimony before the U.S. House of Representatives Committee on Financial Services (Washington, D.C., Oct. 29, 2009).

signals regulators' willingness to provide assistance and may give rise to moral hazard. However, in cases where Treasury does not make a determination, FDI Act requirements for communication and documentation do not apply. Therefore, when a determination is not made along with the announced actions, Congress cannot be assured that Treasury's reasoning would be open to the same scrutiny required in connection with a formal systemic risk determination. Furthermore, uncertainty in these situations can arise because there is no requirement for Treasury to communicate that it will not make a systemic risk determination for an announced action.

Our review of Treasury's systemic risk determinations highlights that the announced FDIC actions were made to reduce strains on the deteriorating markets and to promote confidence and stability in the banking system. Regarding the systemic risk determinations, the regulators concluded that resolving the depository institutions at issue under the traditional least-cost approach would have worsened adverse conditions in the economy and in the financial system. While it is difficult to isolate the impact of those actions from other government assistance, the actions seem to have reassured investors and depositors at the particular banks and encouraged them to continue to provide liquidity, thereby allowing the banks to keep operating. In the case of TLGP, some regulators and market observers have attributed short-term benefits to FDIC guarantees on certain debt obligations, citing improved cost and availability of credit for many institutions.

However, with respect to TLGP determination, some have noted that under a possible reading of the systemic risk exception, the statute may authorize assistance only to particular institutions based on those institutions' specific problems, not systemic risk assistance based on problems affecting the banking industry as a whole. Treasury, FDIC, and the Federal Reserve considered this and other legal issues in recommending and making TLGP determination. The agencies believe the statute could have been drafted more clearly and that it can be interpreted in different ways. They concluded, however, that under a permissible interpretation, assistance may be based on industry-wide concerns. They also concluded that a systemic risk determination waives all of the normal statutory restrictions on FDIC assistance and then creates new authority to provide assistance, both as to the types of aid that may be provided and the entities that may receive it. Under this reading, the agencies believe the statutory criteria were met in the case of TLGP and that the assistance was authorized. We examined these issues as part of our review of the basis of the systemic risk determinations made to date. We found there is some

support for the agencies' position that the exception authorized systemic risk assistance of some type under TLGP facts, as well as for their position that the exception permits assistance to the entities covered by this program. There are a number of questions concerning these interpretations, however. For example, the agencies agree that some of the statutory provisions are ambiguous. Because application of the systemic risk exception raises novel legal and policy issues of significant public interest and importance, and because of the need for clear direction to the agencies in a time of financial crisis, the requirements and assistance authorized under the systemic risk exception may require clarification by Congress.

Systemic risk assistance also raises long-term concerns about moral hazard and weakened market discipline, particularly for large complex financial institutions. This involves a trade-off between the short-term benefits to markets, the economy, and business and households of federal action and the long-term effects of any federal action on market discipline. While the financial regulatory framework can serve an important role in restricting excessive risk-taking activities as a result of weakened market discipline, the financial crisis revealed limitations in this framework. In particular, these limitations include inconsistent oversight of large financial holding companies (bank versus nonbank). Another limitation was a weakness in the risk management practices of these companies. Legislators and regulators currently are considering regulatory proposals to subject systemically important institutions, including those whose market discipline is likely to have been weakened by the recent exercises of the systemic risk exception, to stricter regulatory standards such as higher capital and stronger liquidity and risk management requirements. Furthermore, according to regulators, the lack of resolution authority for systemically important institutions contributes to a belief by market participants that the government will not allow these institutions to fail and thereby weakens incentives for market participants to monitor the risks posed by these institutions. Legislation has been proposed to expand resolution authority to large financial holding companies deemed systemically important that is intended to impose greater market discipline and limit moral hazard by forcing market participants to face significant costs from their risk-taking decisions. It is important for the use of a new resolution authority to be perceived by the market to be credible for it to help achieve the intended effects.

Matters for Congressional Consideration

To help ensure transparency and accountability in situations where FDIC, the Federal Reserve, and Treasury publicly announce intended emergency actions but Treasury does not make a systemic risk determination required to implement them, Congress should consider requiring Treasury to document and communicate to Congress the reasoning behind delaying or not making a determination.

Recent application of the systemic risk exception raises novel legal and policy issues, including whether the exception may be invoked based only on the problems of particular institutions or also based on problems of the banking industry as a whole, and whether and under what circumstances assistance can be provided to “healthy” institutions, bank holding companies, and other bank affiliates. Because these issues are of significant public interest and importance, as Congress debates the modernization and reform of the financial regulatory system, Congress should consider enacting legislation clarifying the requirements and assistance authorized under the systemic risk exception. Enacting more explicit legislation would provide legal clarity to the banking industry and financial community at large, as well as helping to ensure ultimate accountability to taxpayers.

As Congress contemplates reforming the financial regulatory system, Congress should ensure that systemically important institutions receive greater regulatory oversight. This could include such things as more consistent and enhanced supervision of systemically important institutions and other regulatory measures, such as higher capital requirements and stronger liquidity and risk management requirements and a resolution authority for systemically important institutions to mitigate risks to financial stability.

Agency Comments and Our Evaluation

We provided a draft of this report to the Federal Reserve, FDIC and Treasury for their review and comment. The Federal Reserve and Treasury provided us with written comments. These comments are summarized below and reprinted in appendixes III and IV, respectively. FDIC did not provide written comments. We also received technical comments from the Federal Reserve, FDIC, and Treasury that we have incorporated in the report where appropriate.

In its comments, the Federal Reserve agreed with our findings that while the agencies’ actions taken under the systemic risk exception were important components of the response by the government to the financial crisis, these actions have the potential to increase moral hazard and

reinforce perceptions that some firms are too big to fail. In order to mitigate too big to fail and risks to financial stability, the Federal Reserve stated that it agrees with our matter for Congressional consideration that all systemically important financial institutions be subject to stronger regulatory and supervisory oversight and that a resolution system be put in place that would allow the government to manage the failure of these firms in an orderly manner.

Treasury also commented that it agreed with our findings and our matter for Congressional consideration for greater regulatory oversight of the largest, most interconnected financial firms and resolution authority to wind down failing nonbank financial firms in a manner that mitigates the risks that their failure would pose to financial stability and the economy.

We are sending copies of this report to the Chairman of the Board of Governors of the Federal Reserve System; the Chairman of FDIC; the Secretary of the Treasury; and other interested parties. In addition, the report will be available at no charge on GAO's Web site at <http://www.gao.gov>.

If you or your staff have any questions regarding this report, please contact me at (202) 512-8678 or williamso@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix V.



Orice Williams Brown
Director, Financial Markets
and Community Investment

Appendix I: Objectives, Scope, and Methodology

To describe the steps taken by the Federal Deposit Insurance Corporation (FDIC) and the Board of Governors of the Federal Reserve System (Federal Reserve) to make the recommendations and the Department of the Treasury (Treasury) to make determinations in some cases, we reviewed documentation of recommendations that FDIC and the Federal Reserve made for Wachovia, the Temporary Liquidity Guarantee Program (TLGP), Citigroup, Bank of America, and the Public-Private Investment Programs proposed Legacy Loans Program (LLP) as well as documentation of Treasury's determination for Wachovia, TLGP, and Citigroup. We also reviewed press releases by the agencies announcing the respective intended actions. In addition, to gain an understanding of how the agencies collaborated prior to the announcements of emergency actions, we interviewed officials from Treasury, FDIC, and the Federal Reserve. We also spoke with these officials about the status of emergency actions that were announced, but did not result in a systemic risk determination by Treasury. Finally, we reviewed the Federal Deposit Insurance Act (FDI Act) requirements for transparency and accountability with respect to the use of the systemic risk provision and analyzed the implications of announcements that are not followed by a Treasury determination that would trigger these requirements.

To describe the basis for each determination and the purpose of actions taken pursuant to each determination we reviewed and analyzed documentation of Treasury's systemic risk determinations and the supporting recommendations that FDIC and the Federal Reserve made for Wachovia, TLGP, and Citigroup. We interviewed officials from Treasury, FDIC, the Federal Reserve, and the Office of the Comptroller of the Currency (OCC) to gain an understanding of the basis and authority for each determination and the purpose of the actions taken under each determination. We also interviewed three economists, one banking industry association, and a banking analyst. In addition, we collected and analyzed various data to illustrate financial and economic conditions at the time of each determination and the actions taken pursuant to each determination.

We examined whether the legal requirements for making the systemic risk determination with respect to TLGP were met and whether the assistance provided under that program was authorized under the systemic risk exception.¹ For this legal analysis, we reviewed and analyzed the FDI Act,

¹We did not review other legal aspects of TLGP or the legal aspects of the other systemic risk determinations or agency actions.

**Appendix I: Objectives, Scope, and
Methodology**

its legislative history including the Federal Deposit Insurance Corporation Improvement Act (FDICIA), and other relevant legislation. We reviewed FDIC regulations and policy statements as well as written background material prepared by the agencies. We obtained the legal views of Treasury, FDIC, and the Federal Reserve on the agencies' legal authority to establish TLGP, and also obtained the views of banking law specialists in private practice and academia on these issues.

In describing the likely effects of each determination on the incentives and conduct of insured depository institutions and uninsured depositors, as well as assessing proposals to mitigate moral hazard created by such federal assistance, we reviewed and analyzed the research reports of one credit rating agency, Congressional testimonies of regulators and market observers, proposed legislation, and academic studies. We interviewed officials from Treasury, FDIC, the Federal Reserve, and OCC as well as one academic, and three market observers to gain an understanding of how each determination and action impact the incentives and conduct of insured depository institution and uninsured depositors. Finally, we reviewed prior GAO work on the financial regulatory system.

We conducted this performance audit from October 2008 to April 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Analysis of Legal Authority for the Temporary Liquidity Guarantee Program (TLGP)

Introduction and Summary of Conclusions

As part of our review of the basis of the systemic risk determinations made to date under the Federal Deposit Insurance Act's ("FDI Act") systemic risk exception, we examined whether the legal requirements for making such determinations were met with respect to the Temporary Liquidity Guarantee Program ("TLGP") and whether the assistance provided under that program was authorized under the exception. We note that the recent financial crisis is the first time that Treasury, FDIC, and the Federal Reserve ("the agencies") have relied on the exception since its enactment as part of the Federal Deposit Insurance Corporation Improvement Act ("FDICIA") in 1991, and that no court to date has ruled on when or how the exception may be used.¹ We also acknowledge the volatile economic circumstances under which the agencies created TLGP.

The agencies believe that while the statute could have been drafted more clearly and that it can be interpreted in different ways, under a permissible interpretation, a systemic risk determination may be based on adverse circumstances affecting the banking industry as a whole—the situation that prompted creation of TLGP—as well as on adverse circumstances of one or more particular banking institutions. The agencies also believe a systemic risk determination waives all of the normal statutory restrictions on FDIC assistance, as well as creating new authority to provide assistance, both as to the types of aid that may be provided and the entities that may receive it. Under this reading, the agencies believe that the statutory criteria were met in the case of TLGP and that the assistance was authorized.

We agree there is some support for the agencies' position that the statute authorizes systemic risk assistance of some type under TLGP facts, as well as for their position that the exception permits assistance to the entities covered by TLGP. There are a number of questions concerning these interpretations, however. In the agencies' view, for example, some of the statutory provisions are ambiguous. What is clear, however, is that the systemic risk exception overrides important statutory restrictions designed to minimize costs to the Deposit Insurance Fund, and, in the case of TLGP, that the agencies used it to create a broad-based program of

¹The only reported decision involving the systemic risk exception appears to be *Wachovia Corp. v. Citigroup Inc.*, 634 F. Supp. 2d 445 (S.D.N.Y. 2009). The court there noted, by way of background, that Treasury had made a systemic risk determination with respect to Wachovia, but it did not address the issues analyzed here.

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

direct FDIC assistance to institutions that had never before received such relief—"healthy" banks, bank holding companies, and other bank affiliates. Because these novel legal issues are matters of significant public interest and importance, and because of the need for clear direction to the agencies in a time of financial crisis, we recommend that Congress consider enacting legislation clarifying the requirements and the assistance authorized under the exception.²

Background on FDIC's Statutory Authority to Use the Deposit Insurance Fund

As described in greater detail in this report, TLGP provided direct assistance, backed by FDIC's Deposit Insurance Fund, both to insured depository institutions and to their holding companies and other bank affiliates. The FDI Act normally permits Deposit Insurance Fund-supported assistance only to insured depository institutions, however, and allows assistance to operating ("open") insured depository institutions (so-called "open bank assistance") only in three situations, and then only by certain means. As specified in section 13(c) of the FDI Act:

"(c) Assistance to insured depository institutions

"(1) [The FDIC] is authorized . . . to make loans to, to make deposits in, to purchase the assets or securities of, to assume the liabilities of, or to make contributions to, any insured depository institution—

"(A) if such action is taken to prevent the default of such insured depository institution;

"(B) if, with respect to an insured bank in default, such action is taken to restore such insured bank to normal operation; or

²As part of our legal review and similar to our regular practice in preparing legal opinions, see GAO, *Procedures and Practices for Legal Decisions and Opinions*, GAO-06-1064SP (Washington, D.C.: September 2006), <http://www.gao.gov/htext/d061064sp.html> (last visited April 12, 2010), we obtained the legal views of Treasury, FDIC, and the Federal Reserve on their authority to establish TLGP. We also obtained the views of banking law specialists in private practice and academia on these issues.

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

“(C) if, when severe financial conditions exist which threaten the stability of a significant number of insured depository institutions or of insured depository institutions possessing significant financial resources, such action is taken in order to lessen the risk to the [FDIC] posed by such insured depository institution under such threat of instability.”

12 U.S.C. § 1823(c)(1)(A)-(C).

The FDI Act contains a number of additional restrictions on when and how the FDIC may use Deposit Insurance Fund monies:

First, before FDIC may provide assistance to an open bank, FDI Act section 13(c)(8) normally requires it to make a formal determination that the bank is in “troubled condition” under specific undercapitalization and other criteria and that the bank meets other requirements. FDIC must publish notice of any such determination in the *Federal Register*.³

Second, if FDIC decides to provide assistance, the assistance normally must meet so-called “least-cost requirements” in FDI Act section 13(c)(4). Section 13(c)(4)(A) requires FDIC to determine, using financial data about a specific institution, that the proposed assistance is necessary to meet FDIC’s deposit-insurance obligations with respect to the institution’s insured deposits and is the least costly of all possible methods of meeting those obligations.⁴ Section 13(c)(4)(E) prohibits FDIC from providing assistance to creditors or non-insured depositors of the institution if doing so would increase losses to the Fund beyond those that otherwise might result from protecting insured depositors.⁵

Third, FDI Act section 11(a)(4)(C) normally prohibits FDIC from using the Fund to benefit affiliates or shareholders of an assisted depository institution in any way, regardless of whether such assistance would cause a loss to the Fund.⁶

³12 U.S.C. § 1823(c)(8).

⁴12 U.S.C. § 1823(c)(4)(A)-(B).

⁵12 U.S.C. § 1823(c)(4)(E).

⁶12 U.S.C. § 1821(a)(4)(C).

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

The agencies believe, however, that if Treasury makes an emergency determination under the systemic risk exception, this waives all of the foregoing requirements and also creates new authority to provide any type of assistance to any type of entity, as long as the assistance is deemed necessary to avoid or mitigate systemic risk. Specifically, the words of the statute require Treasury to determine: (i) that “compliance with subparagraphs (A) and (E) [the least-cost requirements] with respect to an insured depository institution would have serious adverse effects on economic conditions or financial stability”; and (ii) that “any action or assistance under . . . [the exception] would avoid or mitigate” such effects. If Treasury makes this determination, the FDIC may then “take other action or provide assistance under this section as necessary to avoid or mitigate such effects.” The statute imposes significant deliberative and consultative requirements on the process for making such a determination: it must be made by the Secretary of the Treasury; the Secretary must receive written recommendations from both the FDIC Board of Directors and the Federal Reserve Board of Governors, each made pursuant to at least a two-thirds vote; and the Secretary must consult with the President.⁷

The Agencies’ Reliance on the Systemic Risk Exception to Create TLGP

The agencies agree that without Treasury’s systemic risk determination for TLGP in October 2008, the above statutory restrictions would have prohibited FDIC assistance to most of TLGP recipients, either because the entities would not have met the statutory “troubled condition criteria” for open banks (in the case of many TLGP participants) or because they were bank holding companies or other affiliates of insured depository institutions for which FDIC assistance normally is unavailable. The agencies clearly followed the requisite process in issuing the determination: FDIC and the Federal Reserve both submitted unanimous written recommendations in favor of Treasury making a systemic risk determination; the Secretary consulted with the President; and the Secretary signed a formal determination on October 14, 2008. Acknowledging that the systemic risk exception can be interpreted in different ways, the agencies believe they also met the statute’s substantive requirements under a permissible interpretation of the statute. We discuss

⁷12 U.S.C. § 1823(c)(4)(G)(i). The text of the systemic risk exception is set forth in full following this analysis.

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

below two key legal issues that the agencies considered in making their recommendations and determination.

**1. Authority to Provide Assistance Based on Problems of the
Banking Industry As a Whole**

In invoking the exception for the other two systemic risk determinations made to date—with respect to Wachovia in September 2008 and Citigroup in January 2009—the agencies concluded, based on the facts of those specific institutions, that providing least-cost assistance to those entities’ insured institutions would have had “serious adverse effects on economic conditions or financial stability”—that is, would have caused systemic risk.⁸ The agencies applied the exception differently for TLGP determination: they made what they characterized as a “generic systemic risk determination” made “generically for all [banking] institutions,”⁹ that is, a determination made with respect to “the U.S. banking system in general” and “insured depository institutions in general.”¹⁰ According to the agencies, they took this approach because the problem at hand was not limited to weakness in one or more individual institutions, but was a banking *system* problem, an overall scarcity of liquidity caused by lack of interaction among institutions. The agencies therefore concluded that providing assistance on a bank-by-bank basis would not have relieved the existing instability in the industry and that waiting to provide bank-by-bank relief after individual banks had begun to fail would not have mitigated further systemic risk. The agencies also believed that a bank-specific, wait-for-failure approach would have been more costly than TLGP assistance provided.

The agencies believe these facts supported the required statutory finding that “compliance with [the least-cost requirements] with respect to an insured depository institution” would cause systemic risk, in that they showed that having to apply the least-cost requirements on a bank-by-bank basis (“compliance with the . . . requirements with respect to an . . .

⁸The agencies concluded that a least-cost resolution of the insured institutions, with no assistance provided to uninsured creditors and losses imposed on creditors of the insured institutions’ holding companies, would have had significant adverse effects on economic conditions and the financial markets.

⁹Memorandum to FDIC Board of Directors, Oct. 22, 2008, at 1, 3.

¹⁰TLGP Determination, Oct. 14, 2008, at 1-2; ; Action Memorandum for Secretary Paulson, Oct. 14, 2008, at 3; Memorandum to Federal Reserve Board Chairman, Oct. 12, 2008, at 1.

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

institution”) would have caused systemic risk. The agencies also believe the statute permits a generic rather than a bank-specific determination because under general statutory construction and grammar rules reflected in the Dictionary Act, 1 U.S.C. § 1, the required finding regarding compliance “with respect to *an* institution” can be read as “compliance with respect to *one or more* institutions” unless statutory context indicates otherwise.¹¹

Some have noted that a possible reading of the exception authorizes assistance only to particular institutions, based on those institutions’ specific problems, not, as was done in creating TLGP, systemic risk assistance to all institutions based on problems affecting the banking industry in general.¹² In our view, the language, context, and history of the exception do not clearly restrict its use to assistance to specific institutions. The statute does not prescribe a detailed method by which Treasury must determine whether “compliance . . . would cause systemic risk,” and we agree with the agencies that “compliance . . . with respect to an institution” means the determination can be based on the circumstances of more than one bank—that is, “an institution” can mean “one or more institutions.”

As to whether the statute permits a determination to be made generically based on industry-wide problems at insured depository institutions apart from the health of any particular institution, nothing in the legislative history of the exception explicitly refutes the agencies’ position that the statute permits such a generic determination. The debate leading to enactment of FDICIA centered on FDIC’s role in resolving “too big to fail” institutions whose collapse might pose a risk to the entire financial system, rather than on banking system-wide problems already posing

¹¹The Dictionary Act provides that “[i]n determining the meaning of any Act of Congress, unless the context indicates otherwise [,] words importing the singular include and apply to several persons, parties, or things”

¹²*See, e.g.*, Congressional Oversight Panel, “November Oversight Report: Guarantees and Contingent Payments in TARP and Related Programs,” Nov. 6, 2009, at 36 (also noting FDIC’s belief that statute is sufficiently broad to authorize TLGP); L. Broome, “Extraordinary Government Intervention to Bolster Bank Balance Sheets,” 13 N.C. Banking Inst. 137, 150 (March 2009). *Cf.* Testimony of Edward Yingling, American Bankers Association, before the Committee on Financial Services, U.S. House of Representatives, Feb. 3, 2009, at 4 (reliance on systemic risk exception to create TLGP reflected use of the statute “in ways that no one could have predicted when this authority was enacted in 1991 . . . [T]he programs . . . have taken the FDIC well beyond its chartered responsibilities to protect insured depositors in the event of bank failure.”).

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

serious risk. However, nothing indicates Congress intended to preclude use of the exception when, as with the facts leading to TLGP, an adverse systemic condition is itself the cause of imminent bank failures and the agencies determine that individual least-cost resolutions would not adequately address the condition and in fact would worsen it. While Congress' intent to further restrict the FDIC's authority to provide open bank assistance is clear from the significant new limitations it imposed in FDICIA, Congress' simultaneous enactment of the systemic risk exception indicated a parallel objective to avoid wholesale systemic failure.¹³ In light of these objectives and the language of the statute, we believe there is some support for the agencies' position that the law does not require an institution-specific evaluation where it would result in systemic risk. *Unexcelled Chemical Corp. v. United States*, 345 U.S. 59 (1953) (laws written in comprehensive terms apply to unanticipated circumstances if they reasonably fall within the scope of the statutory language); see generally [GAO-08-606R](#) (March 31, 2008) at 13-18.

In sum, given Treasury's factual determination that systemic risk would have resulted from application of the least-cost requirements to the circumstances leading to creation of TLGP, we believe there is some support for the agencies' legal position that systemic risk assistance of some type was authorized. Whether the particular TLGP assistance provided was within the scope authorized by the systemic risk exception was a second issue the agencies considered, and which we now address.

2. Authority to Provide Assistance to Non-"Troubled" Banks, Bank Holding Companies, and Other Bank Affiliates

In addition to considering whether the banking industry-wide liquidity crisis could be mitigated by providing systemic risk relief, the agencies considered whether the statute authorized relief for all of the entities they believed should receive assistance. The agencies addressed whether the language of the statute—authorizing FDIC, in the event of a systemic risk determination, to “take other action or provide assistance under this

¹³ See generally S. Rep. No. 167, 102d Cong., 1st Sess. (1991) at 4, 45; “Strengthening the Supervision and Regulation of Depository Institutions,” Hearings Before the Senate Banking, Housing and Urban Affairs Committee, 1991 S. Hrg. 102-355, Vol. I, at 74 (Treasury), 1318 (Federal Reserve), 1381 (FDIC). But see 138 Cong. Rec. 3093, 3114 (Feb. 21, 1992)(post-enactment analysis submitted by Chairman Riegle stating that systemic risk determination must be based on effect of least-cost requirements on “a specific, named institution”).

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

section [FDI Act section 13] as necessary to avoid or mitigate” systemic risk—waived the statute’s other restrictions, and they concluded that it both waived the restrictions and then gave FDIC new authority to provide assistance even beyond that otherwise authorized by the FDI Act, as long as the assistance was “necessary to avoid or mitigate” systemic risk. Under this interpretation, the agencies believe FDIC had authority to provide TLGP assistance directly to bank holding companies and other bank affiliates,¹⁴ as well as to insured depository institutions that FDIC had not determined met the statutory troubled-condition criteria (and would not have met them in most cases because most of the institutions were “healthy” under the statutory standards).

