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OVERSIGHT OF THE FEDERAL DEPOSIT INSURANCE CORPORATION

HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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OVERSIGHT OF THE FEDERAL DEPOSIT INSURANCE CORPORATION

Thursday, March 4, 2004

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATION,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:07 a.m., in Room 2128, Rayburn House Office Building, Hon. Sue Kelly [chairman of the subcommittee] presiding.

Present: Representatives Kelly, Paul, Oxley, Gutierrez, Inslee, Moore, Lynch Davis and Bell.

Chairwoman KELLY. [Presiding.] This hearing of the Subcommittee on Oversight and Investigations will come to order.

There are many important roles that Congress provides, but none is more important than protecting consumers through proactive and effective oversight, a commitment that the Financial Services Committee takes very seriously. The American people expect and deserve strong oversight of the regulators protecting their hard-earned money. The Oversight and Investigations Subcommittee will continue to ensure that all Americans have the protection and security that they need within their financial institutions to the best of our ability.

This is the first in a series of oversight hearings on federal agencies within the jurisdiction of the Financial Services Committee. These hearings will enable the committee to assess the State of the agencies, examine their performance, and ensure that they are acting in the public interest. We begin this process by examining the FDIC, the Federal Deposit Insurance Corporation, which serves as the supervisor of the safety and soundness practices for thousands of U.S. financial institutions.

As an independent agency, the FDIC has been tasked by Congress with maintaining stability and confidence in the banking system. The agency supervises the health of roughly 5,300 state-chartered institutions and manages the receivership of the few failed depository institutions under its care. In addition to its safety and soundness mission, the FDIC is the deposit insurer for more than 9,000 of the nation's banks and savings associations, insuring over $3.4 trillion in deposits.

The subcommittee welcomes the FDIC Chairman Donald Powell, and we look forward to his testimony. Last week, the FDIC issued its quarterly banking profile for the fourth quarter of 2003, which reported that the FDIC-insured institutions enjoyed record high earnings for the fourth consecutive quarter, including a 22 percent

increase in profits during the fourth quarter of 2002. In addition, there were only three FDIC-insured institutions that failed in 2003, and the number of problem institutions was reduced from 136 at the end of 2002 to 116 at the year-end of 2003. We hope to hear about the steps that FDIC continues to take to improve efforts to identify and address systemic risks and other structural weaknesses in the financial sector.

We are also especially interested in the progress that financial institutions are making regarding implementation of the Bank Secrecy Act and the Patriot Act's reporting provisions. The Patriot Act required the FDIC to expand its supervisory role with regard to money laundering. This is really vital to the nation's security and our financial stability. It is imperative that we dry up illicit money and we would like to hear about the progress that the agency has made working with the private sector to protect the American people in this way.

The subcommittee also welcomes FDIC Inspector General Gaston Gianni. In 1996, Mr. Gianni became the first presidential-appointed Inspector General of the FDIC. The Inspector General's mission is to promote efficiency and effectiveness of the FDIC programs, as well as protect consumers from fraud, waste and abuse in the programs, an important endeavor that promotes stability and public confidence in our institutions. The subcommittee looks forward to hearing the Inspector General's findings on the programs and operations of the FDIC, including recommendations for improvements.

In addition, Ms. Jeannette Franzel, the Director of Financial Management and Assurance at the GAO, the General Accounting Office, is here today to discuss the GAO's audits in 2002 and 2003 of the FDIC. Ms. Franzel will discuss the GAO's findings that the agency maintains effective control over financial reporting and compliance. I would like to commend Chairman Powell for the clean report that the FDIC has received, and for taking as many steps as he has to improve targeted areas from the previous years, including the addition of a newly created chief information officer.

I thank all of our witnesses for their participation in this important hearing on the FDIC oversight, and we look forward to your testimony. So without objection, all members's opening statements will be made part of the record.

We turn now to Mr. Gutierrez.

[The prepared statement of Hon. Sue W. Kelly can be found on page 26 in the appendix.]

Mr. GUTIERREZ. Good morning and thank you, Chairwoman Kelly, for holding this hearing.

The FDIC plays a very important role in the preservation of our banking system. I am concerned that the FDIC is the only federal financial regulatory agency that still permits banks under its supervision to engage in third party arrangements that allow private payday lending firms to make high cost consumer loans in violation of state usury and licensing laws.