The agencies base their interpretation in part on Congress’ use of the disjunctive term “or” in authorizing “other action *or* . . . assistance under this section,” noting that “or” generally indicates an intention to differentiate between two phrases. They also rely on a statutory construction principle known as the “grammatical rule of the last antecedent,”¹⁵ where a limiting phrase—here, “under this section”—generally should be read as modifying only the words immediately preceding it—here, “assistance,” not “other action.” In the agencies’ view, a systemic risk determination creates two distinct options for assistance: (1) “other action,” that is, “action” “other” than assistance allowed by FDI Act section 13; and (2) assistance allowed by section 13. “Other action” is not subject to the restrictions on section 13 assistance, in the agencies’ view, because by definition it is not section 13 assistance, while “assistance under this section” remains subject to those restrictions unless explicitly waived by the systemic risk exception, as in the case of the least-cost requirements. Under this interpretation, TLGP’s aid to all open healthy (non-“troubled”) banks, considered as a whole, was authorized because it constituted “other action” not subject to the section 13(c)(8) ban on relief to healthy open banks, rather than “assistance under this section” which would have prohibited relief to the same institutions if considered individually. Likewise, according to the agencies, TLGP’s direct

¹⁴As noted in this report, the agencies approved assistance directly to a holding company as part of the 2009 systemic risk determination made for Citigroup, as well as the 2008 TLGP determination.

¹⁵*Jama v. Immigration and Customs Enforcement*, 543 U.S. 335, 343 (2005), quoting *Barnhart v. Thomas*, 540 U.S. 20, 26 (2003).

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

assistance to bank holding companies and other bank affiliates constituted “other action” rather than “assistance under this section.”¹⁶

The agencies’ reading of the statute raises several issues. First, while rules of grammar and statutory construction can provide general guidance about what Congress intended, the actual context and structure of the statute are of equal if not paramount importance.¹⁷ Here, Congress’ interchangeable use of the terms “action” and “assistance” throughout section 13 suggests it did not intend to differentiate between those terms when it used them in section 13(c)(4)(G), the systemic risk exception. For example, although Congress entitled section 13(c), the general FDI Act provision authorizing FDIC aid to open insured institutions, as “*Assistance* to insured depository institutions,” it then used the term “*action*” to identify each circumstance in which such assistance is authorized. *See, e.g.*, 12 U.S.C. §§ 1823(c)(1)(A)-(C), 1823(c)(2), 1823(c)(4)(E). This suggests Congress created only one basic option for systemic risk relief: action or assistance, authorized by section 13 and related restrictions, except restrictions expressly waived by the systemic risk exception. The sequence of the terms “other action” and “assistance” in the statute supports this reading, because if Congress intended to create two types of relief—one subject to the section 13 restrictions and the other subject to no restrictions—arguably it would have reversed the order and authorized

¹⁶In support of this position, the agencies assert that FDI Act section 1821(a)(4)(C) provides independent authority, in the event of a systemic risk determination, to provide FDIC assistance normally prohibited under section 1823(c), specifically assistance that benefits shareholders. Section 1821(a)(4)(C) states in part, “[n]otwithstanding any provision of law other than [the systemic risk exception], . . . the Deposit Insurance Fund shall not be used in any manner to benefit any shareholder or affiliate” of an insured institution. In our view, however, this language is better read simply as a recognition that a systemic risk determination permits use of the Fund to benefit shareholders to the extent authorized by the exception—that is, to the extent permitted by section 1823(c)—rather than representing new authority.

¹⁷*See, e.g., Conroy v. Aniskoff*, 507 U.S. 511, 515 (1993); *Meredith v. Federal Mine Safety and Health Review Com’n*, 177 F.3d 1042, 1054 (D.C. Cir. 1999).

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

“assistance under this section or other action” rather than “other action or assistance under this section.”¹⁸

Second, the fact that the systemic risk exception explicitly waives the least-cost requirements, by two specific references to “subparagraphs (A) and (E),” but waives none of the other statutory requirements, also supports the one-option interpretation because it suggests Congress did not intend its authorization of “other action” to override other statutory restrictions. In this regard, FDIC has long recognized, since promulgation of its revised Open Bank Assistance Policy in 1992, that the section 13(c)(8) restrictions against assistance to healthy open banks apply even when there is a systemic risk determination and that these restrictions must be met prior to providing systemic risk assistance.¹⁹ FDIC thus applied the restrictions as part of its recommendation for the Citigroup systemic risk determination in January 2009, and determined that the open insured depository institutions there were “troubled,” thus qualifying for open bank—and systemic risk—assistance.²⁰ In FDIC’s view, its position that the Citigroup systemic risk determination did not waive (c)(8) for

¹⁸The agencies suggest that this one-option interpretation conflicts with the general rule of statutory interpretation against surplusage, which disfavors interpretations that render part of a statute superfluous, because the one-option interpretation reads “other action” out of the statute. This would only be the case if “action” and “assistance” have different meanings, however, and as noted above, the statutory context suggests they do not. The one-option interpretation thus satisfies a more fundamental canon of statutory interpretation: that statutes are to be read as a whole. As the Supreme Court has observed, the preference for avoiding surplusage “is not absolute” and can be “offset by the canon that permits a court to reject words ‘as surplusage’ if ‘inadvertently inserted or if repugnant to the rest of the statute.’” *Lamie v. United States Trustee*, 540 U.S. 526, 536 (2004) (quoting *Chickasaw Nation v. United States*, 534 U.S. 84, 94 (2001)).

¹⁹FDIC first noted these requirements in the 1992 update to its Open Bank Assistance Policy. FDIC explained there that under the 1991 FDICIA amendments, aid to open banks can be provided “only” if, among other things, the “new prerequisite[s] to the FDIC’s authority to provide assistance” in section 13(c)(8) are satisfied and any assistance provided to banks meeting section 13(c)(8) criteria “must” then meet the least-cost requirements unless Treasury makes a systemic risk determination. 57 Fed. Reg. 60203, 60203-04 (Dec. 18, 1992). FDIC later withdrew its Open Bank Assistance Policy for unrelated reasons—reasons that confirmed, rather than detracted from, its interpretation that section 13(c)(8) restrictions apply even if there is a systemic risk determination. See 62 Fed. Reg. 25191, 25191-92 (May 8, 1997). The agency has confirmed that this reading of section 13(c)(8) remains its position today, except, as discussed below, in cases such as TLGP.

²⁰FDIC Board of Directors Resolution, Nov. 23, 2008, at 2; Memorandum for FDIC Board of Directors, Nov. 23, 2008, at 3; Letter from FDIC Chairman Bair to Treasury Secretary Paulson, Nov. 24, 2008, at 1, 2. FDIC apparently did not, however, follow the requirement in section 13 (c)(8)(B) that it publish its determination in the *Federal Register*.

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

open depository institutions is consistent with its position that TLGP determination did waive (c)(8) for open depository institutions, because the former constituted “assistance under this section” relief while the latter constituted “other action” relief.²¹ FDIC’s 1992 Open Bank Assistance Policy did not address this aspect of the systemic risk exception, FDIC told us, because until TLGP, no one had considered the possibility of systemic risk stemming from industry-wide conditions rather than bank-specific conditions. We recognize that FDIC’s interpretation has evolved in response to new circumstances, but we believe its current and arguably inconsistent “other action” interpretation is subject to question for the reasons noted above.²²

Third, the practical effect of a systemic risk determination under the agencies’ reading is to authorize any type of assistance to any type of entity, provided the aid is deemed necessary to avoid or mitigate systemic risk. This is because if relief does not meet the restrictions imposed on “assistance under this section,” the identical relief is by definition authorized as “other action.” If Congress had intended to give FDIC such broad new authority, however, it could have simply said so, authorizing FDIC to “take action” in the event of systemic risk. Instead, Congress added qualifying language apparently intended to limit FDIC’s options, only authorizing it to “take other action or provide assistance *under this section*.”

Finally, the overall legislative history of FDICIA also suggests Congress did not intend the exception to provide the breadth of new authority claimed by the agencies. FDICIA was aimed in part at curbing what Congress believed had been excessive costs of FDIC bank assistance that increased the exposure of the Deposit Insurance Fund. Congress therefore imposed new restrictions intended to raise, not lower, the bar for FDIC

²¹Under the Citigroup systemic risk determination, FDIC also provided direct assistance to Citigroup, Inc., the holding company, and to other non-depository Citigroup affiliates. As with TLGP recipients, FDIC was prohibited from providing “assistance under this section” relief to these recipients; it instead provided “other action” assistance not subject, in its view, to the section 13(c)(8) limitations.

²²The issue of whether Congress intended the exception to override all restrictions on FDIC’s authority helps illustrate why congressional clarification of the exception could be appropriate. Even though, as discussed above, a permissible reading of the exception might permit a *determination* that is not tied to specific institutions, the continuing applicability of section 13(c)(8) suggests that the resulting *assistance* still would have to be institution-specific—as reflected in FDIC’s application of section 13(c)(8) in recommending systemic risk assistance for Citigroup.

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

relief. Limits were added, for example, on which entities could receive assistance (*e.g.*, only open banks in “troubled condition”) and how much assistance could be provided (least-cost). Congress also imposed so-called prompt corrective action mandates on the banking regulators, requiring them to take increasingly severe actions as an institution’s capital deteriorates.²³ Additionally, like its predecessor exception, the systemic risk exception was enacted as part of a provision imposing cost-based limits on FDIC assistance—the least-cost requirements—rather than as a separate provision granting new authority.²⁴ In light of FDICIA’s overarching remedial purposes, it is questionable that Congress would have intended to simultaneously provide FDIC with new and substantially broader authority than the agency had been given since its creation in 1933, and would have done so by means of an implication in a narrowed exception to a cost restriction. *Commissioner v. Clark*, 489 U.S. 726, 738-39 (1989)(“Given that Congress has enacted a general rule . . . , we should not eviscerate that legislative judgment through an expansive reading of a somewhat ambiguous exception.”); *Whitman v. American Trucking Ass’n*, 531 U.S. 457, 468 (2001)(“Congress, we have held, does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes.”) (citations omitted).

In response to these issues, the agencies make two additional points.

First, they suggest that any uncertainty regarding whether “other action” authorized TLGP assistance to bank holding companies was resolved by 2009 amendments to the systemic risk exception. At the time TLGP was created, the exception required FDIC to recover any losses to the Deposit Insurance Fund caused by its systemic risk assistance, but authorized recovery only from insured depository institutions. In response to concerns by FDIC and banking industry representatives that bank holding companies should also bear some of TLGP costs because they had received substantial assistance under the program, Congress modified the

²³ 12 U.S.C. § 1831o(e)-(i).

²⁴ Prior to FDICIA, the FDI Act limited assistance that FDIC could provide to open insured institutions to the amount reasonably necessary to save the FDIC the cost of liquidating the insured bank, but provided an exception where the FDIC determined that continued operation of the bank was “essential to provide adequate banking services in the community.” 12 U.S.C. § 1823(c)(4)(A) (1988)(Supp. II 1991). FDICIA replaced this liquidation-cost test with the more restrictive least-cost test and replaced the essentiality exception with the more restrictive systemic risk exception.

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

provision in May 2009 to permit assessments against bank holding companies as well as depository institutions. Pub. L. No. 111-22, sec. 204(d), codified at 12 U.S.C. § 1823(c)(4)(G)(ii). The agencies believe this confirms the FDIC's authority to provide assistance to bank holding companies under TLGP because Congress did not simultaneously amend the exception to explicitly prohibit such assistance going forward. We agree the amendment provides some support for the agencies' position under a general tenet of statutory construction that congressional awareness of an agency's practice in implementing a statute, without striking down that practice, indicates congressional acquiescence in the agency's interpretation.²⁵

Second, the agencies maintain that their interpretation of any ambiguous aspects of the systemic risk exception warrants substantial deference under the Supreme Court's decision in *Chevron U.S.A. v. Natural Resources Defense Council*, 467 U.S. 837 (1984), and related cases. Under *Chevron*, when the meaning of a statute is unclear, either because the statute is silent on an issue or the language is ambiguous, an interpretation by an agency charged with the statute's administration warrants substantial deference provided the interpretation is reasonable, even if it is not the only interpretation or the best interpretation. Whether and to what extent deference is warranted depends on factors including the agency's specialized expertise in implementing the statute, whether the agency's interpretation has been subjected to public scrutiny through public notice-and-comment rulemaking, and whether its interpretation is consistent with its previous pronouncements. *United States v. Mead Corp.*, 533 U.S. 218, 227-29 (2001) (citations omitted). Under *Mead*, *Chevron* deference is warranted where the interpretation is made as part of an agency rulemaking or other agency action that Congress intended to carry the force of law, and, even if *Chevron* deference is not warranted, lesser deference is warranted under *Skidmore v. Swift*, 323 U.S. 134 (1944), if the agency's interpretation is "persuasive" based on factors such as the thoroughness and validity of the agency's reasoning, the consistency of its interpretation over time, and the formality of its action.

We believe these deference principles have some force as applied to the systemic risk exception and TLGP. Congress did not explicitly address

²⁵See generally *Commodity Futures Trading Com'n v. Schor*, 478 U.S. 833 (1986); *Creekstone Farms Premium Beef v. Dep't of Agriculture*, 539 F.3d 492, 500-01 (D.C. Cir. 2008).

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

whether FDIC may provide systemic risk relief directly to bank holding companies or healthy open banks, and a court arguably could find that the statute's authorization of "other action or assistance under this section" is ambiguous.²⁶ If it did, we believe the agencies' reading might merit at least some degree of deference. Congress charged these three financial regulatory agencies with implementing the systemic risk exception, and charged FDIC with implementing other provisions of the FDI Act related to this exception. The agencies interpreted the exception to authorize assistance to holding companies, other bank affiliates, and non-troubled banks as part of the systemic risk determination, and FDIC exercised its general rulemaking authority to issue regulations establishing TLGP, including regulations providing for assistance to these entities. According to the agencies, their interpretation of what "other action or . . . assistance" authorizes was necessarily part of the rulemaking because critical aspects of the program—assistance to "healthy" banks, and to bank holding companies and other bank affiliates—were premised upon this interpretation and would otherwise have been prohibited. Further, FDIC's rulemaking preambles asserted that TLGP was authorized by Treasury's systemic risk determination.²⁷ The fact that the regulations and preambles did not solicit public comment on the underlying legal interpretations—and in fact did not indicate what the interpretations were—did not disqualify them from *Chevron* deference, according to the agencies, because under other Supreme Court precedent, an agency's interpretation of a statute may warrant deference if the interpretation was the only logical basis for a rulemaking, even if the agency does not disclose its interpretation.²⁸ Finally, we note that the very process Congress established for issuance of systemic risk determinations reflects great congressional respect for the agencies' judgment and expertise, if not a strict basis for legal deference to their interpretation of the statute.

²⁶The agencies assert that the fact that it is possible to read the systemic risk exception in different ways demonstrates the statute is ambiguous. Mere disagreement over the meaning of statutory language does not itself create ambiguity, however. *Brown v. Gardner*, 513 U.S. 115, 118 (1994)(citation omitted)("Ambiguity is a creature not of definitional possibilities but of statutory context.").

²⁷*See, e.g.*, 73 Fed. Reg. 64179, 64179-80 (Oct. 29, 2008).

²⁸*National Railroad Passenger Corp. v. Boston & Maine Corp.*, 503 U.S. 407, 428 (1992)(*Chevron* deference given to ICC interpretation that was "a necessary presupposition" of agency order even though agency was silent about its legal interpretation). It is not clear whether the Supreme Court's seminal decision in *Mead*, decided in 2001, may have undercut the precedential value of *National Railroad Passenger Corp.*, decided in 1992.

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

We nonetheless believe the arguments for deference to the agencies' interpretation are undercut by the statutory interpretation concerns discussed above, which raise questions about the persuasiveness of the agencies' arguments, and by the different and arguably inconsistent positions taken by FDIC regarding whether the systemic risk exception waives the prohibition against assistance to "healthy" institutions.

Conclusion

We believe there is some support for the agencies' position that the systemic risk exception authorizes assistance of some type under TLGP facts, as well as for their position that the exception permits assistance to the entities covered by this program. There are a number of questions concerning these interpretations, however. Because application of the systemic risk exception raises novel legal and policy issues of significant public interest and importance, and because of the need for clear direction to the agencies in a time of financial crisis, we recommend that Congress consider enacting legislation clarifying the requirements and assistance authorized under the exception. Congress is now debating modernization and reform of the financial regulatory system, including regulation that addresses systemic risk, and this may provide an opportunity for such congressional consideration.²⁹ Enacting more explicit legislation will provide legal clarity to the agencies, the banking industry, and the financial community at large, and will help to ensure greater transparency and accountability to the taxpaying public.³⁰

²⁹We have previously reported on the need for such reform. *See, e.g.*, GAO, "FINANCIAL REGULATION: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System," [GAO-09-216](#) (Washington, D.C. Jan. 8, 2009).

³⁰According to FDIC, the Debt Guarantee portion of TLGP is backed by the full faith and credit of the United States. *See* 57 Fed. Reg. 72244, 72252 (Nov. 26, 2008); FDI Act section 15(d), 12 U.S.C. § 1825(d).

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

The Systemic Risk Exception

**Federal Deposit Insurance Act Section 13(c)(4)(G),
Title 12, United States Code, Section 1823(c)(4)(G)**

§ 1823. Corporation monies * * *

(c) Assistance to insured depository institutions * * *

(4) Least-cost resolution required * * *

(G) Systemic risk

(i) Emergency determination by Secretary of the Treasury

Notwithstanding subparagraphs (A) and (E) [the least-cost requirements], if, upon the written recommendation of the [FDIC] Board of Directors (upon a vote of not less than two-thirds of the members . . .) and the Board of Governors of the Federal Reserve System (upon a vote of not less than two-thirds of the members . . .), the Secretary of the Treasury (in consultation with the President) determines that—

- (I) the Corporation's compliance with subparagraphs (A) and (E) with respect to an insured depository institution would have serious adverse effects on economic conditions or financial stability; and
- (II) any action or assistance under this subparagraph would avoid or mitigate such adverse effects,

the Corporation may take other action or provide assistance under this section as necessary to avoid or mitigate such effects.

(ii) Repayment of loss

(I) In general

The Corporation shall recover the loss to the Deposit Insurance Fund arising from any action taken or assistance provided with respect to an insured depository institution under clause (i) from 1 or more special assessments on insured depository institutions, depository institution holding companies (with the concurrence of the Secretary of the Treasury with respect to holding companies), or both, as the Corporation determines to be appropriate.

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

(II) Treatment of depository institution holding companies

For purposes of this clause, sections 1817(c)(2) and 1828(h) of this title shall apply to depository institution holding companies as if they were insured depository institutions.

(III) Regulations

The Corporation shall prescribe such regulations as it deems necessary to implement this clause. In prescribing such regulations, defining terms, and setting the appropriate assessment rate or rates, the Corporation shall establish rates sufficient to cover the losses incurred as a result of the actions of the Corporation under clause (i) and shall consider: the types of entities that benefit from any action taken or assistance provided under this subparagraph; economic conditions, the effects on the industry, and such other factors as the Corporation deems appropriate and relevant to the action taken or the assistance provided. Any funds so collected that exceed actual losses shall be placed in the Deposit Insurance Fund.

(iii) Documentation required

The Secretary of the Treasury shall—

- (I) document any determination under clause (i); and
- (II) retain the documentation for review under clause (iv).

(iv) GAO review

The Comptroller General of the United States shall review and report to the Congress on any determination under clause (i), including—

- (I) the basis for the determination;
- (II) the purpose for which any action was taken pursuant to such clause; and
- (III) the likely effect of the determination and such action on the incentives and conduct of insured depository institutions and uninsured depositors.

(v) Notice

**Appendix II: Analysis of Legal Authority for
the Temporary Liquidity Guarantee Program
(TLGP)**

(I) In general

The Secretary of the Treasury shall provide written notice of any determination under clause (i) to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives.

(II) Description of basis of determination

The notice under subclause (I) shall include a description of the basis for any determination under clause (i).

Appendix III: Comments from the Board of Governors of the Federal Reserve System



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

April 6, 2010

Mr. Richard J. Hillman
Managing Director
Financial Markets and Community Investment
Government Accountability Office
Washington, D.C. 20548

Dear Mr. Hillman:

The Federal Reserve appreciates the opportunity to comment on a draft of the GAO's report on the use of the systemic risk exception in the Federal Deposit Insurance Act (FDI Act) during the financial crisis (GAO-10-100).

The systemic risk exception may be invoked only through action by the Federal Reserve, the FDIC's board of directors, and the Secretary of the Treasury after consultation with the President. It is extraordinary authority that the agencies have used sparingly and judiciously since it was enacted in 1991. Prior to the financial crisis that began in 2007, the exception had not been used at all. And during the financial crisis, which is widely acknowledged as the worst financial disruption since the Great Depression, the Secretary has made the necessary determination and authorized the FDIC to provide assistance or take action under the exception only three times--to facilitate the proposed acquisition of the banking operations of Wachovia Corporation by Citigroup, Inc., to establish the Temporary Liquidity Guaranty Program (TLGP), and to participate in a package of loss protections and liquidity supports for Citigroup, Inc. These determinations are the focus of the GAO's report.

As the report recognizes, in each of these cases the agencies acted in conformance with the requirements of the systemic risk exception. In addition, as the report recognizes, the agencies acted to address circumstances that had the potential to significantly worsen the already substantial strains on the financial system, and the FDIC's actions and assistance under the systemic risk exception helped stabilize the specific institutions involved and promoted confidence and liquidity in the banking industry generally. Moreover, the report acknowledges that the agencies' recommendations, decisions, and analysis regarding each of these actions, including the TLGP, are supported by the statute.

Appendix III: Comments from the Board of
Governors of the Federal Reserve System

Mr. Richard J. Hillman
April 6, 2010
Page 2

I am confident that the actions taken by the agencies were fully consistent with, and authorized by, the terms of the systemic risk exception. Moreover, the actions taken and assistance provided by the FDIC under the systemic risk exception were important components of the response by the U.S. Government to the financial crisis. These actions, as well as those taken by the Federal Reserve and the Treasury, helped prevent a further worsening of the financial crisis and, thus, helped promote the flow of credit to households, businesses, and state and local governments.

While the agencies' actions were necessary in light of prevailing conditions, these actions have the potential to increase moral hazard and reinforce perceptions that some firms are too big to fail. To help address these negative consequences, your report recommends that Congress ensure that all systemically important financial institutions be subject to stronger regulatory and supervisory oversight and that a resolution system be put in place that would allow the government to manage the failure of large, complex, and interconnected financial firms in an orderly manner.

The Federal Reserve agrees with these two recommendations and, indeed, for some time has strongly advocated that Congress enact comprehensive legislation that would ensure that all systemically important financial firms—including those that do not own a bank—are subject to the same framework for consolidated prudential supervision as bank holding companies. In addition, I and other members of the Federal Reserve have repeatedly testified that a crucial element of any regulatory reform agenda must be the development of a new regime that would allow the orderly resolution of a systemically important financial firm in a way that imposes losses on shareholders and creditors while minimizing the potential for systemic consequences. We must end too big to fail, and a critical step is providing an alternative to government bailouts or a disorderly bankruptcy of large interconnected financial firms.

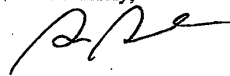
As your report acknowledges, the Federal Reserve already is taking steps, in conjunction with other domestic and foreign supervisors where appropriate, to strengthen the supervision and regulation of large financial firms. The Federal Reserve has played a key role in international efforts to ensure that systemically critical financial institutions hold more and higher-quality capital, have enough liquidity to survive highly stressed conditions, and meet demanding standards for company-wide risk management. We also have taken the lead in addressing flawed compensation practices by issuing proposed guidance and commencing supervisory initiatives to help ensure that compensation structures at banking organizations provide appropriate incentives without encouraging excessive risk-taking. In addition, we are developing an off-site, enhanced quantitative surveillance program for large bank holding companies that will use data analysis and formal modeling to help identify vulnerabilities at both the firm level and for the financial sector as a whole.

**Appendix III: Comments from the Board of
Governors of the Federal Reserve System**

Mr. Richard J. Hillman
April 6, 2010
Page 3

We appreciate the time, effort, and professionalism of the GAO review team. Federal Reserve staff separately has provided GAO staff with technical comments on the draft report. We hope that these comments were helpful.