The OCC and the OTC and the Federal Reserve Board have all made clear this practice is unacceptable use of federal preemption authority, and effectively ended all indirect participation in payday lending by institutions under their supervision. I would hope and

encourage the FDIC would follow the lead and prohibit these third party arrangements, many of which exist to avoid strong State and local disclosure laws for payday lending and remittances.

I am also troubled by the proposed CRA regulations which would change the definition of small institutions to mean an institution with total assets of less than $500 million, regardless of the size of the holding company. This would greatly increase the number of institutions that are eligible for small bank streamlined CRA examination, removing more than 1,100 banks from the more rigorously examined large bank category. Under current regulations, an institution is considered small if it has less than $250 million in assets and is independent or affiliated with a holding company with total bank and thrift assets of less than $1 billion.

I have other concerns with the new proposed CRA regulations and I would like to see financial institutions receive CRA credit for their remittances activities when they are providing low-cost remittances service to low-and moderate-income customers.

As you may be aware, the issue of costs associated with remittances has been a high priority for me. I am particularly pleased and want to thank the Chairman that the FDIC's Chicago office has been working with some of the institutions to encourage them to offer remittances services particularly in areas where there are a significant number of immigrant workers. I would like to know if there are plans, Mr. Chairman, to expand this work nationwide.

However, many institutions are not providing adequate disclosure to its consumers, and I would like to see if the FDIC as well as other regulators provides greater oversight regarding the disclosure of fees and other charges for remittances by their regulated institutions. I have legislation that would require meaningful disclosure, but I do believe that regulators could currently impose the disclosure requirements on the institutions under their purview.

I will also have some specific questions for Chairman Powell regarding the resolution of a failed thrift in my district, Universal Savings. I helped, along with the FDIC, I believe properly closed down and reopened the institution, and I understand that 100 percent of the FDIC-insured folks just kept working. Forty-eight hours later, they had access to their accounts again. But there are still some questions, so I would ask the chairman to please indulge us and give us some more information.

I look forward to the testimony of the Chairman, as well as the Inspector General and GAO Director, and I yield back the balance of my time.

Chairwoman KELLY. Thank you.

Ms. Maloney, have you an opening statement?

Mrs. MALONEY. Yes I do, Madam Chairman, and thank you very much for holding this hearing.

Welcome, Chairman Powell. I thank you for joining the subcommittee this morning. I want to begin by saying I join your call for deposit insurance reform this year. I am pleased that you are here to report healthy insurance funds. However, I do want to restate my opposition to efforts to increase above $100,000 the base amount of insurance available on individual accounts. I continue to be in agreement with Chairman Greenspan and others that raising

the coverage limit is unnecessary and would only increase taxpayer liability.

I would also like to join with the Ranking Member in his concern on payday lending. At the present time, no national banks, thrifts or members of the Federal Reserve partner with payday lenders. In contrast, 11 state-chartered banks supervised by the FDIC currently partner with payday lenders. For one stark example, after pressure from the Federal Reserve to discontinue its partnership with a payday lender, First Bank of Delaware withdrew from the supervision of the Federal Reserve System and became regulated by the FDIC.

Additionally, responding to a number of safety and soundness risks and blatant violations of consumer protection laws, the OTS, the OCC and the Federal Reserve have taken strong action to prevent national banks from renting their charters to payday lenders. I would like to hear in your remarks whether you agree with the specific concerns that these and other agencies have raised about this practice.

I would also like to put in the record some startling statistics. Payday lending fees cost U.S. families $3.4 billion annually, and 91 percent of all payday loans are made to borrowers with five or more payday loans per year. In other words, people are trapped in a payday lending cycle and cannot get out. As you are aware, these payday loans are often originated with little or no underwriting, as people simply turn over their checks to the lender for a cash advance at a high interest rate. Sadly, payday lenders are often found around military bases where they can depend on a steady supply of young financial novices with guaranteed government checks who are easy pickings.

So I would like to hear in your remarks today at some point if the FDIC is going to continue to allow payday lenders to rent bank charters, which is the clear signal given of the lack of action the agency has taken thus far. Shouldn't the agency at the very least give guidance, clarifying that these loans must include an analysis of the borrower's ability to repay the loan, including debt-income ratios and understanding of other borrower obligations?