Sincerely,



Appendix IV: Comments from the Department of the Treasury



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

April 12, 2010

Ms. Orice Williams-Brown
Director of Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Williams-Brown:

The Department of Treasury (Treasury) appreciates the opportunity to review and comment on the U.S. Government Accountability Office (GAO) draft report, entitled *Federal Deposit Insurance Act: Regulators' Use of Systemic Risk Exception Raises Moral Hazard Concerns and Opportunities Exist to Clarify the Provision* (GAO 250428). Treasury also appreciates the GAO's careful and considered review of the facts and circumstances that resulted in systemic risk determinations regarding the Wachovia Corporation's subsidiary insured depository institutions, the FDIC's Temporary Liquidity Guarantee Program assistance to insured depository institutions, and the asset guarantee related to Citigroup Inc.'s subsidiary insured depository institutions.

As you know, Treasury made the systemic risk determinations during a severe and rapidly deteriorating financial crisis to enable the FDIC to take actions that would stabilize the financial system. Treasury carefully considered its authority under the Federal Deposit Insurance Act, and it acted well within that authority.

The GAO recommends that Congress ensure that systemically important institutions receive greater regulatory oversight. Treasury strongly agrees and supports swift enactment of regulatory reform legislation that provides for greater regulatory oversight of the largest, most interconnected financial firms and resolution authority to wind down failing nonbank financial firms in a manner that mitigates the risks that their failure would pose to financial stability and the economy.

Once again, Treasury appreciates the opportunity to review this report and the GAO's thoughtful recommendations.

Sincerely,

A handwritten signature in black ink, appearing to read "G. W. Madison", is written over a horizontal line.

George W. Madison

Appendix V: GAO Contact and Staff Acknowledgments

GAO Contact

Orice Williams Brown (202)-512-8678 or <mailto:williamso@gao.gov>

Staff Acknowledgments

In addition to the contacts named above, Karen Tremba (Assistant Director), Rachel DeMarcus, John Fisher, Kristopher Hartley, Michael Hoffman, Marc Molino, Akiko Ohnuma, Barbara Roesmann, Carla Rojas, Susan Sawtelle, and Paul Thompson made key contributions to this report.

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Washington, DC 20548



Exhibit B

56470

Board that payroll has declined every month in 2008, resulting in a total loss of 760,000 jobs, causing the unemployment rate to increase to 6.1 percent

Mr. Brown then stated that a recent study by Corporation staff on the effect of a run on uninsured deposits on economic activity indicates that a 5 percent run would reduce GDP growth by 1.16 percent per annum in a normal economy while the same run on a stressed economy could decrease GDP growth by as much as 1.96 percent per annum. With economic growth already dampened, he said, a run of that magnitude could be enough to push the U.S. into recession or deepen or prolong a recession if the economy already is in one. Mr. Brown continued, adding that, while conditions to date do not appear to have reached the level of these stress scenarios, there is ample evidence over the last few months that there have been, and continue to be, rapid and substantial outflows of uninsured deposits from institutions that are perceived to be under stress.

Mr. Brown then turned to the Treasury - Eurodollar ("TED") spread, or the difference between 3-month dollar LIBOR and the yield on 3-month Treasury instruments, which has traditionally been narrow and stable at a level just below 50 basis points. Contrary to typical TED spreads, he noted that, in the summer of 2007, the TED spread spiked upward, reaching 238 basis points on August 20, 2007; that, since then, the daily average has been 138 basis points; and that the situation worsened considerably starting in mid-September of this year, with the TED spread rising to 415 basis points by October 9. Further, he said, market participants maintain that relatively little lending is occurring even at those elevated spreads. Mr. Brown added that the Federal Reserve has had difficulty maintaining the effective (or actual) Federal funds rate at the target Fed funds rate, which is currently at 1.50 percent. Such volatility, he said, indicates that banks are hoarding money and not lending in the Federal funds market, and that the (b)(9)

[REDACTED]

Mr. Brown informed the Board that investors briefly saw negative yields on the 3-month Treasury bill on Wednesday September 17, 2008, something that has not occurred since January 1940. Investors in these instruments, he said, were essentially paying the government for the privilege of having no credit or liquidity risk. In times of heightened uncertainty, Mr. Brown stated that investors may find this small loss

Exhibit C

October / 3 2008

MEMORANDUM: The Board of Directors

FROM: Mitchell L. Glassman, Director *Mitchell L. Glassman*
Division of resolutions and Receiverships

CONCUR: Sandra L. Thompson, Director *SLT*
Division of Supervision and Consumer Protection

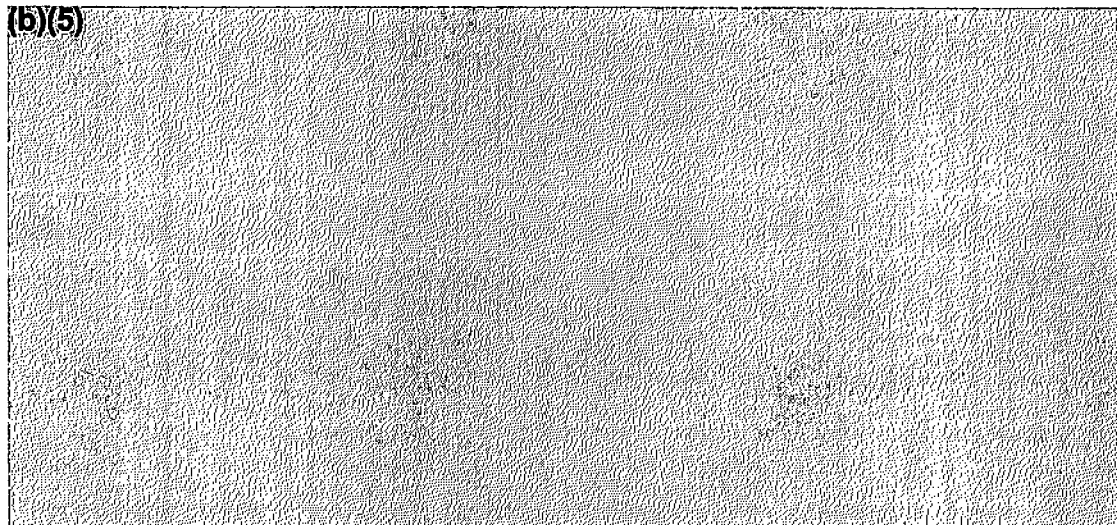
Arthur L. Murton, Director *Arthur L. Murton*
Division of Insurance and Research

Sara A. Kelsey *Sara A. Kelsey*
General Counsel

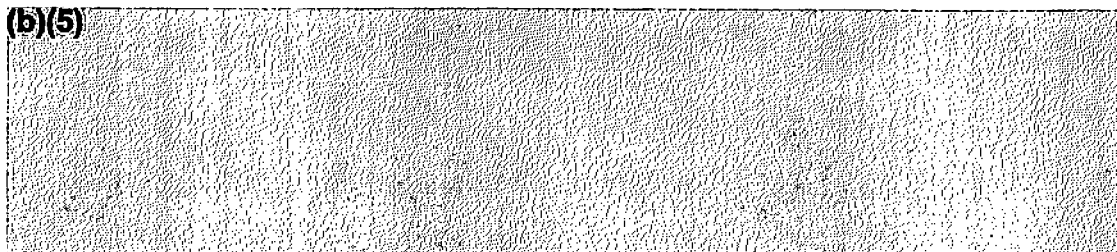
SUBJECT: FDIC Guarantee of Bank Debt

I. Summary of Recommendations

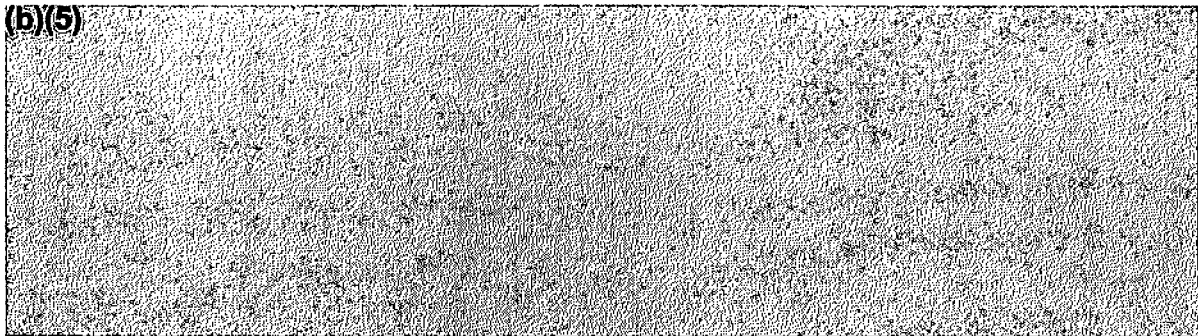
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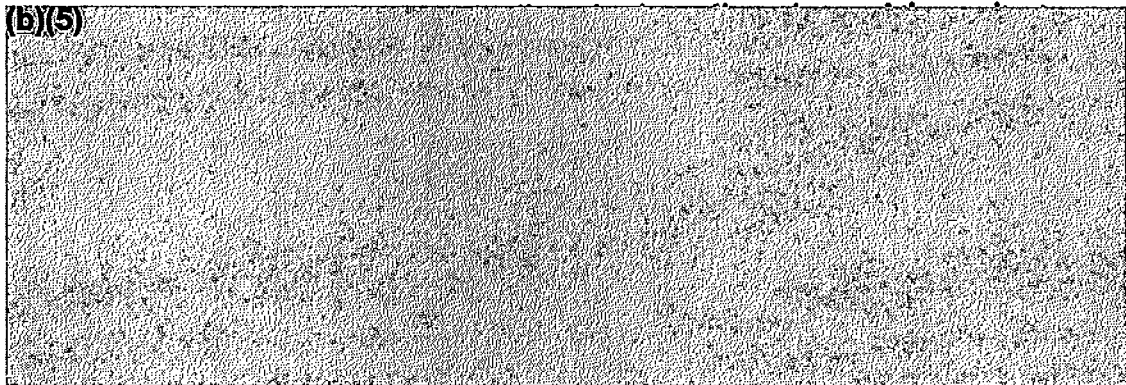


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I. SYSTEMIC RISK

(b)(5)



Recent Overall Market Conditions

Second quarter evidence suggests that banks have responded to the market turmoil by retaining cash and tightening lending standards. Most banks surveyed by the Federal Reserve in July reported tightened lending standards and terms on all major loan categories compared to the April survey. About 58 percent of domestic banks tightened lending standards for C & I loans to large and medium firms, while 65 percent reported tighter lending standards for C & I loans to small firms. About three-quarters of respondents increased spreads of loan rates on C & I loans. About 80 percent of domestic banks reported tightening lending standards on commercial real estate loans, and 74 percent tightened lending standards on prime residential real estate loans. Close to two-thirds of surveyed banks reported tighter lending standards for consumer loans of

all types. Demand for loans from both business and households weakened during the second quarter, with banks that experienced weaker demand citing a decrease in customers' needs to finance investment in plants, equipment, and inventories.

With regard to borrowing by businesses, households, and state and local governments, annualized growth in the net issuance of credit market debt by U.S. nonfederal nonfinancial sectors has slowed markedly since the onset of financial market disruptions in mid 2007. After growing by over \$2 trillion annually each year from 2005 through 2007, the debt of nonfederal nonfinancial sectors grew at an annual rate of only \$816 billion in the second quarter of 2008 – well before the most recent intensification of the crisis. Net issuance of municipal securities in the second quarter was only \$45 billion annualized (compared to \$215 billion last year), while net issuance of residential mortgage debt fell to just \$29 billion (down from over \$1 trillion each year from 2004–06). Even the pace of net business borrowing has fallen by half, from \$1.2 trillion last year to \$608 billion (annualized) in the second quarter. Regarding nonfinancial debt, we expect to see further contraction in the pace of business borrowing in the third and fourth quarters as the effects of current credit market disruptions are fully realized.

A recent study by FDIC staff on the effect of a run on uninsured deposits on economic activity indicates that a 5 percent run would reduce GDP growth by 1.16 percent per annum in a normal economy. The same run on a stressed economy could decrease GDP growth by as much as 1.96 percent per annum. With economic growth already dampened, a run of this magnitude could be enough to push the U.S. into recession or may deepen or prolong a recession if we are already in one.

(b)(5) & (b)(8)

(b)(5) & (b)(8)

While overall third quarter data and studies are not available, we discuss below examples drawn from several quarters that existing bank debt markets remain seriously disrupted. And, indeed, that disruption has become more severe since the end of the second quarter.

Interbank Market

The TED (Treasury – Eurodollar) spread, or the difference between 3-month dollar Libor and the yield on 3-month Treasury instruments, has traditionally been narrow and stable at a level just below 25 basis points. However, in the summer of 2007 the TED spread spiked upward, reaching 238 basis points on August 20, 2007. Since then, the daily average has been 138 basis points. The situation worsened considerably starting in Mid-September of this year, with the TED spread rising to 415 basis points by October 9. Further, market participants maintain that relatively little lending is occurring at this elevated rate. The Federal Reserve has had a difficulty maintaining the effective (or actual) federal funds rate at the target federal funds rate, which is currently at 1.50 percent. For example, it closed at 1.40 percent on Thursday October 9, 2008, but the intraday high was 5.50 percent and the low was 0.01 percent. This volatility indicates that banks are hoarding money and not lending in the federal funds market, and that the

(b)(5)

Investors briefly saw negative yields on the 3-month Treasury bill on Wednesday September 17, 2008. According to Los Angeles-based Global Financial Data, the last

time the 3-month T-bill was at or below zero was January 1940. Investors in these instruments were essentially paying the government for the privilege of having no credit or liquidity risk. In times of heightened uncertainty, investors may find this small loss preferable to the losses they may stand to experience on alternative investments.

Commercial Paper

Disruptions to money markets, especially disruptions since the Lehman Brothers failure, has significant impaired the ability of even creditworthy companies to issue commercial paper -- particularly at longer maturities. Federal Reserve data show that the average weekly issuance of AA-rated asset-backed commercial paper with maturities over 80 days fell to \$809 billion in the last two weeks of September from \$4.7 trillion in the previous two weeks. Even more pronounced was the decline in issuance of other long-term open market paper which was \$1.6 trillion during the last two weeks of September, down from \$8.4 trillion during the previous two weeks. Issuance rose somewhat in both categories during early October as the Federal Reserve's new Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility grew by over \$145 billion.

Meanwhile, interest rates on asset-backed commercial paper continue to be extremely high. The average rate on 30-day ABCP spiked to 6.05% on September 30 before falling slightly to 4.33% on October 9. During the first two weeks of September, the average rate on 30-day ABCP had been about 2.6 percent.

Private Asset-Backed Securitization

Issuance of both private Residential Mortgage Backed Securities (RMBS) and Commercial Mortgage Backed Securities ("CMBS") in the first half of this year have

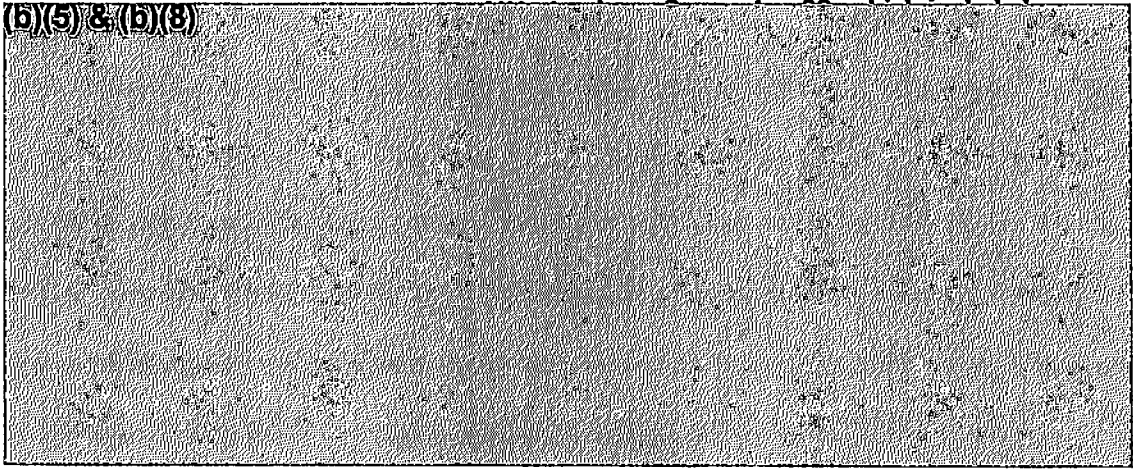
fallen by more than 90% from year ago levels. For all intents and purposes, these markets have shut down. Securitizations of second lien mortgage and non-mortgage financial assets which have declined to a lesser degree have experienced widespread increases in funding costs. Issuance of asset-backed securities ("ABS") fell by 68 percent to \$117 billion as of August 2008 from the same month a year ago. ABS issuance in the first quarter of 2008 was the lowest in eight years. The decline was primarily due to reduced issuance of ABS backed by home equity, automobile, and student loans. Credit card ABS issuance is currently the single largest component of non-mortgage ABS, comprising 47 percent of issuance as of August 2008. Home equity-backed ABS, which dominated ABS issuance in 2007 with a 57 percent share, dropped to a zero percent share this year. Like other structured finance products, ABS credit spreads have widened during the past year. Swiss bank UBS reported recently that the unusually wide spreads on non-mortgage-related consumer ABS have been driven more by sharply diminished liquidity than collateral performance trends.

Treasury "Fails"

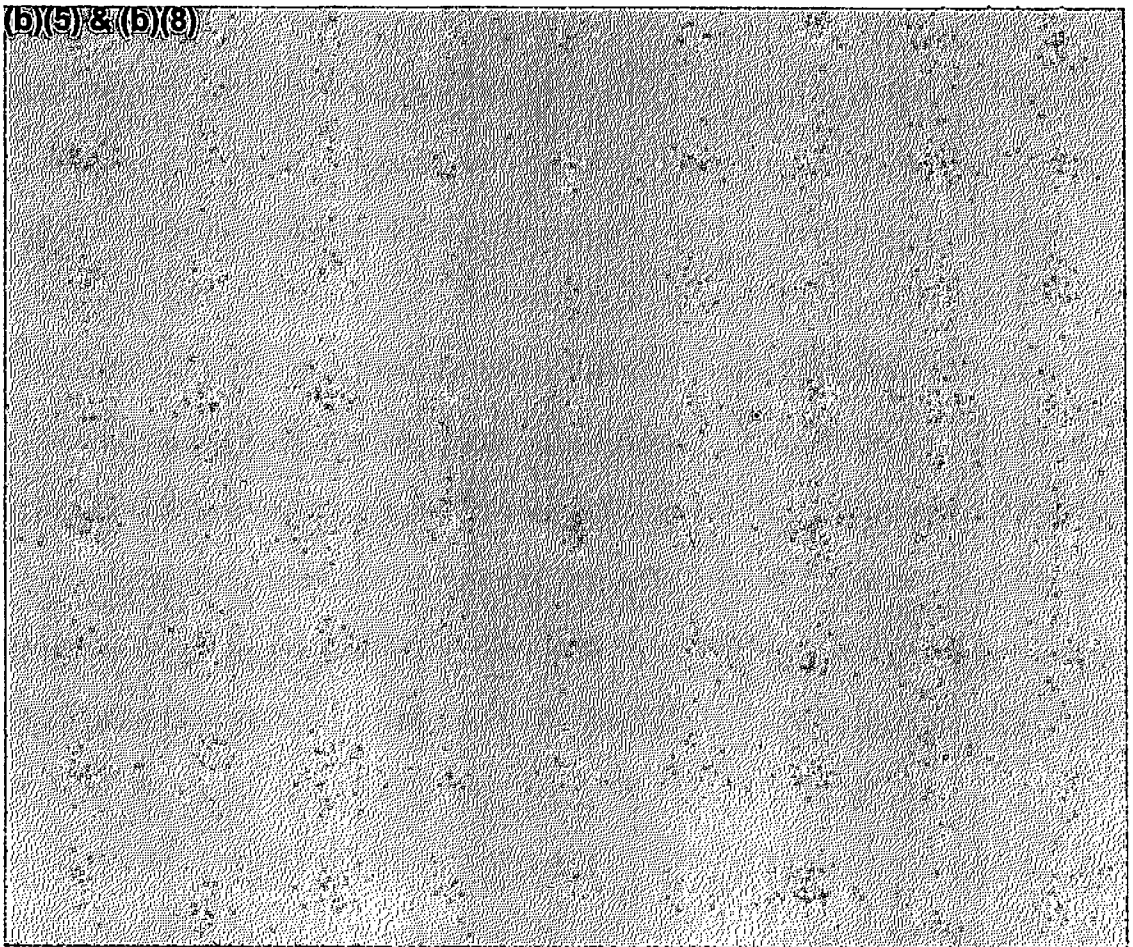
Failures to deliver or receive US Government securities rose to a record in recent weeks before the Treasury stepped up debt sales to relieve shortages. Failures jumped about 35 percent to \$4.79 trillion in the week ended October 1, according to the Federal Reserve Bank of New York. Fails averaged about \$185 billion a week since July 1990. Demand for the relative safety of government securities has surged as the difficulties in credit markets have deepened. The increase in failures is an indication of scarcity in the US Government securities market. Dealers often let trades in the repurchase agreement

("repo") market go uncompleted when it is difficult to obtain the securities or when the cost to get the securities becomes too expensive.

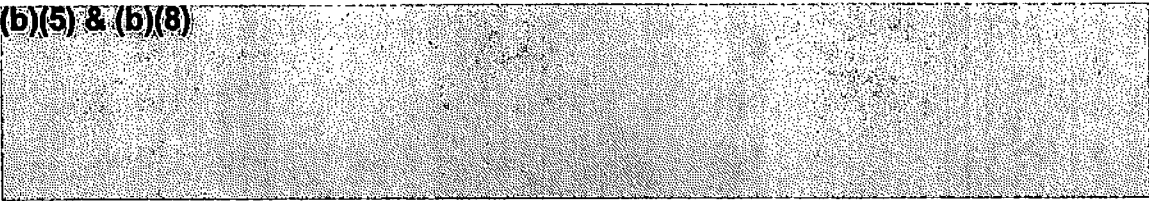
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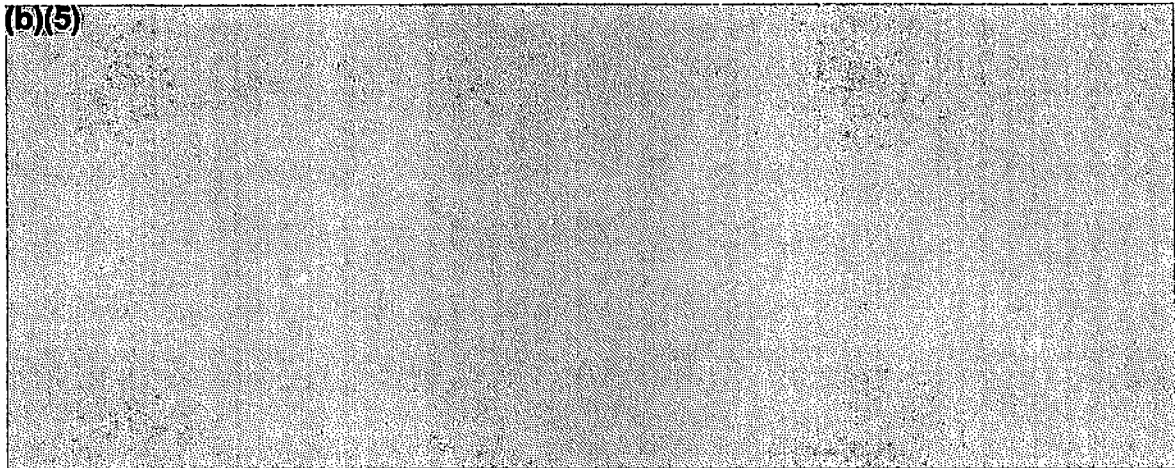
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II. FDIC GUARANTEES

A. FDIC Unsecured Debt Guarantee Program

(b)(5)



The FDIC's guarantee would apply only to the following liabilities:

- All newly issued senior unsecured debt issued on or before June 30, 2009, including promissory notes, commercial paper, inter-bank funding, and any unsecured portion of secured debt. The amount of debt covered by the guarantee may not exceed 125 percent of such debt maturing before June 30, 2009. For eligible debt issued on or before June 30, 2009, coverage would only be provided for three years beyond that date, even if the liability has not matured.

The Guaranty Program would not apply to debt that is contractually subordinated to other debt of the insured depository institution.