I really consider this a safety and soundness issue and certainly good management. So I look forward to your comments today and I am pleased to hear that we have healthy insurance funds. So, thanks.

Chairwoman KELLY. Thank you, Ms. Maloney.

For the benefit of anyone who has not testified here before who will be testifying, there are small black boxes on the table. They have lights on them. The green light means you are free to go. You have 5 minutes. The yellow means that you have 1 minute left, and the red light means that it is time to stop, just like a stoplight.

We are very pleased to have our first panel, the FDIC Chairman, Mr. Donald Powell. He was sworn in on August 29, 2001. Mr. Powell, you have been with us before. We look forward to your testimony and we thank you very much for being here this morning. You will be recognized for a 5-minute summary of your testimony. Without objection, all written testimony will be made a part of the record. Please proceed.

STATEMENT OF HON. DONALD E. POWELL, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. POWELL. Thank you, Madam Chair. I appreciate this opportunity to testify today.

The FDIC was established 70 years ago to promote stability and confidence during one of our country's darkest periods. Since that time, we have stood as a pillar of trust, providing Americans the assurance that their nest eggs are safe and that the banking system is sound. We come before you today in an era of unprecedented prosperity for banks and savings institutions. The industry earned a record $31.1 billion in the fourth quarter of 2003, marking the fourth quarter in a row that earnings set a new high. The results for the fourth quarter also brought the industry's earnings for the full year to a record $120 billion, surpassing the previous annual record of $105 billion set in 2002.

The prosperity of the industry is mirrored by the strong financial footing of the FDIC. The FDIC brings decades of trust and confidence, through good times and bad, backed up by the strength of the guarantee we administer and the liquidity of the deposit insurance funds. A year-end 2003, the balance in the BIF was $33.8 billion and the balance in the SAIF was $12.2 billion. These balances represent 1.32 percent and 1.37 percent of estimated deposits in the BIF and SAIF respectively—well above the statutory target reserve ratio of 1.25 percent.

In addition, it is important to remember that the FDIC brings more than a guarantee and a sizeable fund held in trust for the American people. We bring the ability to resolve banking problems, when they do occur, with a minimum impact on the lives of ordinary Americans and their communities. It is our efficiency in resolving economic calamities with a minimum cost in disruption and at least cost to the taxpayer which ensures the financial stability that is the bedrock of our economic system.

Because the FDIC performs this unique function and because of its financial interest in safety and soundness of America's financial institutions, the corporation brings a unique perspective to the question of bank supervision and the administration of the federal financial safety net. The FDIC ensures and has an interest in the continued well being of every bank in America, not just those we directly supervise. Bank capital is important to the FDIC. It is a tangible symbol of the strength and essential buffer between risk in our financial system and the deposit insurance funds.

We have a common interest with the financial services industry to make sure that the industry remains focused on customers, both by serving them well and treating them fairly. The FDIC brings an independent outlook and industry-wide expertise and works to strike a fair balance between the important innovations of the free market and the overall stability of the financial system.

As the FDIC carries out these responsibilities, we try to be good stewards of the public trust. We are mindful of our budget, promote innovation and excellence in our workforce, and advocate policy positions we believe are fair and in the best interests of the industry and the American people. But there are additional flexibilities the FDIC needs if it is to continue its efforts to maintain a high-performance organization.

First, the FDIC needs greater flexibility to manage its deposit insurance responsibilities. We call for a comprehensive reform to provide this flexibility—the merging of the deposit insurance funds, the freedom to manage the funds's size relative to overall deposits, and the freedom to charge premiums based upon risk. These are responsible common-sense changes, and I thank this committee and the U.S. House of Representatives for overwhelmingly answering our call last year. We will continue our efforts to enact this important bill.

Second, the FDIC needs additional flexibility in managing its employees. I have placed renewed emphasis on merit at the FDIC, rewarding performance and excellence at all levels of the workforce. There is much more to do and we will need Congress's help if we are to realize our full potential in this area. We will soon propose a package of legislative reforms to give the FDIC the tools needed to hire the right people, retain and promote employees who perform at high levels, and to strengthen the link between performance and compensation. I look forward to working with this committee and other appropriate committees in the Congress to make these reforms a reality.

Finally, the FDIC wants to successfully conclude the important discussions currently underway regarding bank capital. The proposed Basel II capital accord is terribly important and will have profound implications on how we manage and regulate bank capital in America. We have sought from the beginning to ensure our system of capital regulation in America is not undermined by our legitimate desire for a more risk-sensitive and modern system of determining regulatory capital. The FDIC is working closely with its fellow regulators to ensure we all strike the appropriate balance.

While it is true that the FDIC has a financial interest in the question of capital, we believe there are other worthy reasons for getting it right. Our success in retaining the industry's strong capital position will provide the regulators with the flexibility needed to allow ever-greater market innovations. Maintaining a solid foundation of capital that is beyond dispute will allow the marketplace, not the regulatory structure, to determine the future of banking and this, in my view, is exactly as it should be. I will continue working to strike this balance at the FDIC and will bring this perspective to our deliberations.

I appreciate the opportunity to testify here today and look forward to your questions. Thank you.

[The prepared statement of Hon. Donald E. Powell can be found on page 118 in the appendix.]

Chairwoman KELLY. Thank you very much, Mr. Powell.

I want to begin by commending the FDIC for the agency's work in financial education with the Money Smart program. Financial education is extremely important to get those people who are not in the banking system into the banking system. I am very impressed with what you have done. Last year, I worked on Title V of the FCRA reauthorization legislation specifically for the strategy for assuring financial empowerment, the SAFE strategy. I wonder if you could tell us about the successes on the Money Smart program and if the FDIC will be bringing these experiences to the new commission that was created in the FACT Act.

Mr. POWELL. Thank you. I am excited about this particular effort at the FDIC. I concur with you, Congresswoman Kelly, about the need for financial literacy for all Americans. We do participate in the new commission that just was formed. In fact, we had our first meeting about 15 days, maybe 2 weeks ago. I am proud to be part of the FDIC's Money Smart initiative. I can say that because it was started before I came and the work had been done. It is an award-winning program. We now have it in three or four different languages. We have something like 200 instructors that have trained 5,000 people to teach Money Smart in all communities around America. We have in excess of 200 partnerships with nonprofits, partnerships with government agencies, such as the Department of Defense. We are doing some work there. We are doing work in all 50 states in America.

It is an exciting program. Its target is adults. I attended the first graduation ceremony in Chicago about 18 months or 2 years ago. I looked into the eyes of those people who participated in the Money Smart program. I can remember asking them about checking accounts, savings accounts, budgets, borrowing money, all those issues. While they did not get every answer, they got most of the answers correctly. So I am excited that we are in fact part of the financial literacy in America. We have a great, great program, incidentally, that is free. Anybody can ask for it and we are happy to share it with them.

Chairwoman KELLY. Thank you.

I would like to know what the FDIC is doing in order to implement the Patriot Act provisions and what the criteria and the methods are that the agency uses to decide which BSA cases should be referred to the FinCEN for enforcement analysis.

Mr. POWELL. That is part of the regular supervision that when we go into an institution and the compliance with the law. Our people, first of all, were trained on what the Patriot Act in fact is about. We equipped them with the tools, including the training that will enable them to go into institutions and look for violations of that particular act. I have complete confidence in our examiners to go into an institution and make sure that in fact that institution is complying with the Patriot Act and the Bank Secrecy Act.

Obviously there will be times that we will miss some things and go back and correct some things. It is a continuing process. We have found that most bankers are more than willing. All banks understand the need. All banks will have put in place compliance officers. They have controls in place. They are taking this extremely seriously. We go in and, like we would on any other compliance examination, look for procedures, look at management's commitment to it, do they have a compliance officer, are they well trained, are they following the law. We will not be bashful in calling their hand when we believe that there are violations. We have the necessary enforcement tools that will get their attention.

Chairwoman KELLY. I have one more follow-up on that, which is that the Patriot Act asked for increased cooperation and communications between regulators. You have talked about the bank side of that. What about the communications that are going on between the regulators, and how frequently does the FDIC discuss this sort

of thing with other regulators? Is there something that we need to do to improve that kind of coordination?

Mr. POWELL. I do not think so, Madam Chair. I think there is extraordinary communication, not only on this particular issue, but I have found that the communication between all of the bank regulators is extraordinary. We share data. We share information. We share concerns. We debate. We have training sessions together. I just attended a training session for supervisors Monday, sponsored by the FFIEC, attended by something in excess of 100 regulators from all four of the different agencies. So I think there is communication. I think we share concerns. We share issues. We share problems. I do not think that is an issue.