For the first 30 days of the Guaranty Program, the FDIC will not charge a fee associated with the guarantee, however, thereafter, any institution having FDIC-guaranteed debt will pay fees to the FDIC, unless the covered institution provides written notice to the FDIC prior to the end of the 30-day period, that it has chosen to opt-out of the guarantee. After the 30-day period fees would be imposed as follows:

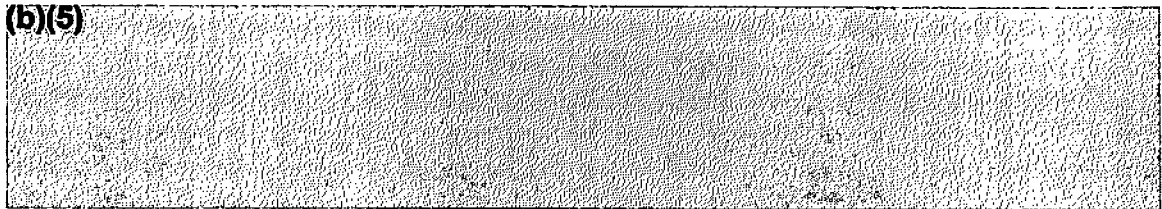
- For all newly issued senior unsecured debt, an annualized fee equal to 75 basis points multiplied by the amount of debt issued under this program.
- For non-interest bearing transaction deposit accounts, a 10 basis point surcharge would be applied to non-interest-bearing transactions deposit accounts not otherwise covered by the existing deposit insurance limit of \$250,000. This surcharge will be added to the participating bank's existing risk-based deposit insurance premium paid on those deposits.

B. FDIC Guarantee of Certain Uninsured Accounts

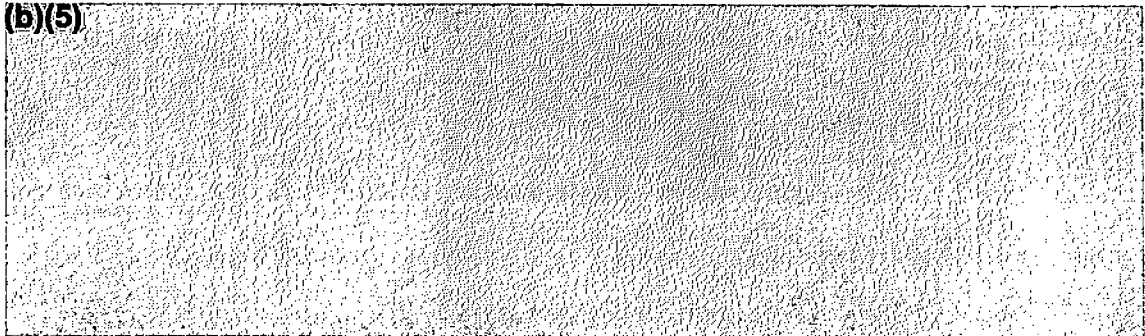
In addition, the staff proposes that FDIC fully guarantee noninterest bearing transaction accounts held in all insured depository institutions as of the date of the adoption of the Board's resolution until December 31, 2009. Such accounts are comprised of accounts in which depositors can make an unlimited number of deposits and withdrawals at any time, and include demand deposit accounts ("DDA") and similar accounts. This will not affect the insured status of other customer accounts. The foregoing guarantees will be subject to a fee/opt-out system similar to that of the Guarantee Program.

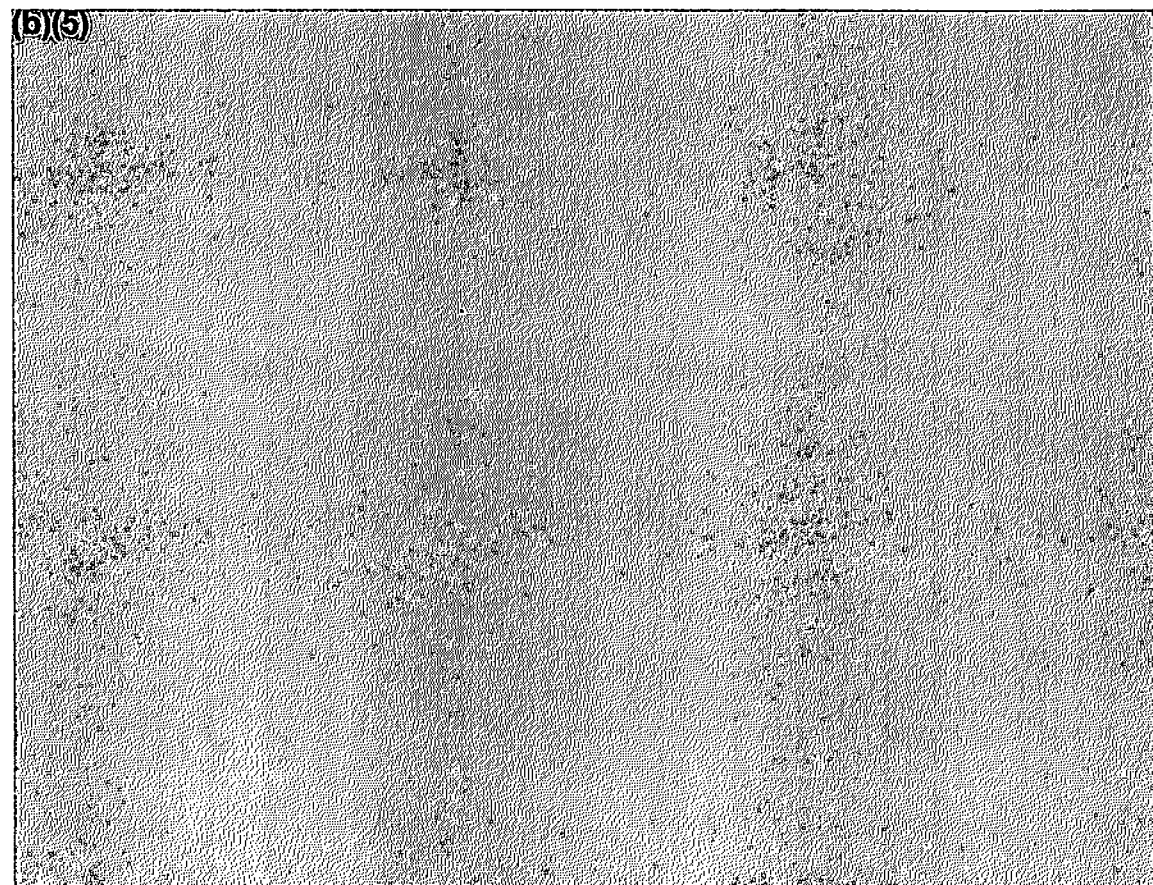
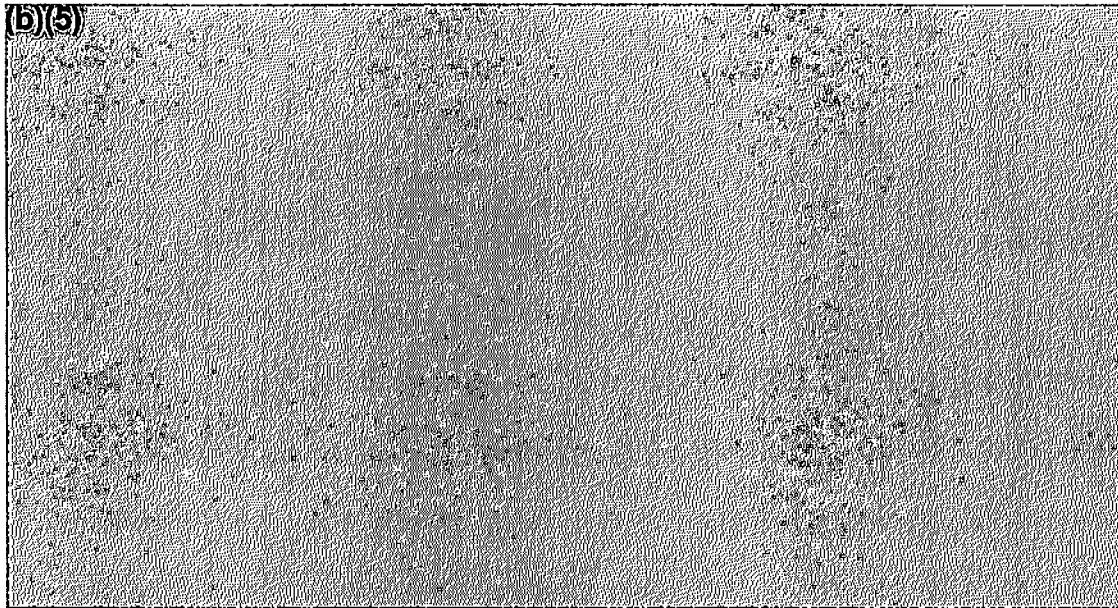
Summary

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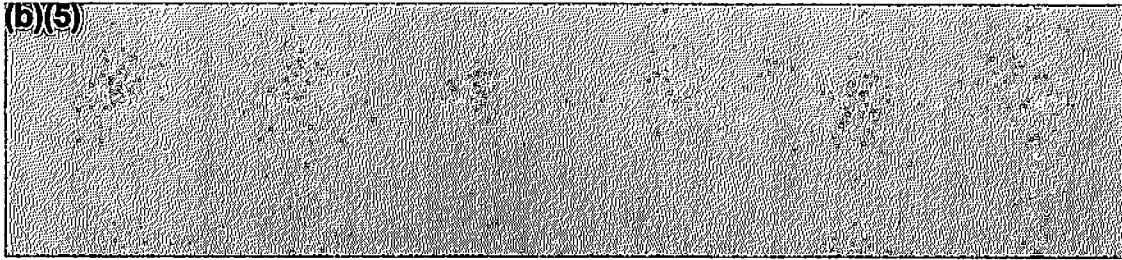


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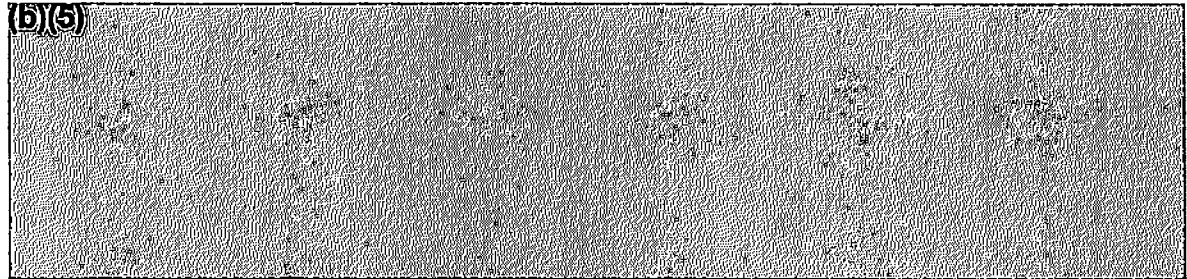


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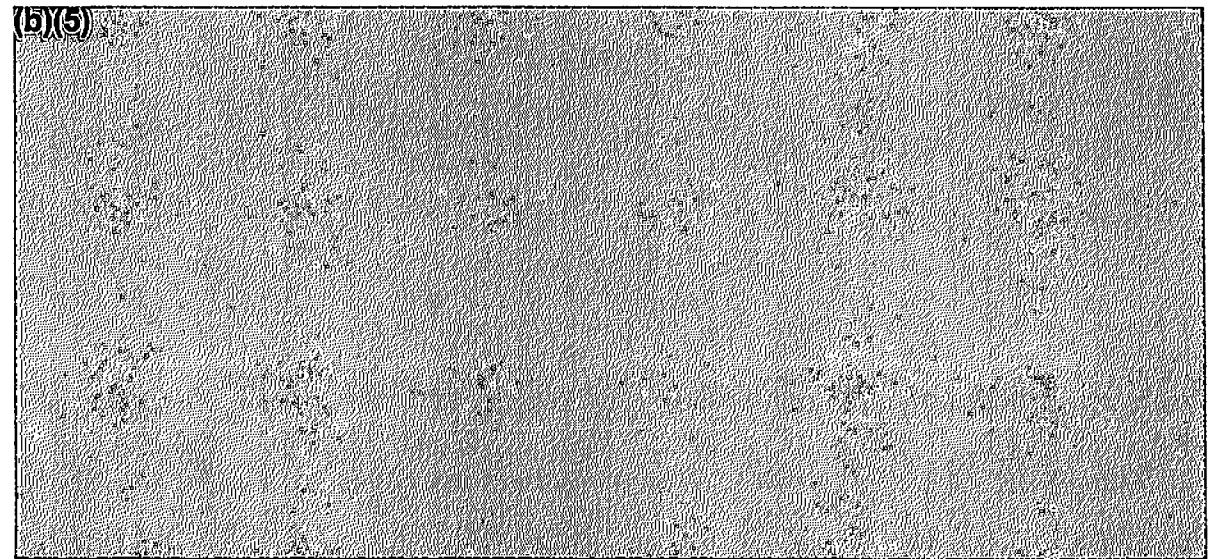


CONCLUSION

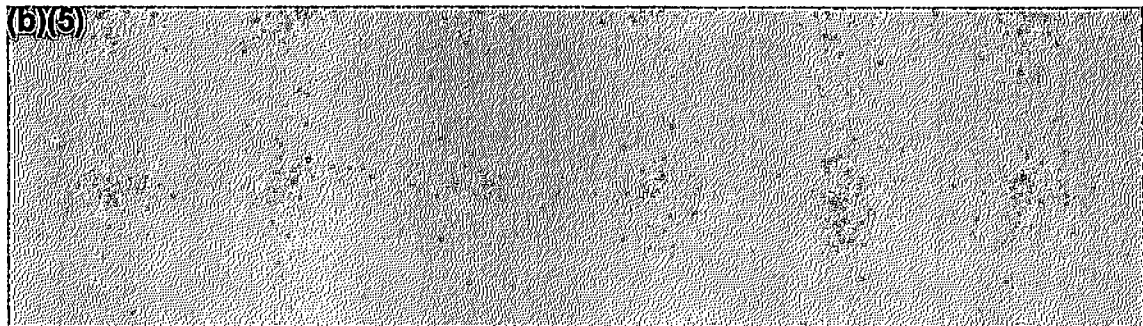
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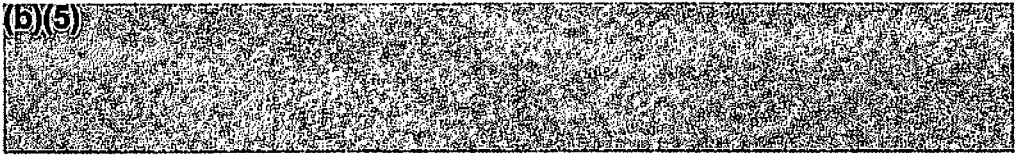
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(b)(5)

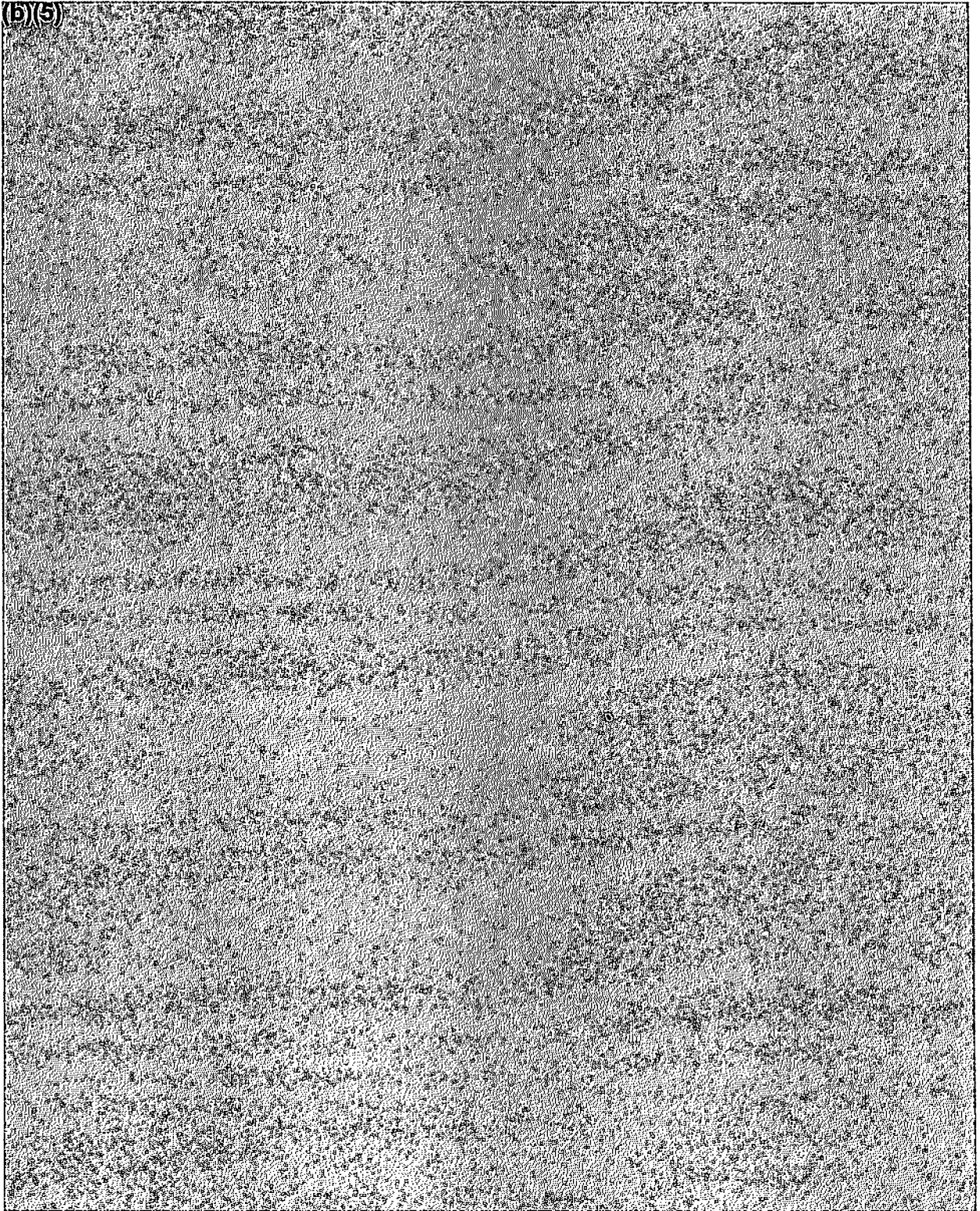


(b)(5)



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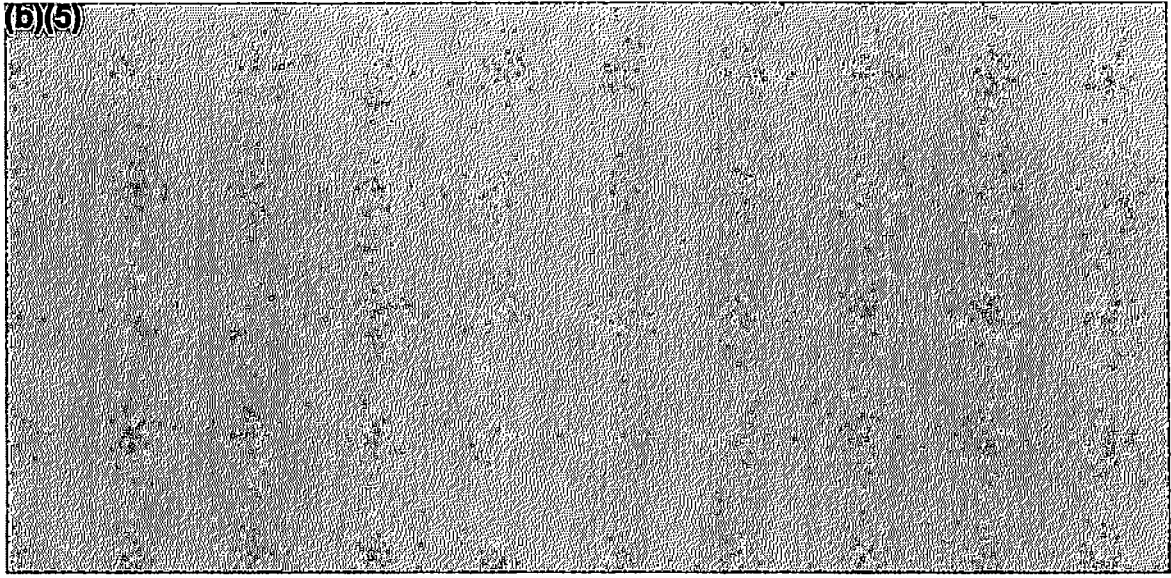
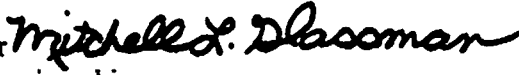


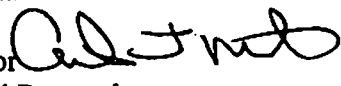
Exhibit D

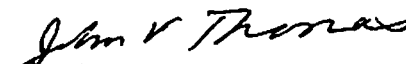
January 15, 2009

MEMORANDUM: The Board of Directors

FROM: Mitchell L. Glassman, Director 
Division of Resolutions and Receiverships

Sandra L. Thompson, Director 
Division of Supervision and Consumer Protection

Arthur J. Murton, Director 
Division of Insurance and Research

John V. Thomas, 
Acting General Counsel

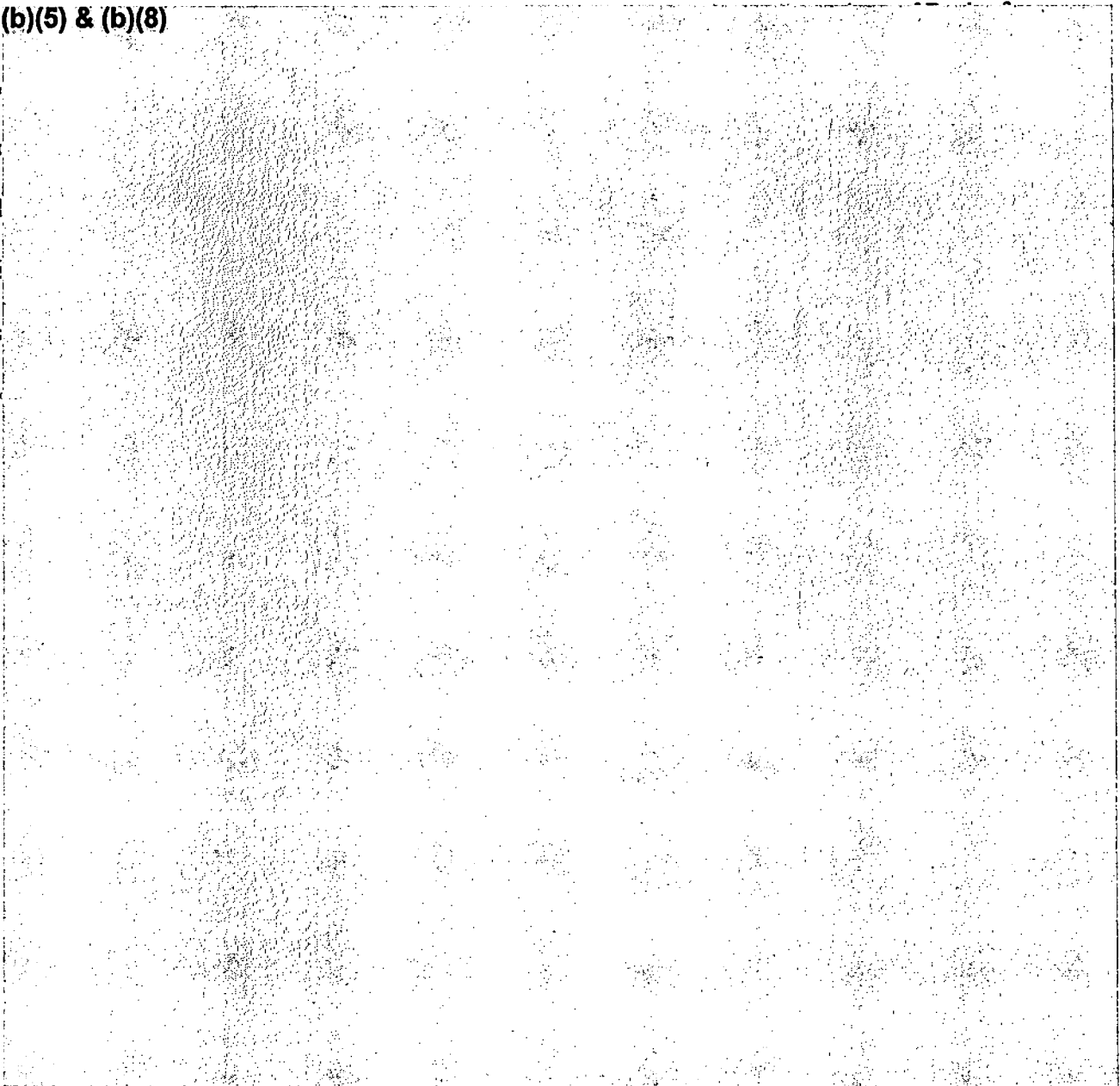
SUBJECT: Bank of America, National Association, Charlotte, North Carolina
Countrywide Bank, FSB, Alexandria, Virginia
FIA Card Services, Wilmington, Delaware
Merrill Lynch Bank USA, Salt Lake City, Utah
Merrill Lynch Bank & Trust Company, FSB, New York, New York
Bank of America Oregon, National Association, Portland, Oregon
Bank of America, Rhode Island, National Association, Providence, Rhode Island
Bank of America California, National Association, San Francisco, California, CA

Bank of America Corporation (Bank Holding Company) Information
(As of September 30, 2008; \$ Thousands):
Total Assets: \$1,831,177,000
Total Deposits (including Foreign): \$874,051,000
Uninsured Deposits: \$290,859,000
Foreign Deposits: \$95,523,000
Tier 1 Leverage/Total Risk Based (Lead Bank): 6.01/11.60

(b)(8)

Recommendation

(b)(5) & (b)(8)



In order to prevent the foregoing systemic risk, staff recommends that the Board authorize the FDIC to enter into an agreement with BAC, the U.S. Department of the Treasury (Treasury), and the Federal Reserve Board in exchange for consideration. Under the agreement, Treasury will inject

\$20 billion in capital from the Troubled Asset Relief Program. In addition, the U.S. Government (USG) would provide for shared loss coverage on specified BAC assets, with the FDIC's potential loss protected by the issuance of preferred stock by BAC. The FDIC and the Treasury's Troubled Asset Relief Program (TARP) will provide guarantees on certain residential assets for 10 years and certain other assets for a period of 5 years. BAC will bear the first \$10 billion in losses. Additional losses will be shared with the FDIC, Treasury, and the Federal Reserve covering 90 percent of the losses with BAC bearing 10 percent. After the first \$10 billion in losses, the FDIC and Treasury will cover losses pro rata in proportions of 25% for the FDIC and 75% for Treasury up to a cap of \$2.5 billion for the FDIC and \$7.5 billion for the Treasury. Further losses will be covered 90% by the Federal Reserve through nonrecourse lending. The FDIC will receive compensation in the form of what is projected to be \$1 billion in preferred stock and warrants with an aggregate exercise value of 10% of the amount of preferred issued.¹ The chart below provides detail on estimated losses.