Chairwoman KELLY. I am glad to hear that. I hope that is true. We have had some indication that there is not an ease of coordination in terms of communication between some of the agencies, not specifically with your agency, but with some others. I was just interested in how you felt that was working.

Mr. POWELL. I think there is always obviously some friction from time to time, but I can assure you at the principals level there is a commitment to that.

Chairwoman KELLY. Good. Thank you. I am out of time.

Mr. Gutierrez?

Mr. GUTIERREZ. Mr. Chairman, I am going to ask you about two areas, so we will have a lot of time even within the 5-minute framework, I am sure, to be able to discuss them.

Universal Savings, a mutual thrift in my district failed several years ago. I would like to know the status of that resolution. Have the depositors been paid and to what extent? I understand that an investigation may be pending into the circumstances surrounding the closure of the institution. Can you comment on that? And is there any other information you can give me about the institution of Universal Savings?

Mr. POWELL. As you indicated, that institution was closed by the OTS in June of 2002. I am happy to report that all insured depositors have been paid. I am extremely happy to report that 94 percent of the uninsured depositors have been paid. I think that is important. I may have misspoken. What I meant to say, if I did not say it, if you were a depositor and you were uninsured, you got 94 percent of your money back. If you had $100 over the insurance limit, you got 94 percent of it paid. That is important. But just as important, I think, I am proud of the record of the FDIC in that we did this, as you and I talked about before the hearing, in a record time. Most of those people had their money within 24 hours. Some had it within 48 hours.

As you indicated, there is a criminal investigation going on now, and because of that, I would not comment on that.

Mr. GUTIERREZ. So there is a criminal investigation and you cannot comment on that criminal investigation into Universal Savings?

Mr. POWELL. That is true.

Mr. GUTIERREZ. Okay. The second area is, currently 10 FDIC regulated State banks rent their charters to pawn shops, payday loan outlets, check cashers, so that the storefronts can make loans that would be illegal under our State usury and small loan laws.

The OCC, the OTS and the Fed have taken regulatory action to stop their banks from payday loan charter renting. The FDIC is the regulator of choice for payday lenders, even letting a Fed member bank switch regulators to stay in business.

I would like for you to comment on this situation and to help. In light of the progressive actions that you have taken as Chairman and the FDIC has taken in order to help remittances, for example, can you help so that FDIC-regulated banks basically do not lend out their charters. They say, well, we don't have to worry about the State laws; and we don't have to worry about them. Can you help us in that area and the particular area of payday lending?

Mr. POWELL. Let me attempt to answer you. You raise several points. The first thing that struck me as you were making your comments is that we do not want insured banks to participate in any illegal activity. We will not condone anything that is illegal. At the same time, as you know, we are safety and soundness conscious. Through the guidance that we issue to the payday lenders, I think they understand that we are very serious about making sure that they do not do anything that would jeopardize the capital of their institution, to the extent that we all recognize and understand that these particular loans have unusual characteristics that would pose additional risk.

Because of that, capital allocation sometimes is 1.5; sometimes it is three times as much, and it can be 100 percent allocated; 100 percent of the capital must be allocated to the outstanding balance on those loans. So we take the safety and soundness issue very seriously and we take the legality very seriously. We take also the seriousness of consumer laws that may be required from a broad range of consumer protection laws. We check for compliance with those consumer laws. At the same time, we look for discrimination. Is there any discrimination on the part of those payday lenders? And finally, we want to be sure that they are fair in dealing with consumers.

I have thought a lot about the issue of payday lending. I have thought a lot about how we deal with this in America. As I shared with you before the testimony, I have gone to convenience stores. I have visited with people that are in line to get their check cashed. I think there are lots of issues here. I will share with you an experience that I shared with the folks at a conference we sponsored about three or four months ago, a conference on the unbanked. We talked a lot about payday lending at that particular conference.

What I shared with that group was when I visited with one individual gentleman, I said, "You recognize and understand you can go down the street one block and cash your check free. You do not have to have an account there. If you have $100 check, they will give you back $100." He looked at me and said, "I know that and I know what I am paying here at the payday lender, but that is the same institution that foreclosed on my brother's pickup." We talked a little bit about that.

I think part of it is what Congresswoman Kelly mentioned a moment ago. Part of it is education. Part of it is culture. Part of it is trust. Somehow, banks have got to get down into the community and not have a banking lobby environment. Mix with the workers and say, "You can trust us." We can understand that. I think that

is a critical issue. I think it is a cultural issue. The folks that are customers of the payday lenders, I think some of them, they know exactly what they are paying. It is a matter of convenience. It is a matter of intimidation. It is a matter of trust.

Mr. GUTIERREZ. I understand, Mr. Chairman.

Mr. POWELL. I want to emphasize again. We do not want to participate in any illegal activity at all.

Mr. GUTIERREZ. I understand. And maybe we can do this, because of the time, and I wanted to give you ample time. That is why I only asked two questions. Maybe you could answer specifically and you can put it in writing to the committee, and that is, if we do have FDIC charters, and they are using and basically lending out as fronts for payday lenders, I just want you to take a look at payday loans. If by doing that, they eliminate State laws that are very, very clear on usury kinds of interest rates and charges.

Mr. POWELL. Yes, usury.

Mr. GUTIERREZ. Usury. Would you stop that? Because we already know that the OCC and the OTS and the Fed are doing that, and we would like you to look at it, write back to us, and join those other institutions so that people do not use the federal government, your institution, to give out loans that we might agree in private are probably bad, bad loans that should not be handed out.

Mr. POWELL. I am happy to do that and respond to you in writing.

Mr. GUTIERREZ. Thank you.

Chairwoman KELLY. Thank you, Mr. Gutierrez.

Mr. Paul?

Mr. PAUL. Thank you, Madam Chairman.

Good morning, Chairman Powell. I have a question dealing somewhat with philosophy, as well as a practical question about the obligations and responsibilities of the FDIC. I am very interested in the Austrian economic school. This, of course, is a school that was popularized by Nobel prizewinner Frederick Hayek. Their explanation of the business cycle, of course, is that the Federal Reserve is responsible for the business cycle and that artificially low credit causes investors to do dumb things like over-invest and mal-invest, and consumers to borrow more than they should. It creates bubbles that are destined to burst. I think history over the last 100 years bears this out to be a pretty plausible theory.

The Austrians believe that the FDIC participates in the mal-investment, in that it is really not insurance. This is a government guarantee, flat-out, because if you had private insurance, you would have variable rates and depending on the solvency of the bank, the insurance would either be denied or the rates would be raised. So we really do not have insurance, but we as an official body and as you as representative of the FDIC have a responsibility to try to protect the taxpayer. Therefore, when we have troubles, which we have had multiple times over the last 70 years, we come in with just more regulations, which is of course an added burden on the banks and bank customers.

So philosophically, one question I have is, would you concede that this illusion of insurance contributes to over-investment and bad investment, although the so-called good at the FDIC, is to pro-

tect consumers and you can point out where the FDIC has done a lot of good, but overall it does a great deal of harm contributing to a mal-invested economy that eventually has to be corrected, and quite possibly we are in the midst of that correction now. We certainly saw that with the stock market crash of 2000.

But right now, the banks hold over $1 trillion worth of GSEs. There are some who theorize that this is a huge bubble. What if we have a 20 percent decrease in housing prices, or what if interest rates go up, which they very possibly could. Haven't we really overobligated the taxpayers to protect all these deposits and now with deregulation, banks get involved in other activities, and funds are always fungible. Therefore, the argument could be made that we have placed a tremendous potential burden on the taxpayer, although in the meantime it looks like we are doing good protecting the depositors, ultimately we could well face a major crisis of confidence where the bailing out necessary would put the dollar in jeopardy.

Is there any thought to that on your part? Do you give any credence to this idea that the FDIC may contribute to the mistakes that will eventually have to be corrected?

Mr. POWELL. I am not an economist, up front, but I am a former banker. I have given lots of thought about the FDIC insurance. I have thought about, and I have visited with lots of consumers about the importance and why are Americans concerned about stability in their banking system. I often kid that I did not know what "moral hazard" meant until I came to Washington.

Having lived in the crisis and being a banker in the crisis, I can remember talking to consumers, calling me each and every day, "Is my money safe?" I think we would all, Congressman, agree that stability in the banking system is important for the economy of the United States. I think that is the reason the FDIC was created some 70 years ago because, in fact, there was instability in the banking system.