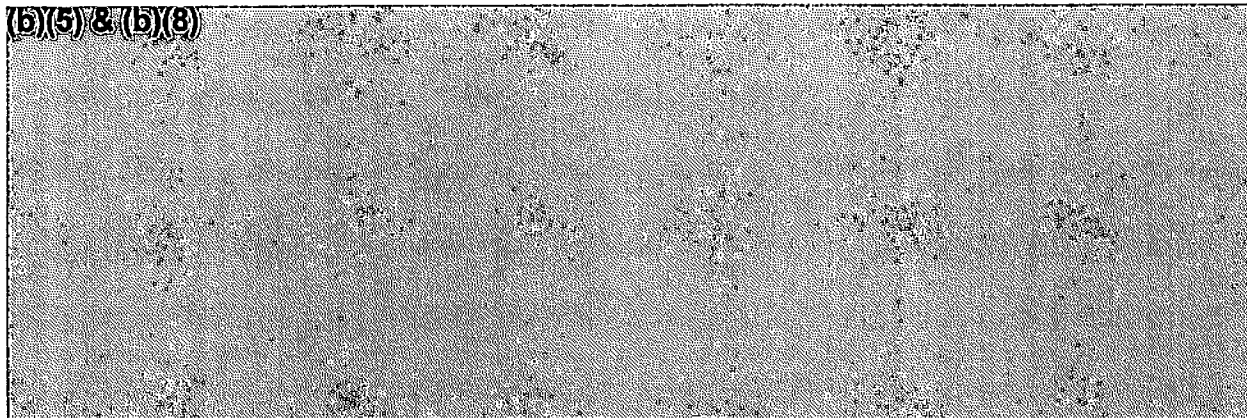
The Federal Reserve Board will, under certain circumstances, provide non recourse financing secured, in part, by assets designated by the USG and BAC.² BAC will manage the assets, with instructions provided by the FDIC, TARP and Federal Reserve. The template will include a foreclosure mitigation policy agreeable to the USG. In addition, BAC will be subject to specific limitations on executive compensation and dividends during the loss share period. FDIC staff will work with all parties to ensure that BAC is subject to appropriate periodic reporting.

The Federal Reserve has agreed to work with the FDIC regarding appropriate reporting including monitoring the use of government assistance.

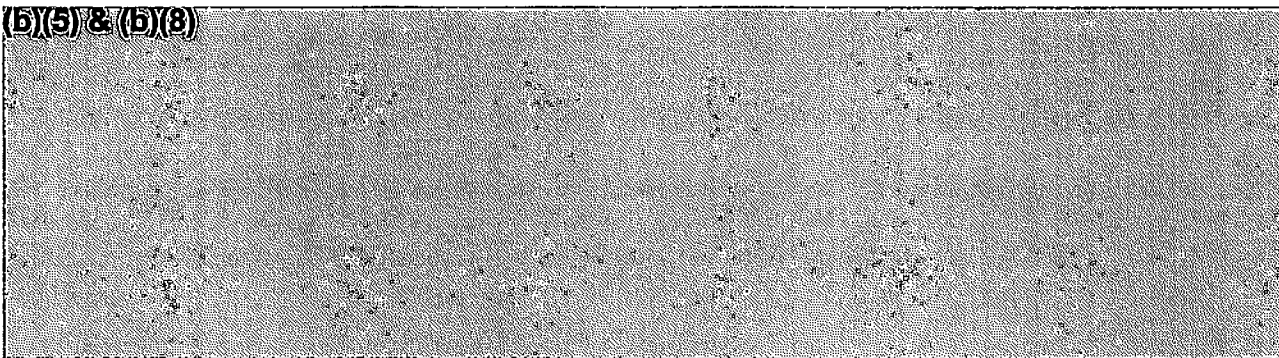
¹ Treasury will receive \$3 billion in preferred stock for its guarantee.

² The FDIC, Treasury and the Board of Governors of Federal Reserve will be referred to collectively as the USG.

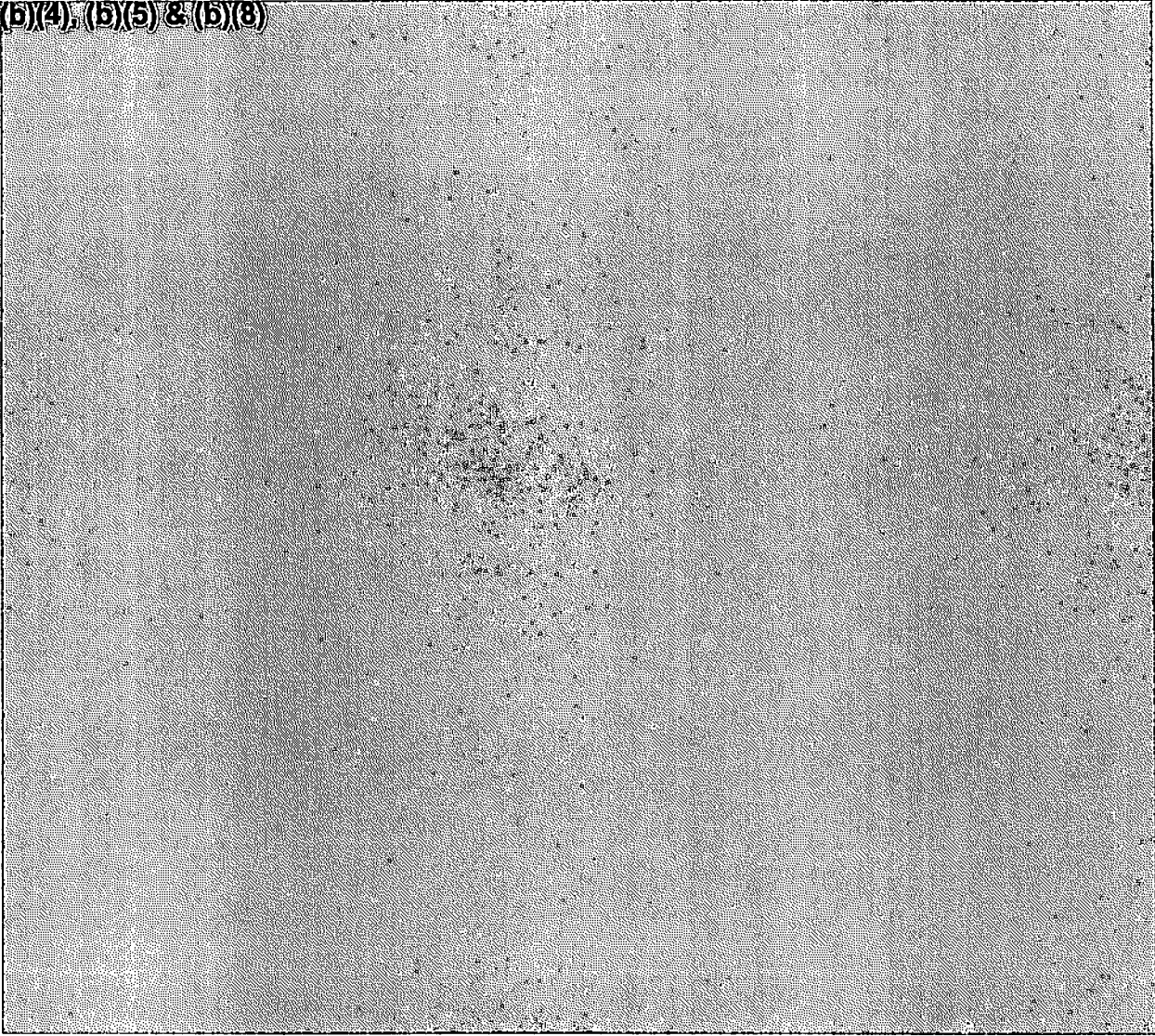
(b)(5) & (b)(8)



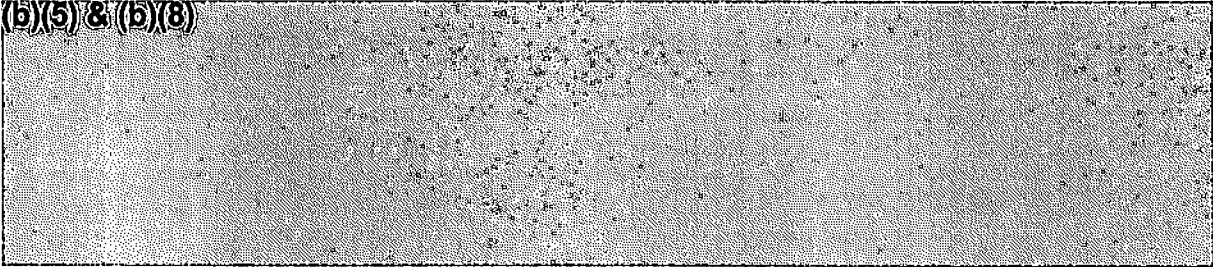
(b)(5) & (b)(8)



(b)(4), (b)(5) & (b)(8)



(b)(5) & (b)(8)



Commitments by Bank of America Corporation

In exchange for the guarantees discussed above, BAC has agreed to 1) limit its common stock dividends to \$.01 per share per quarter for three years unless consent is given by the USG; 2) develop an executive compensation program that rewards long-term performance and profitability to be approved by the USG; and 3) implement loan modification procedures acceptable to the USG. Additionally the FDIC and TARP will receive preferred stock and related warrants as reasonable compensation for the guarantees provided.

Related Transaction

As part of the same overall transaction, Treasury will make a substantial preferred stock investment. The stock will have an 8% dividend yield. Warrants to purchase common stock will be issued as part of this transaction.

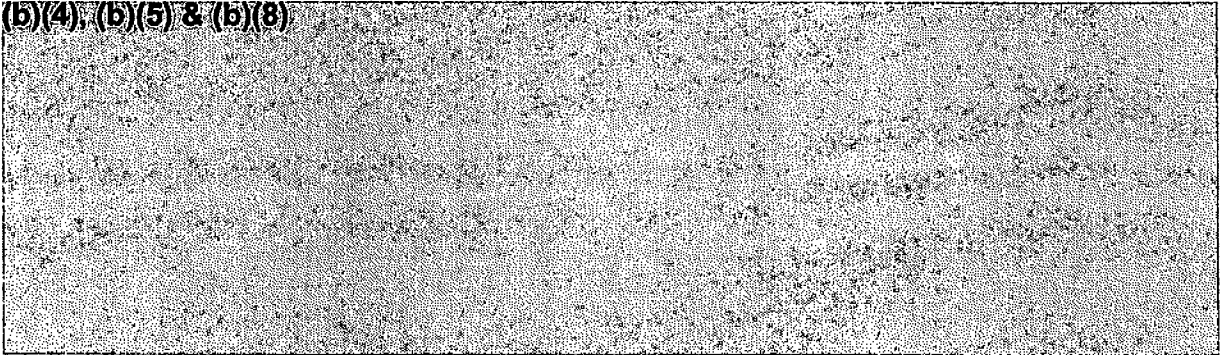
Summary Description

Bank of America, N.A. (BANA) is a nationally chartered bank founded in 1904 that is the lead bank within Bank of America Corporation (BAC), a financial holding company regulated by the Federal Reserve. BANA is the second largest bank in the U.S. with \$1.4 trillion of assets and prior to BAC's acquisition of Merrill Lynch, BANA represents approximately 80 percent of BAC's consolidated assets. The BANA is also the largest holder of insured deposits in the U.S. with over 10 percent of total domestic deposits. BAC and BANA's executive management is identical and risk is managed on a line of business rather than a legal entity basis.

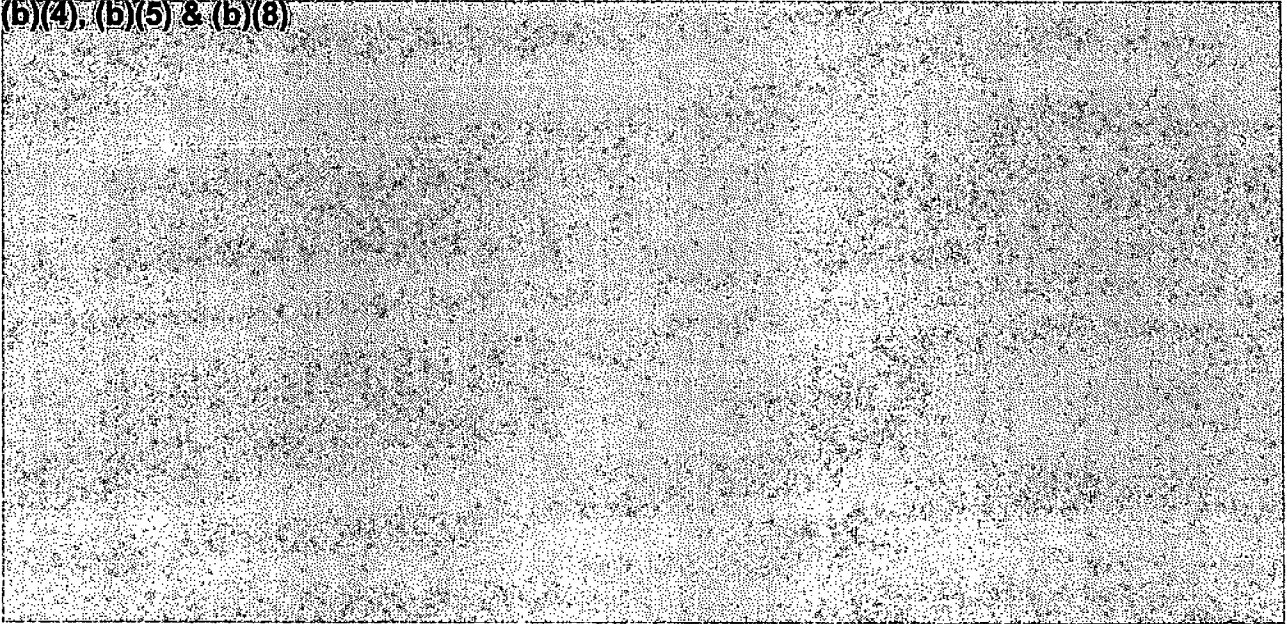
BANA's core business is its domestic retail banking franchise with over 6,100 branches in 33 states. The Bank participates in virtually every financial activity permissible to banks.

Foreign operations are modest relative to the overall size of the bank, with activities focused on serving corporate customers and trading, primarily in Western Europe. In addition to eight insured bank charters, BAC has four significant non-insured affiliates: Banc of America Securities, LLC, a full-service investment bank and brokerage firm; Banc of America Investments (BAI), a retail brokerage business; Banc of America Specialist, a NYSE specialist firm; and Columbia Management, the nation's eighth largest mutual fund company.

(b)(4), (b)(5) & (b)(8)



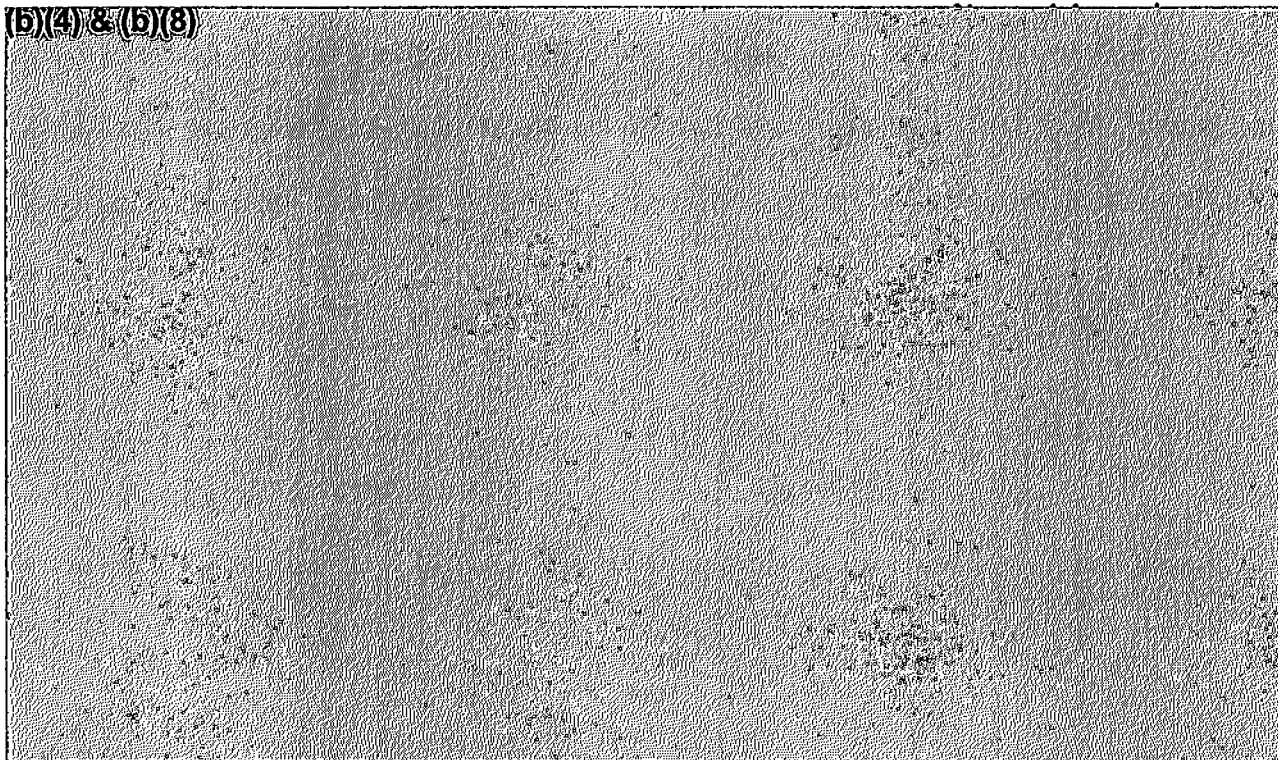
(b)(4), (b)(5) & (b)(8)



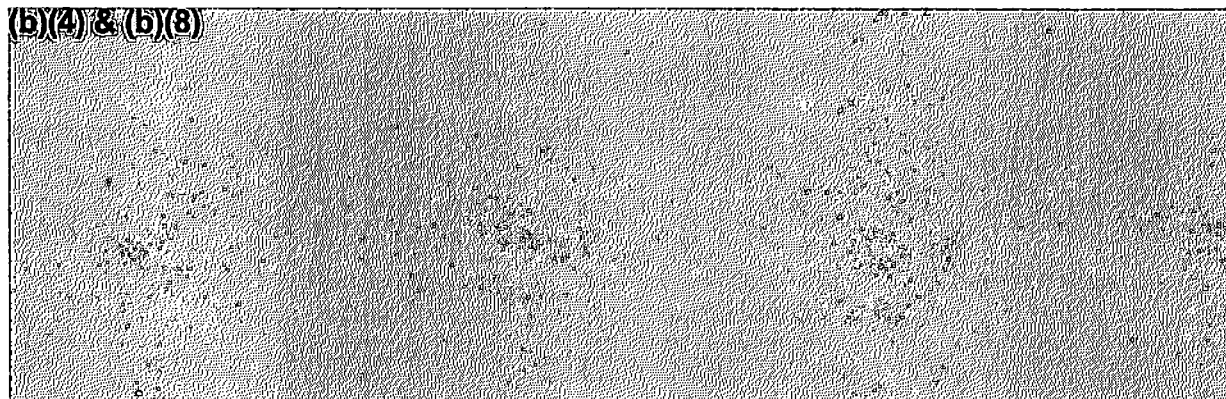
Supervisory History and Condition

Condition

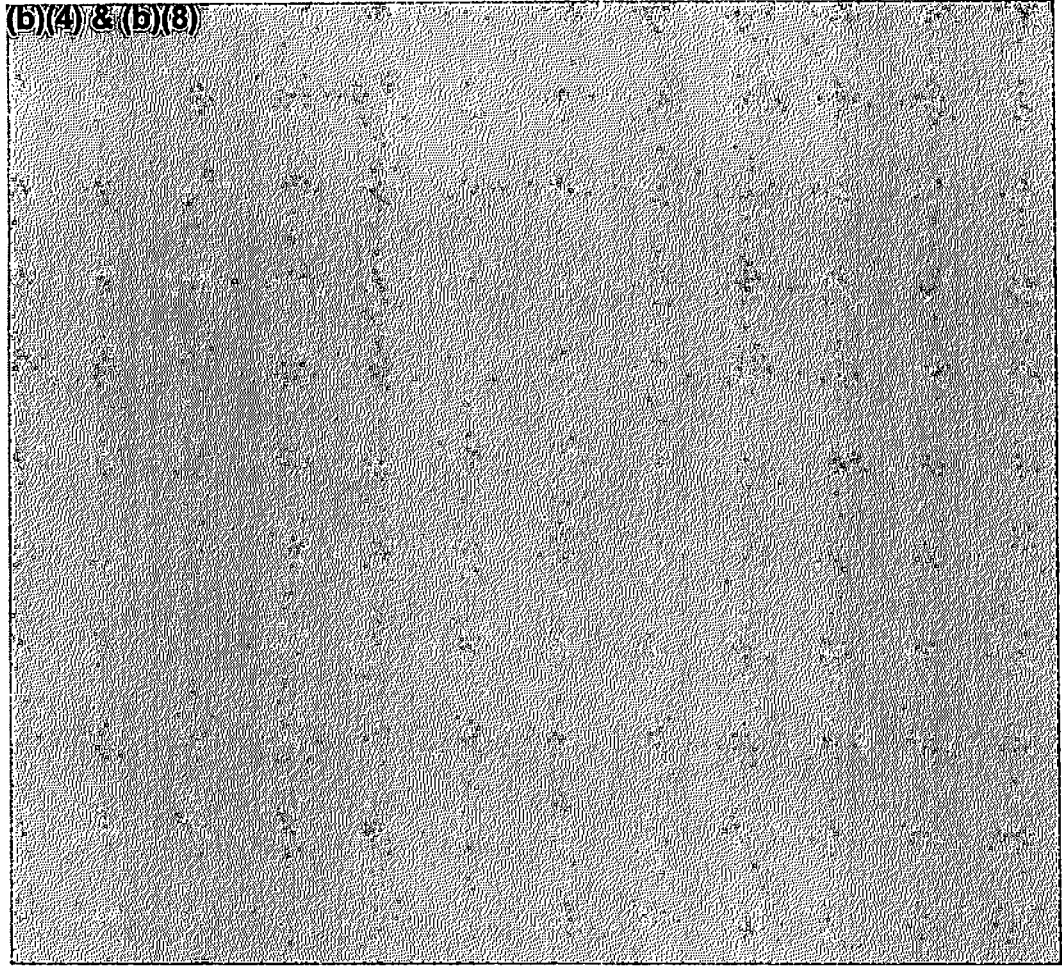
(b)(4) & (b)(8)



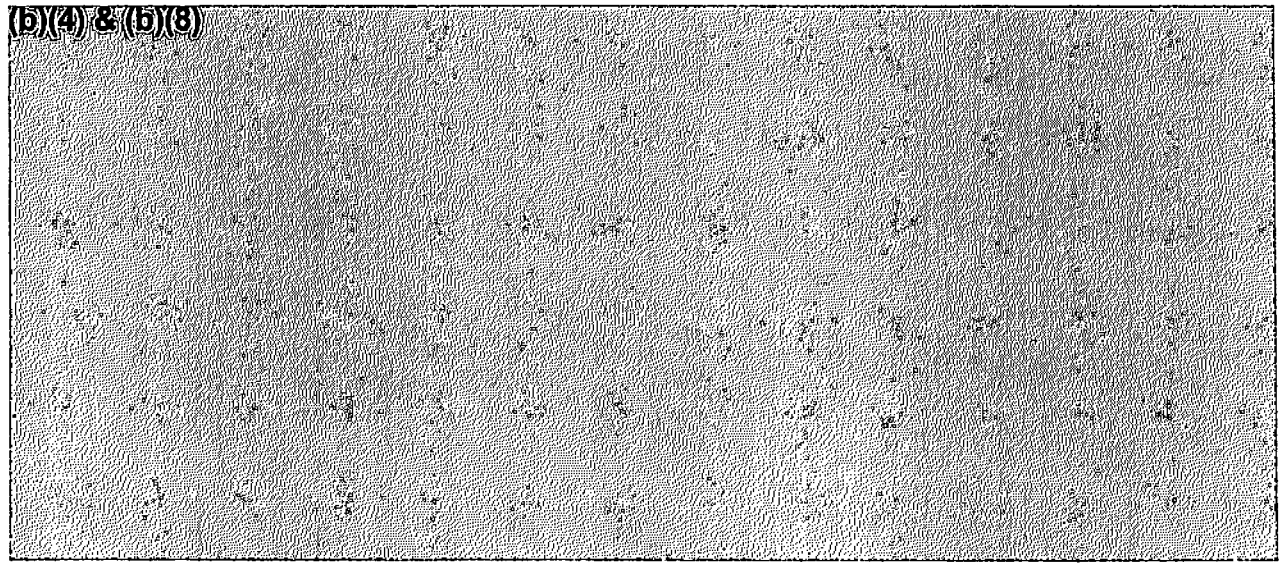
(b)(4) & (b)(8)



(b)(4) & (b)(8)



(b)(4) & (b)(8)



(b)(4) & (b)(8)



(b)(4) & (b)(8)

(b)(4) & (b)(8)

(b)(4) & (b)(8)

Supervisory History

The insured legal entities of BAC are shown in the table below, and the larger entities are discussed below.

Insured Entities (9/30/2008)	Assets	Deposits
Bank of America, N.A.	1,359,071	846,231
FIA Card Services, N.A.	160,210	13,380
Countrywide Bank, FSB	112,947	55,370
Merrill Lynch Bank USA	61,643	50,943
Merrill Lynch Bank & Trust Co.	35,846	22,703
Bank of America, RI, N.A.	36,154	0
Bank of America California, N.A.	22,003	0

(b)(4) & (b)(8)

Bank of America Oregon, N.A.	11,876	0	(b)(4) & (b)(8)
(b)(4) & (b)(8)			

Bank of America, N.A. (BANA)

(b)(4) & (b)(8)

(b)(4) & (b)(8)

Countrywide Bank, FSB (CWB)

CWB is the largest mortgage lender in the country. It is also the largest mortgage servicer in the country with a \$1.5 trillion portfolio. CWB's parent, Countrywide Financial Corporation (CFC), has a distribution platform including over 1,000 offices (mostly mortgage origination offices operated by its non-bank affiliate Countrywide Home Loans) and over 50,000 employees. BAC acquired CFC and CWB on July 1, 2008. (b)(4) & (b)(8)

(b)(4) & (b)(8)

(b)(4) & (b)(8)

(b)(4) & (b)(8)

FIA Card Services, N.A. (FIA)

FIA is BAC's credit card bank. (b)(4) & (b)(8)

(b)(4) & (b)(8)s. FIA activities are mostly domestic, with foreign activities primarily in the United Kingdom and Canada, but also include Ireland and Spain to a lesser extent. (b)(4) & (b)(8)

(b)(4) & (b)(8)

Merrill Lynch Bank, USA (MLBUSA)

MLBUSA, an industrial bank chartered by the State of Utah, is a wholly-owned subsidiary of ML Group, Inc., which is wholly owned by the top tier parent, Merrill Lynch & Co., Inc. MLBUSA provides a variety of commercial and consumer lending products to new and existing Merrill Lynch clients. Merrill Lynch & Co., Inc., through its subsidiaries and affiliates, provides investment banking and advisory services, wealth management, investment management, insurance, and other services on a global basis to individual and institutional investors.

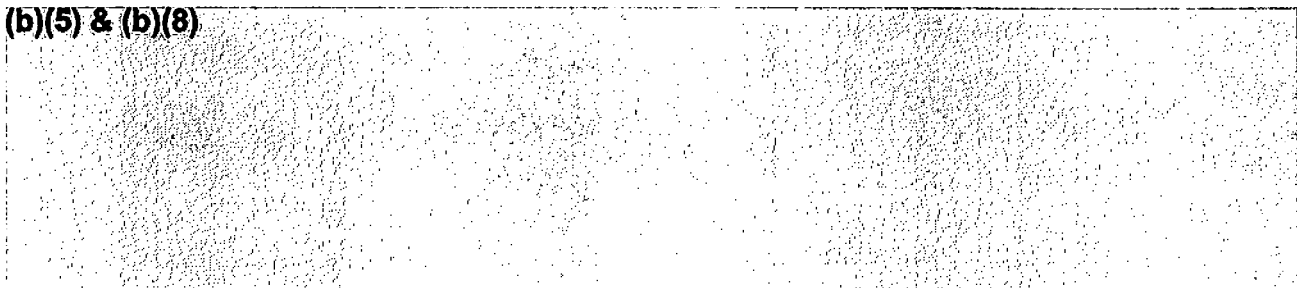
Merrill Lynch Bank & Trust Company, FSB (MLBT)

MLBT is a wholly-owned subsidiary of ML Group, Inc., which, in turn, is owned by Merrill Lynch & Co., Inc. MLBT has traditionally been a residential mortgage lender and a

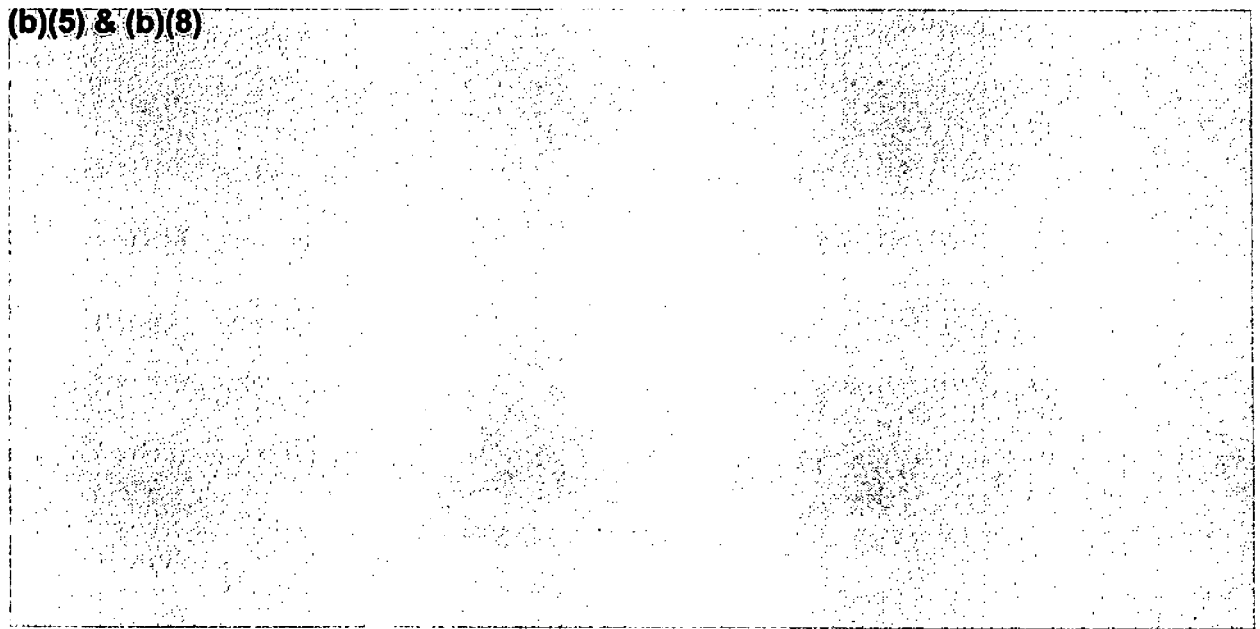
provider of trust services, but in 2006 the bank ventured into the subprime mortgage lending business with the purchase of First Franklin Mortgage, which was subsequently sold to a non-bank affiliate in September 2008 as a result of increasing losses.

Systemic Risk

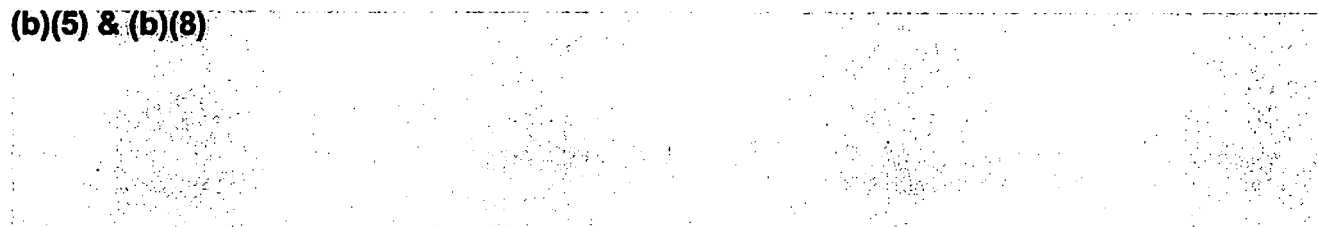
(b)(5) & (b)(8)



(b)(5) & (b)(8)



(b)(5) & (b)(8)



(b)(5) & (b)(8)

Disruptions to global money and credit markets have already contributed to sharp downturns among major coincident indicators of real economic activity. The U.S. economy entered a recession in December 2007 that is already the longest since the 16-month recession that ended in 1982. Payroll employment has declined each month in 2008; 2.6 million jobs were eliminated last year, and over 1.5 million of those were lost in the fourth quarter. The unemployment rate is now 7.2 percent, up 2.8 percentage points from its cyclical low in March 2007. Retail sales showed sharp declines each month of fourth quarter 2008. In December 2008, retail sales were 2.7 percent lower than in November 2008 and 9.8 percent below December 2007. The Federal Reserve Board's index of industrial production in November 2008 was 5.5 percent lower than in November 2007. (b)(5) & (b)(8)

(b)(5) & (b)(8)

(b)(5) & (b)(8)

(b)(5) & (b)(8)

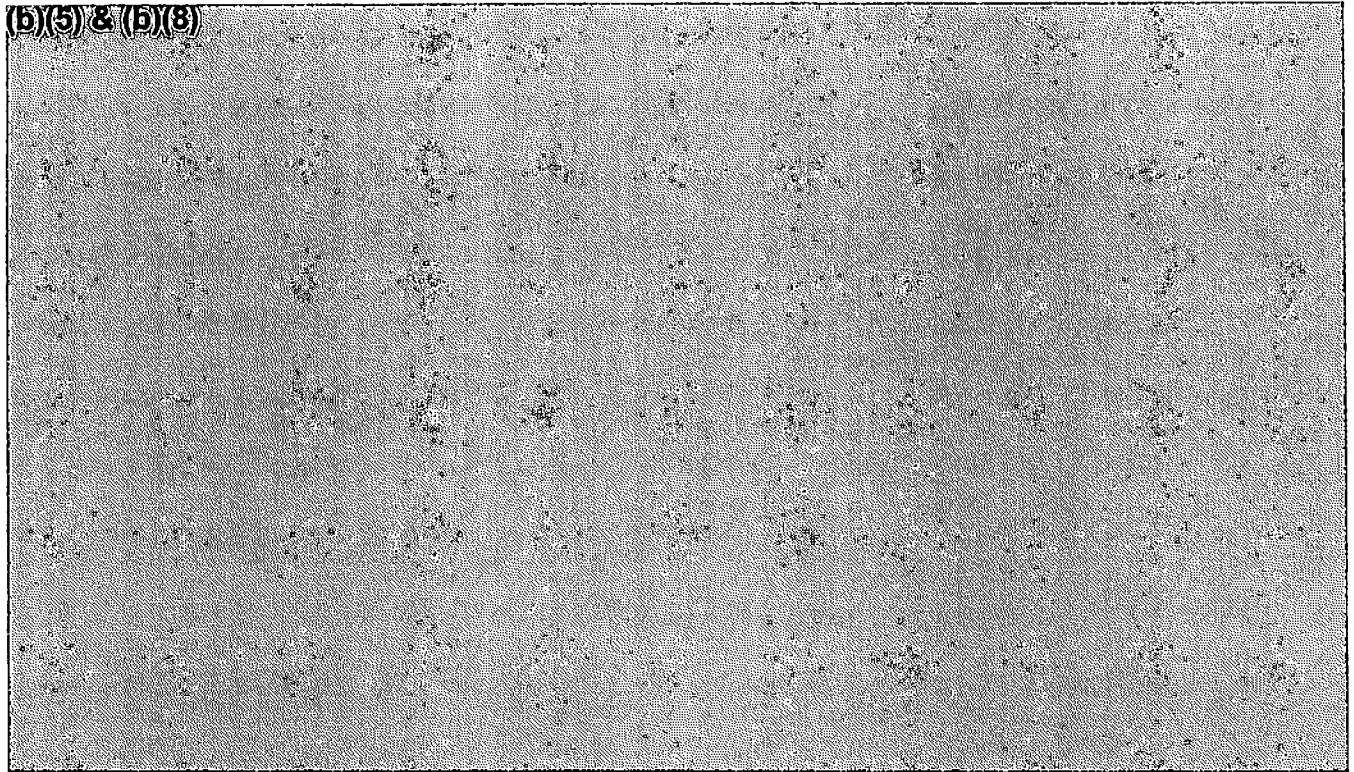
(b)(5) & (b)(8)

Conclusion

(b)(5) & (b)(8)

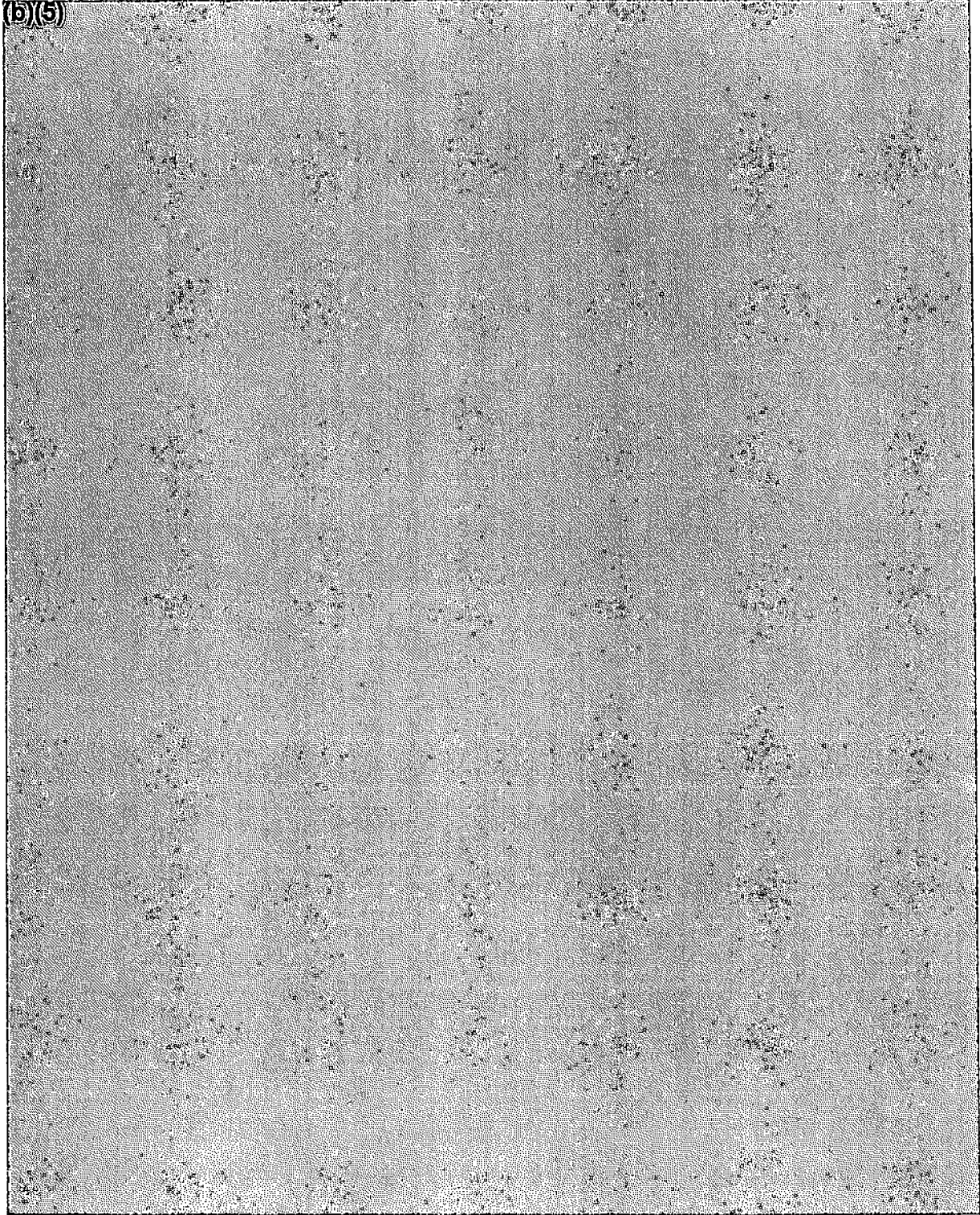
The financial market disruptions of 2007 and 2008 have dramatically reshaped the financial services sector. Although market spreads indicate that credit terms have moderated since October 2008, credit markets remain highly stressed, and the improvement we have seen

thus far likely would not have occurred without government intervention. (b)(5) & (b)(8)

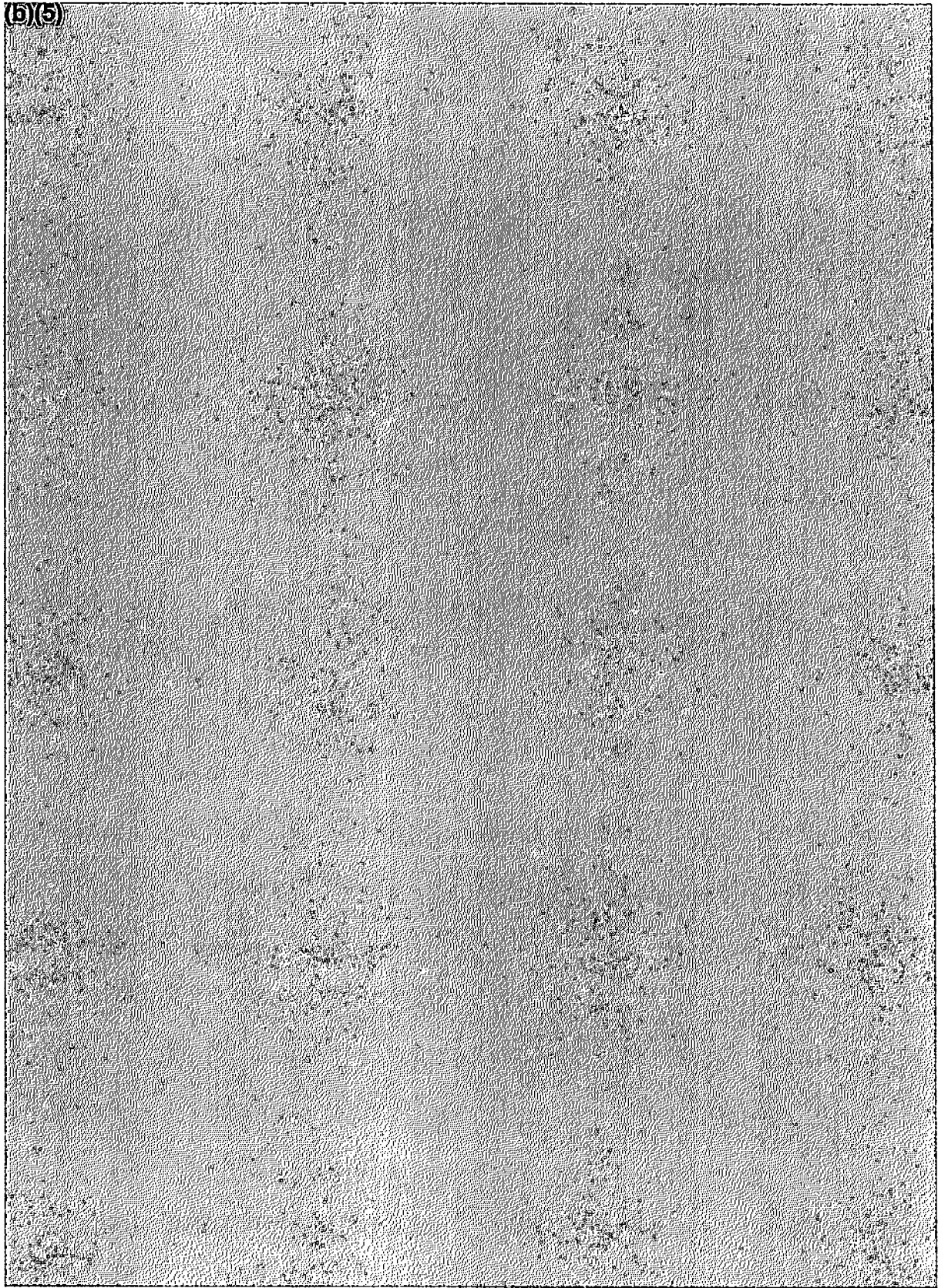


(b)(5)

(b)(5)



(b)(5)



(b)(5)

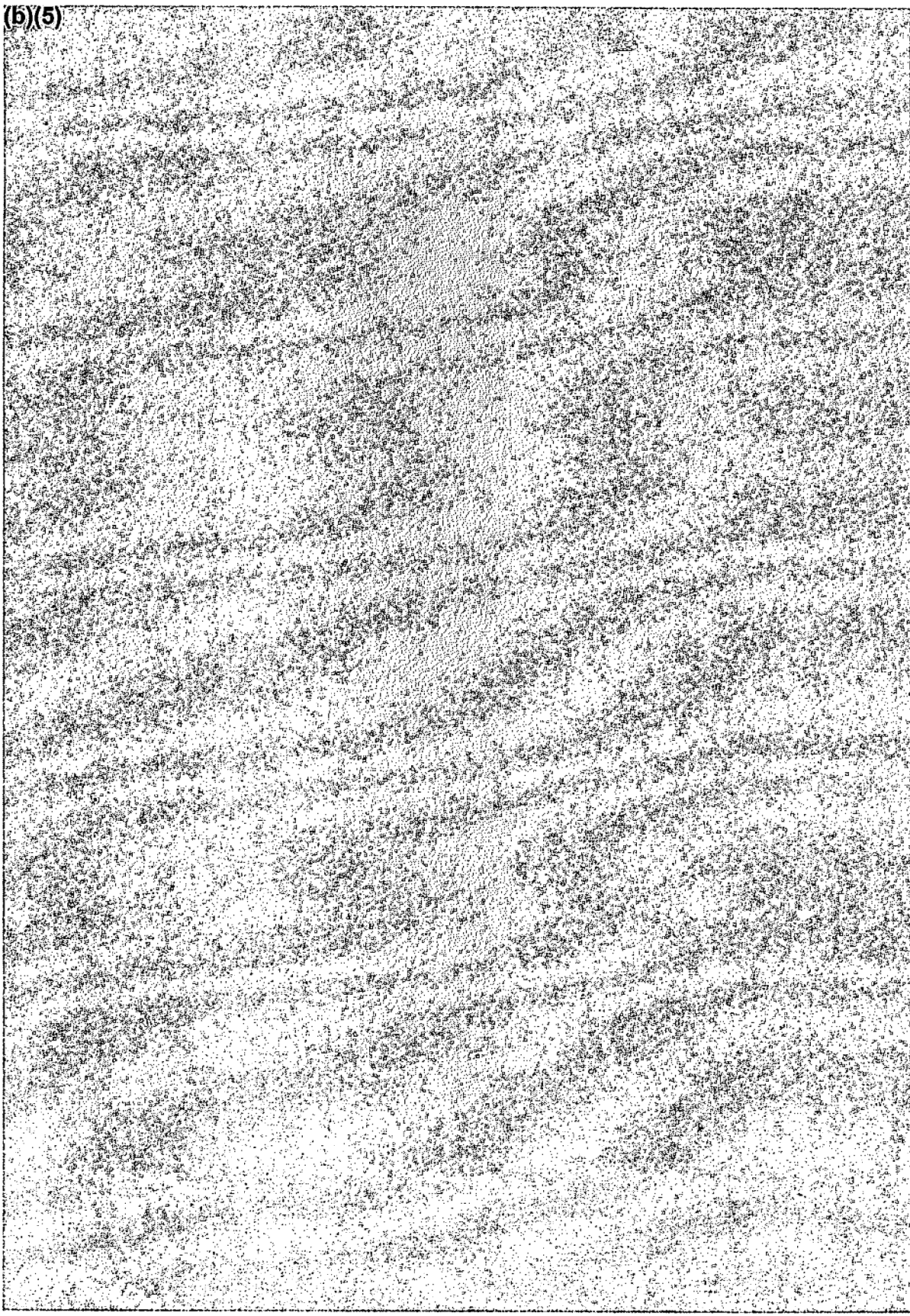


Exhibit E

November 23, 2008

MEMORANDUM: The Board of Directors

THROUGH: Mitchell L. Glassman, Director *Mitchell L. Glassman*
Division of Resolutions and Receiverships

Sandra L. Thompson, Director *STL*
Division of Supervision and Consumer Protection

FROM: James R. Wigand, Deputy Director *JRW*
Franchise and Asset Marketing Branch
Division of Resolutions and Receiverships

Herbert J. Held, Assistant Director *HJH*
Franchise and Asset Marketing Branch
Division of Resolutions and Receiverships

(SUBJECT: Citibank, National Association, Las Vegas, Nevada
Citibank (South Dakota), National Association, Sioux Falls, South Dakota
Department Stores National Bank, Sioux Falls, South Dakota
Citicorp Trust Bank, FSB, Wilmington, Delaware
Citibank (Banamex USA), Century City, California

Citigroup Inc. (Bank Holding Company) Information (\$ Thousands)
(As of June 30, 2008):

Total Assets: \$2,100,385,000

Total Deposits (including Foreign): \$803,642,000

Uninsured Deposits: \$181,183,775,

Foreign Deposits: \$543,287,000

Tier 1 Leverage/Total Risk Based (Lead Bank): 6.51/13.38

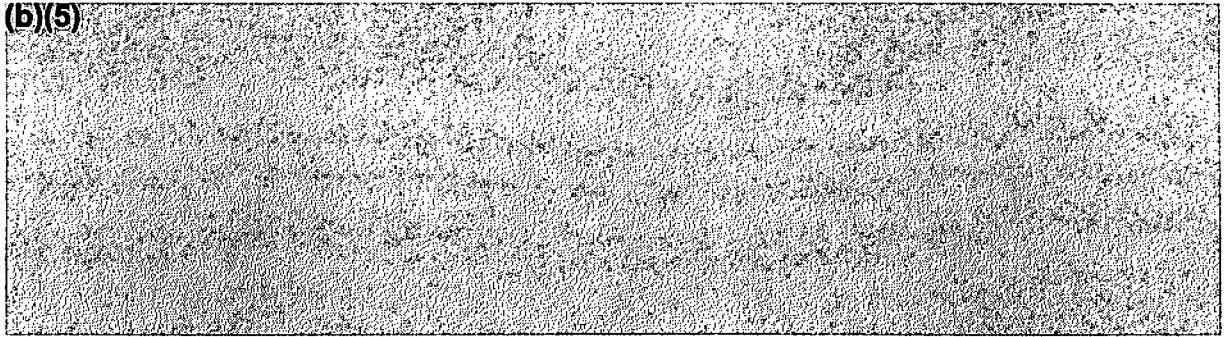
(b)(8)

Recommendation

(b)(5)



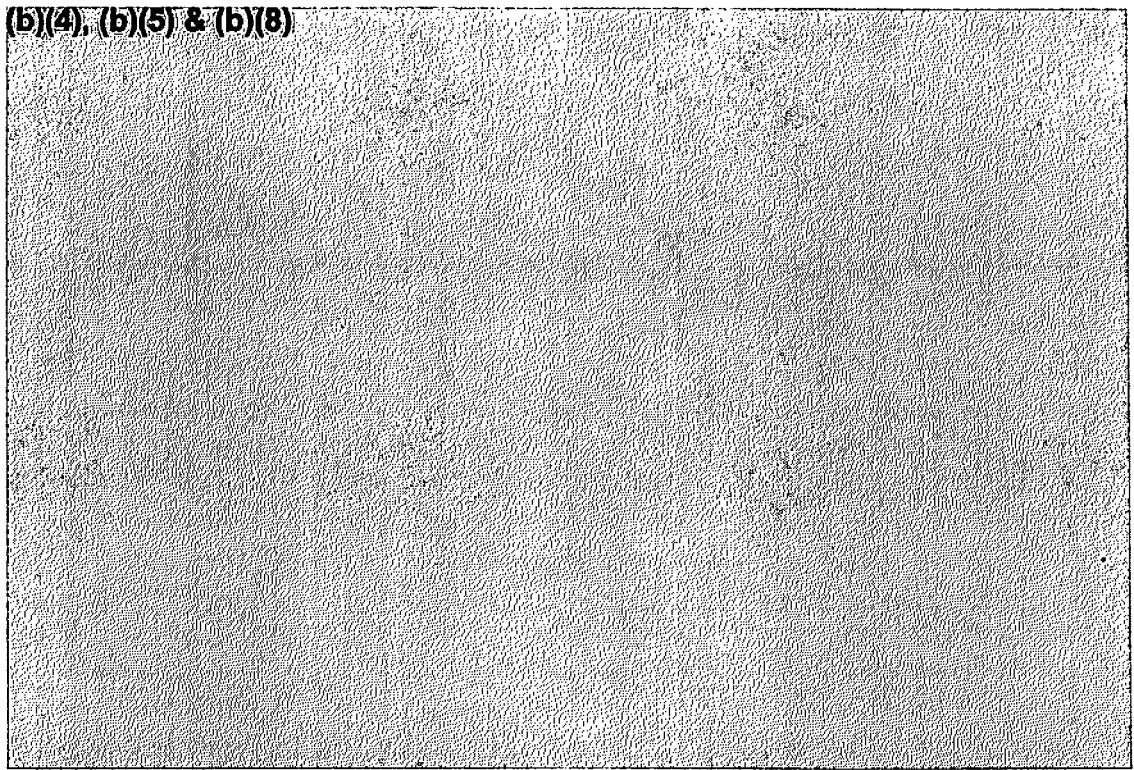
(b)(5)



In order to prevent the foregoing systemic risks, staff recommends that the Board authorize the FDIC to enter into a transaction to provide for shared loss coverage, along with the U.S. Treasury's Troubled Asset Relief Program, with the FDIC's potential loss protected by the issuance of preferred stock by Citigroup. The FDIC and the U.S. Treasury's Troubled Asset Relief Program (US/TARP) will provide guarantees on certain residential assets for 10 years and certain other assets for a period of 5 years. The FDIC will be exposed to loss only after Citigroup absorbs the first \$37 billion in losses and the TARP absorbs \$5 billion in losses. The FDIC's loss share will be capped at \$10 billion and it will receive compensation in the form of \$3 billion in preferred stock. In addition, the Board of Governors of Federal Reserve will provide certain financing secured, in part, by assets in a portfolio of consumer and commercial loans designated by the Agencies and Citigroup.¹ The chart below provides detail on estimated losses.

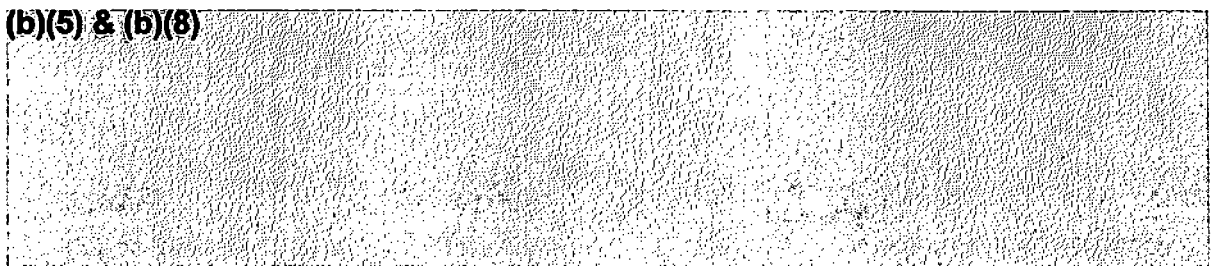
¹ The FDIC, Treasury and the Board of Governors of Federal Reserve will be referred to collectively as the Agencies.

(b)(4), (b)(5) & (b)(8)



Citigroup and the Agencies will share losses with Citigroup will having a 10 percent loss share on all losses in excess of the \$37 billion. The US/TARP takes the second loss position up to \$5 billion and the FDIC takes the third loss position up to \$10 billion. The loss share of the FDIC and US/TARP will be capped as above. The Federal Reserve will take remaining losses. Citigroup will manage the assets, with instructions provided by the FDIC, US/TARP and Federal Reserve. Instructions will include required use of loan modification procedures comparable to those used at IndyMac Federal Bank, unless otherwise agreed. In addition, Citigroup will be subject to specific limitations on executive compensation and dividends during the loss share period.

(b)(5) & (b)(8)



Commitments by Citigroup

In exchange for the guarantees discussed above, Citigroup has agreed to 1) seek the prior approval of the Agencies before paying dividends for 2 years; 2) develop an executive compensation program that rewards long-term performance and profitability to be approved by the Agencies; 3) implement loan modification procedures conforming with the FDIC's model used at IndyMac Federal Bank for mortgages in the asset pool unless otherwise agreed. Additionally the FDIC and US/TARP will receive preferred stock as reasonable compensation for the guarantees provided.

Executive Summary

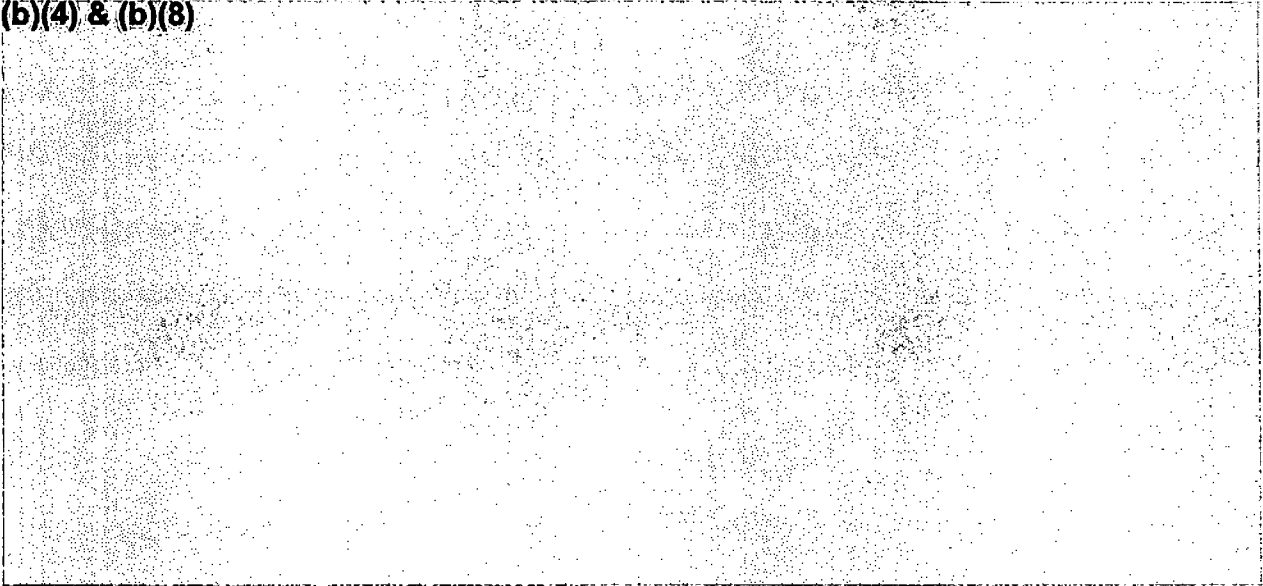
Citibank, NA (CBNA or Bank) is a nationally chartered bank founded in 1812 that is the lead bank within Citigroup, Inc. (Citigroup) a financial holding company regulated by the Federal Reserve. CBNA is the third largest bank in the nation and is the predominant legal entity representing 63 percent of consolidated holding company assets. The insured legal entities of Citigroup consist of three national banks, one federal savings bank and one state non-member bank. Citigroup is the largest consumer finance lender in the world, third largest mortgage servicer and the fourth largest student lender. It is the world's largest credit card lender and the third largest in the United States. It is also one of the world's largest private banking and private wealth management businesses.

Citigroup has three principal nonbank subsidiaries; Citigroup Global Markets Holdings, Inc (broker-dealer); Citigroup Funding, Inc (primary funding vehicle of Citigroup); and Associates First Capital Corporation (parent company of CitiFinancial, which provides consumer finance). There is one foreign banking subsidiary Grupo Financiero de Banamex SA de CV (Mexican banking organization).

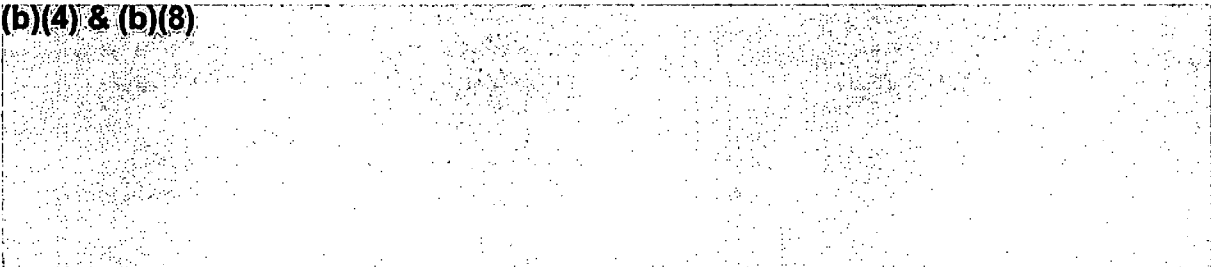
CBNA engages in extensive foreign activities and has operations in over 100 countries.

It operates approximately 1,000 retail branches in 13 states, the District of Columbia, and Guam.

(b)(4) & (b)(8)



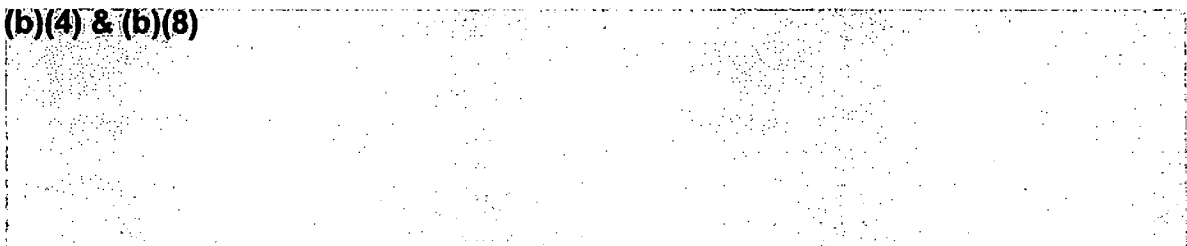
(b)(4) & (b)(8)



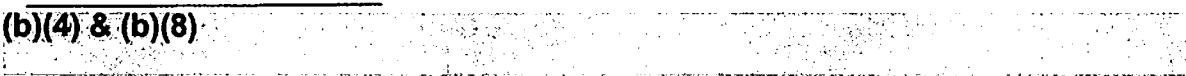
Supervisory History and Condition

Condition

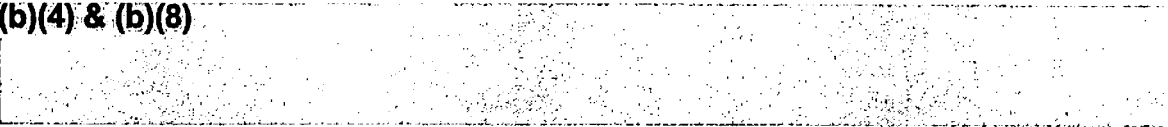
(b)(4) & (b)(8)



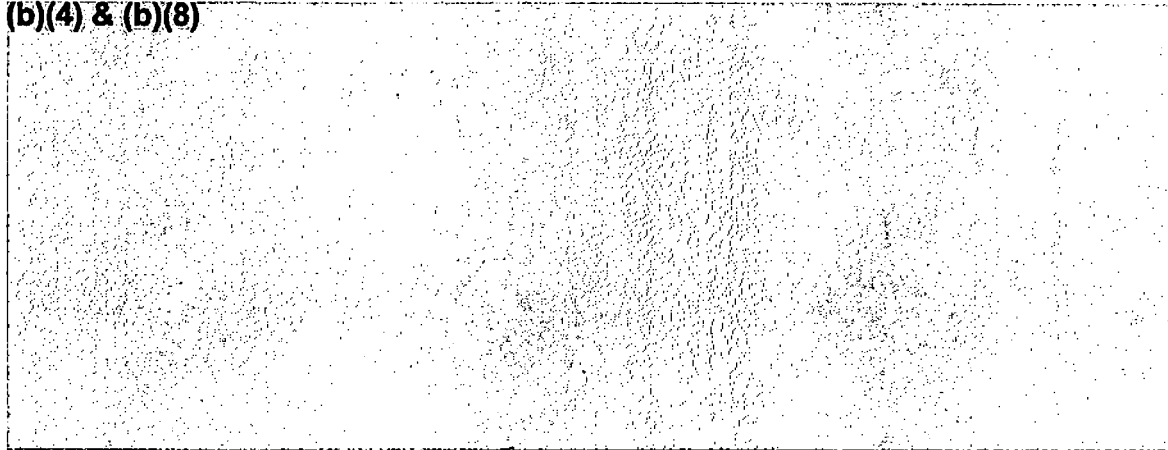
(b)(4) & (b)(8)



(b)(4) & (b)(8)

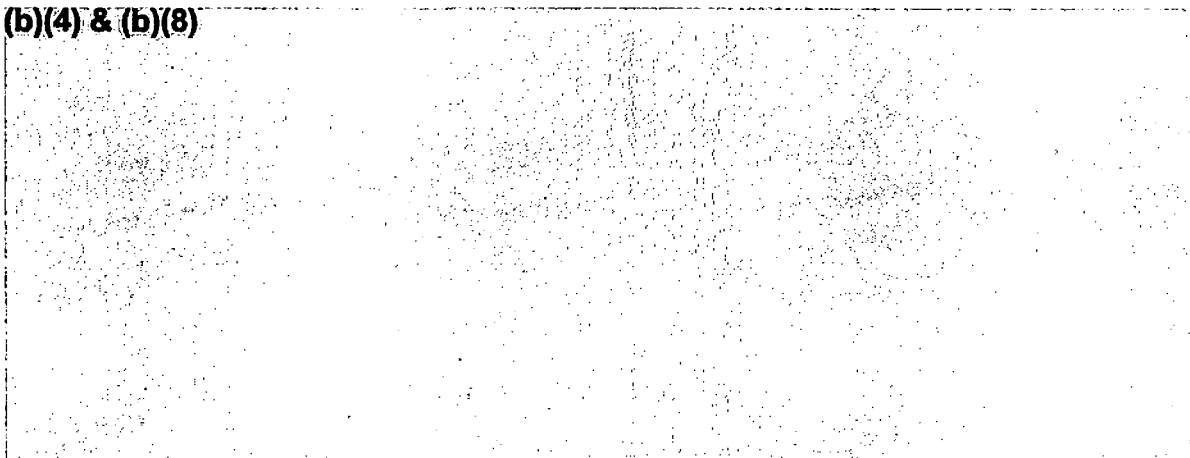


(b)(4) & (b)(8)



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(b)(4) & (b)(8)

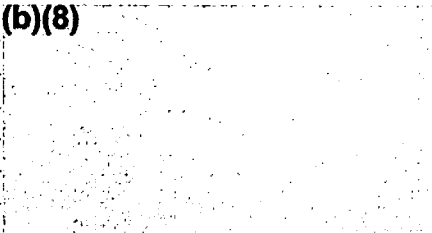


Supervisory History

The insured legal entities of Citigroup are shown in the table below.

Entities (9/30/2008)	Assets	Deposits
Citibank, National Association	1,207,007	748,841
Citibank (South Dakota), N.A.	77,738	42,357
Citicorp Trust Bank, FSB	19,599	7,231
Citibank (Banamex USA)	1,323	1,009
Department Stores National Bank	375	301

(b)(8)

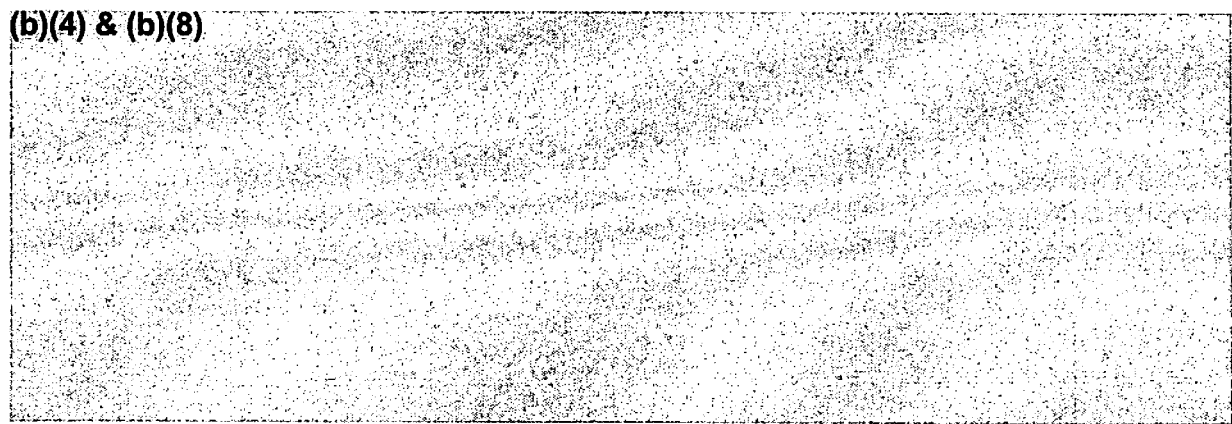


Citibank, National Association (CBNA)

(b)(8)

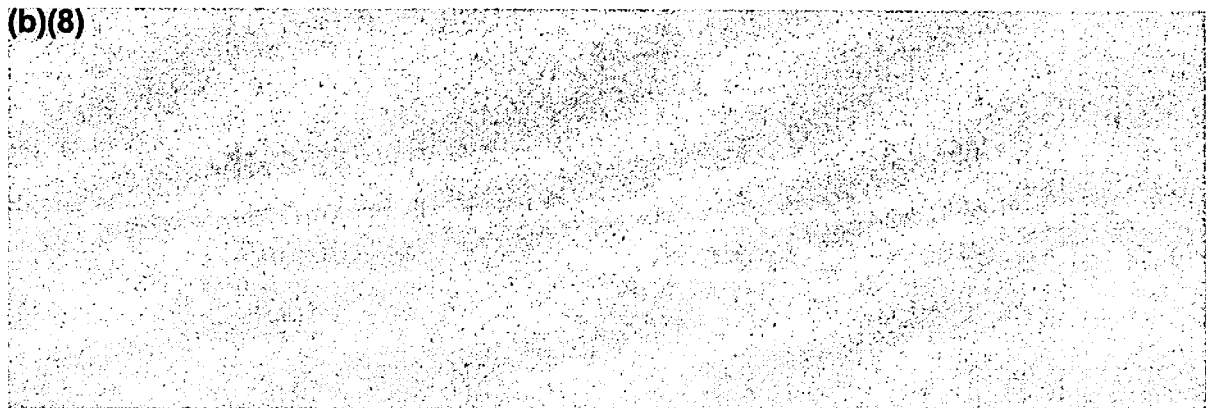


(b)(4) & (b)(8)



Citibank (South Dakota), N.A.

(b)(8)



Citicorp Trust Bank, FSB

This thrift originates fixed-rate, nonconforming (nonprime), single-family residential real estate mortgages and private-label credit card loans. The thrift does not have a branch network.

Citibank (Banamex USA)

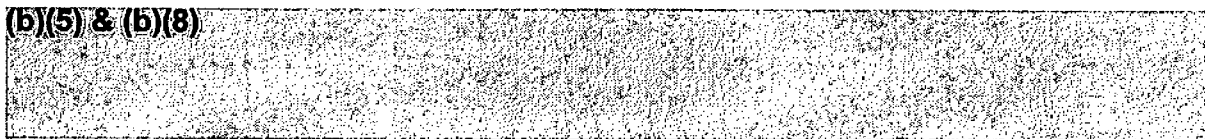
This non-member bank provides banking services for companies and individuals in Mexico and the United States. Banamex USA offers checking and master accounts, time deposit accounts, electronic funds transfer, foreign exchange, and VISA or MasterCard credit cards for individuals. Banamex USA provides corporate banking products, such as working capital loans, import/export lines of credit, accounts receivable and inventory financing, commercial and stand-by letters of credit, and deposit and investment accounts. Banamex USA was founded in 1963 as Community Bank of San Jose and changed its name to California Commerce Bank, Inc. in 1980, and finally changed its name to Citibank (Banamex USA) in 2006.

Department Stores National Bank (DSNB)

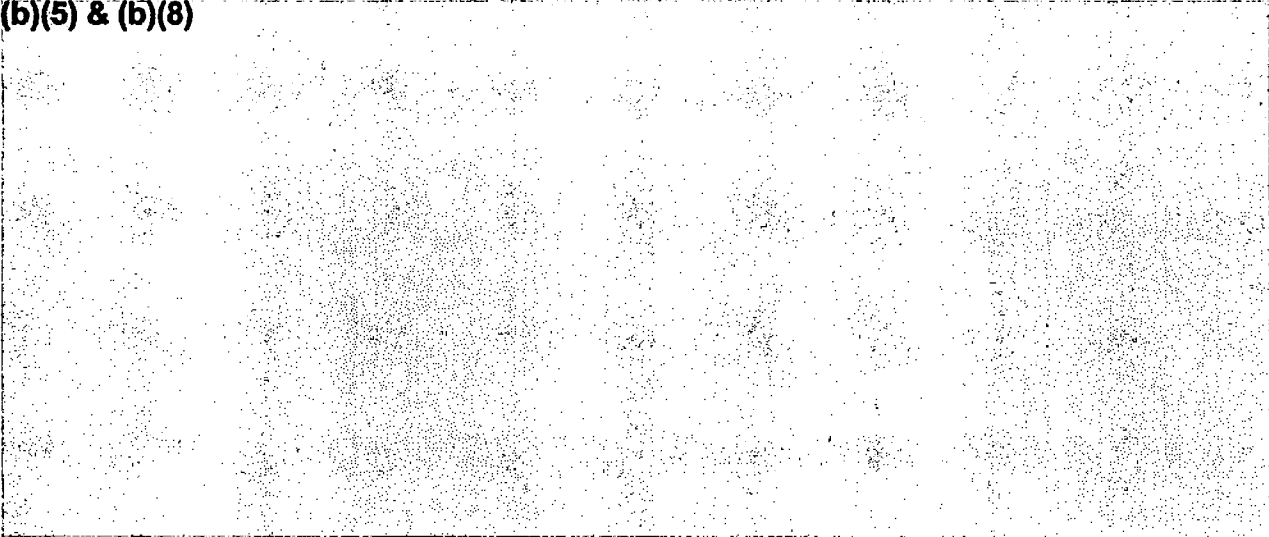
DSNB is the credit card issuer of Visa and retail private label accounts for Citigroups' relationship with Macy's Inc. DSNB is a subsidiary of Citibank (South Dakota), N.A., and does not have any employees or any branch banking offices. All servicing of DSNB's accounts is currently provided by affiliates and third parties.

Systemic Risk

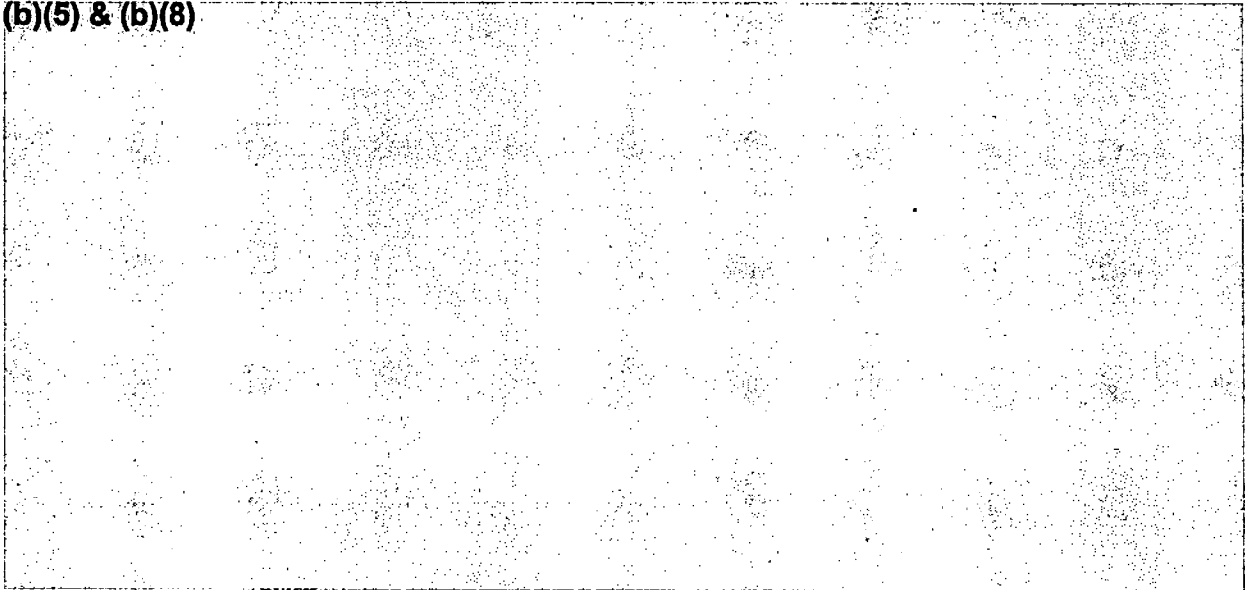
(b)(5) & (b)(8)



(b)(5) & (b)(8)

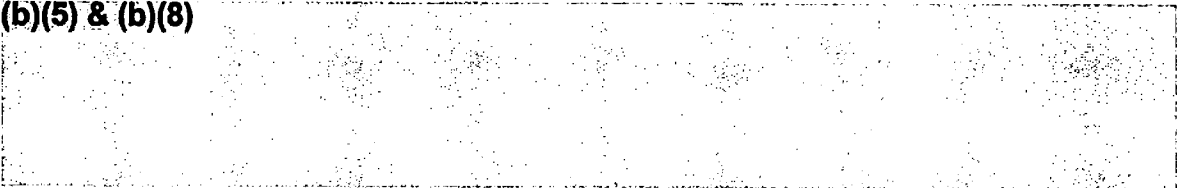


(b)(5) & (b)(8)



Conclusion

(b)(5) & (b)(8)

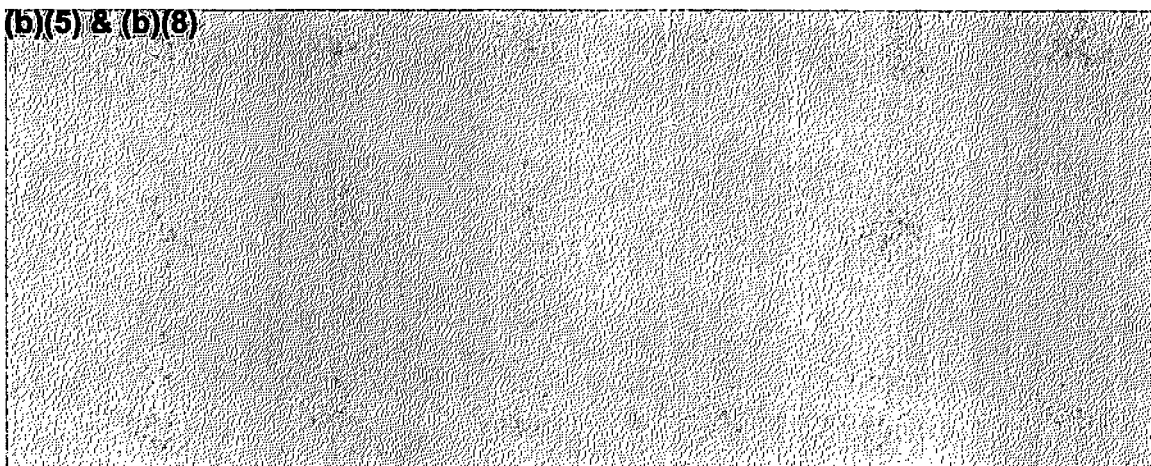


 Disruptions to global money and credit markets since September have resulted in sharp downturns among major coincident indicators of real economic activity. The index of

industrial production published by the Federal reserve Board declined by 4.2 points in September – its largest point decline ever and the largest decline in percentage terms in over 50 years.

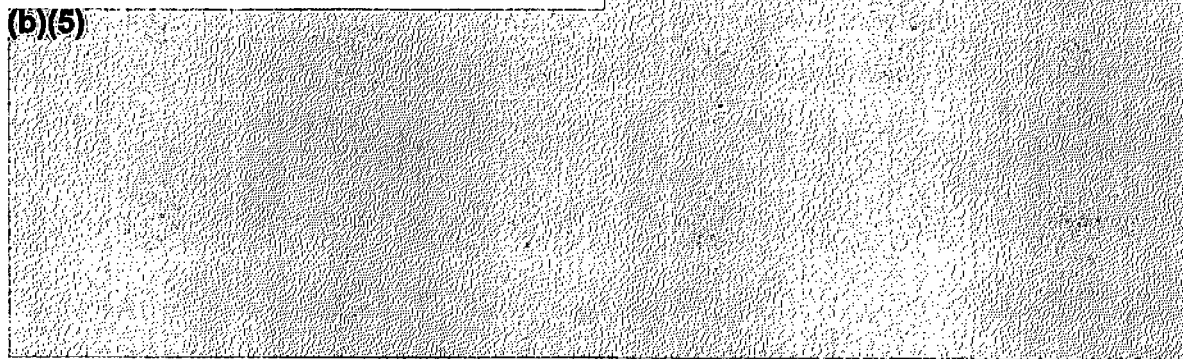
Retail sales fell 2.8 percent in October, the largest monthly decline in over 20 years, exceeding even the monthly decline immediately following the September 2001 terrorist attacks. Payroll jobs declined by 240,000 in October and a revised 284,000 in September as employers reacted to financial market uncertainty by cutting back on positions. (b)(5) & (b)(8)

(b)(5) & (b)(8)

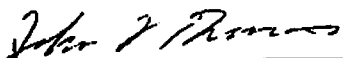


In creating the systemic risk exception,

(b)(5)



This recommendation is supported by:

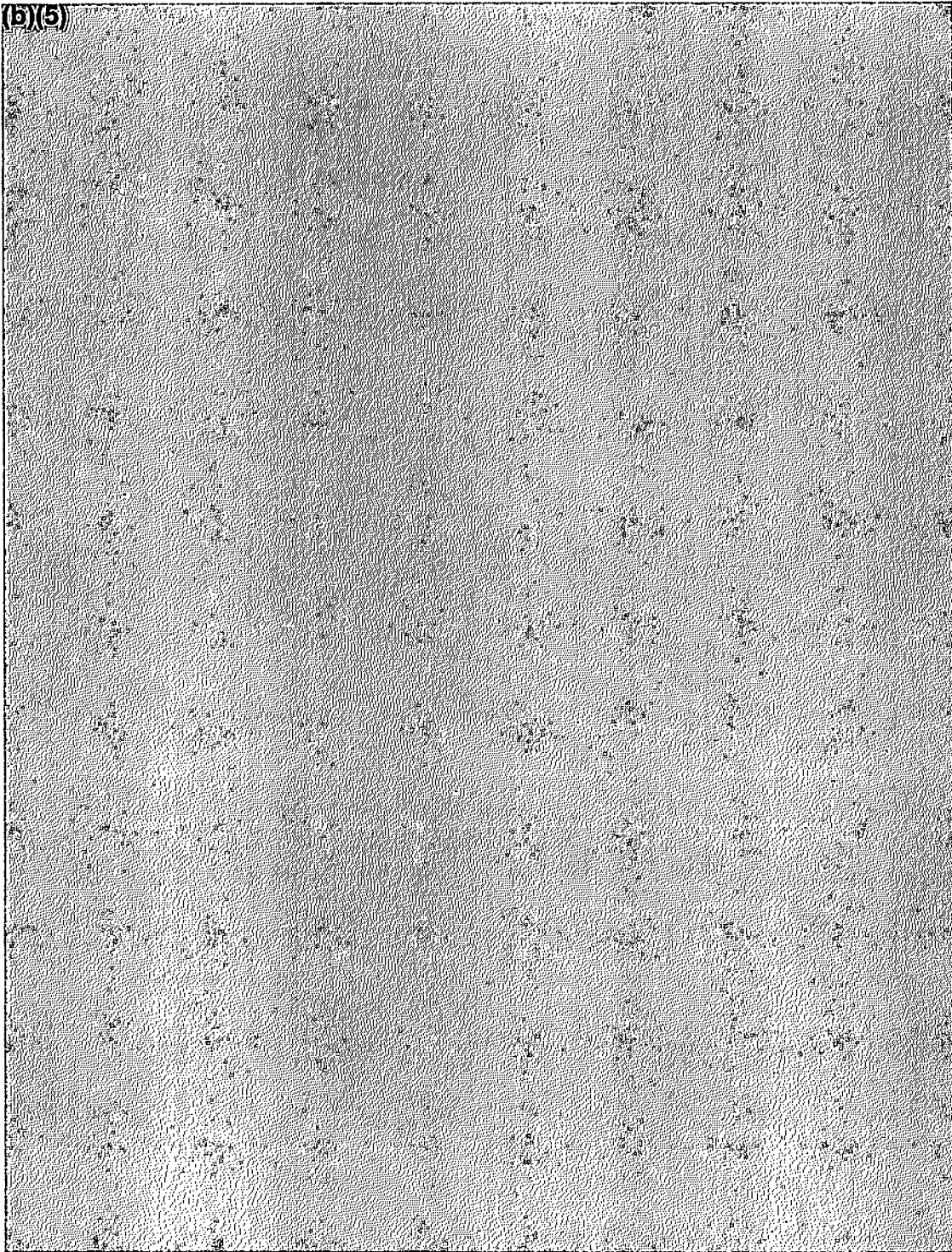


John V. Thomas

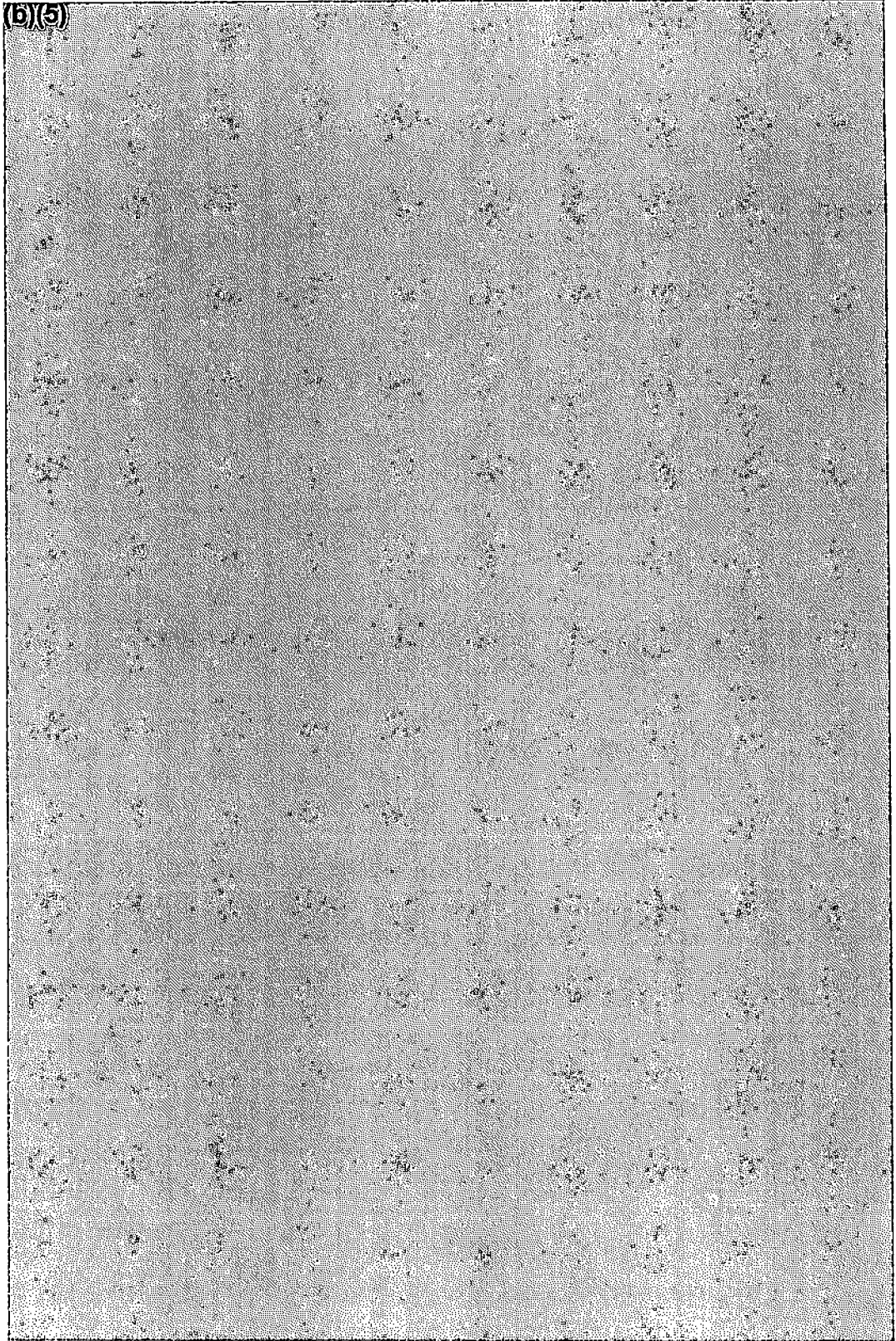
Acting General Counsel

(b)(5)

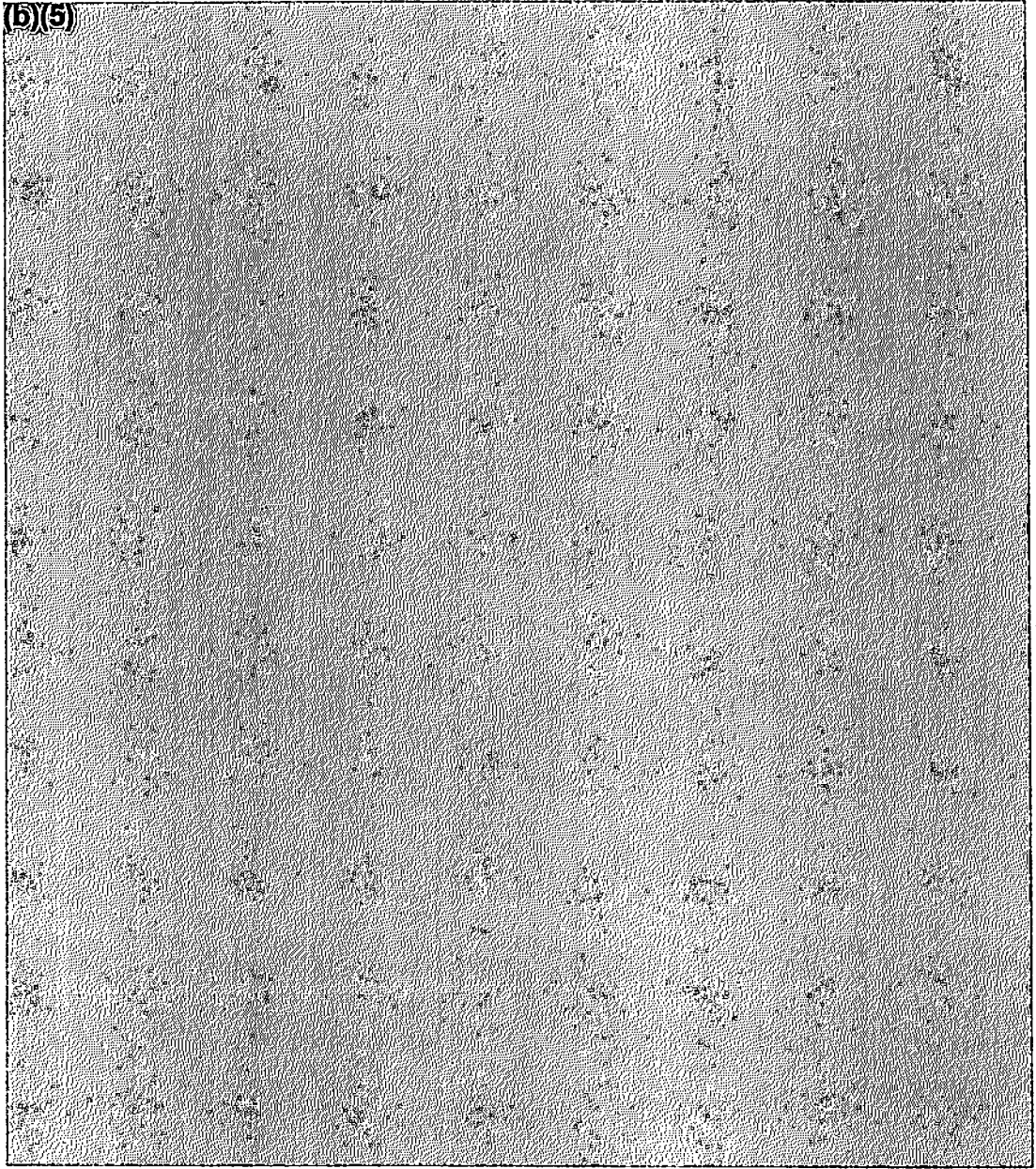
(b)(5)



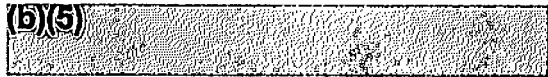
(b)(5)



(b)(5)



(b)(5)



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