Where that level of coverage should be, we can debate. But I think there is and it has been proven over the years, the importance of the FDIC insurance for the consumers of America. It is the symbol of confidence, and I think Americans have to have confidence in their banking system. They have to have confidence when they deposit money in an insured institution, they will be able to get the money out.

That safety net, how much does it contribute to this issue of moral hazard, is a different issue. We could say the coverage should be $50,000; we could debate it should be $200,000. That is a debate within itself. As you know, we at the FDIC have basically said it should be indexed, and put that issue to the side.

I will tell you during the crisis that the FDIC insurance did contribute to the crisis, in my view, no question. But I will also quickly add to you it was not the only thing. It was not the only thing—commodity prices, the Tax Act of 1986, the imbalance in the thrifts in the balance sheet, and poor judgment were part of that. I am always curious when people do not understand that if I am the CEO of an institution, that I am not going to take unusual risks just because I have the FDIC insurance, because if I take unusual

risk, the first person going down is going to be me. I am going to lose my job and I am going to lose my investment.

So it is a balancing act. I think it has served America well for the past 70 years and I think Americans depend upon it. I think obviously we need to have these debates from time to time about where is it, is it important. We have had that at the FDIC. We have talked about how much of the private sector could, in fact, be part of the risk. We believe that an important part of deposit insurance reform is that premiums ought to be based upon risk. They are not today.

Mr. PAUL. Thank you.

Chairwoman KELLY. Thank you, Mr. Paul.

Ms. Maloney?

Mrs. MALONEY. Thank you.

Mr. Chairman, as you know, the outsourcing of jobs overseas is a particularly sensitive issue for our constituents, particularly with the high level of unemployment. As a highly competitive global industry, the banking sector is one of the industries at the forefront of efforts to move jobs to countries where they can save on labor costs. Already, U.S. banks have moved large numbers of call center jobs to India and other countries. I understand that many bank back office functions are now performed overseas and that this trend is increasing.

I would like you to answer two questions with regard to outsourcing. First, is the FDIC studying the risk to consumer privacy and identity theft when sensitive personal financial data is transmitted halfway around the world? Are they adhering to our laws for privacy protection?

Mr. POWELL. To my knowledge, we have not.

Mrs. MALONEY. Then secondly, is the FDIC studying whether outsourcing of an increasing array of underwriting and record keeping jobs increases risk to the safety and soundness of the banking system? Is this potentially an increased operational risk?

Mr. POWELL. To my knowledge, we have not, but we would be happy to do so. I think obviously we are concerned about identity theft and we are concerned about some of the issues that you have posed. If in fact we see any evidence of that, we will act accordingly.

Mrs. MALONEY. I am encouraged to hear that. I truly appreciate any effort to conduct a study of the risks outsourcings may pose to the safety and soundness of the banking system.

Mr. POWELL. We are happy to do that.

Chairwoman KELLY. Chairman Powell, I would be very interested, the committee would be interested in having you report back specifically after having done a study on the issues that Ms. Maloney has raised.

Mr. POWELL. I will do that.

Chairwoman KELLY. Thank you.

Mrs. MALONEY. As you know, this committee is closely following Basel II, with the commitment that American businesses and financial institutions should not be put at a disadvantage. In your testimony, you reaffirmed the consensus that Basel II will lower capital standards for large U.S. institutions that come under this new regime. Yet in a separate section of your testimony, you note

the 47 percent reduction in the number of community banks in the U.S. since 1990.

So my question is, what is the FDIC's latest thinking on how many institutions in the U.S. will be under Basel II when all is said and done? And what will be the impact on consolidation and competitiveness if only a few large banks come under it? And also, I read one article where internationally, subsidiaries of banks or other community-type banks in foreign countries will not have the same strict capital requirements as we do, therefore possibly putting our institutions at a competitive risk; your comments on where it stands, and certainly we do not want to do anything that in any way undermines the competitiveness of American institutions, yet some papers I have read indicate that they believe it will. So your feelings on it?

Mr. POWELL. I have not read all of those papers, but clearly one of our concerns is the competitive nature of what may happen as it relates to Basel. I do not think that question has been answered yet. It has been asked, and I think there are various views about that. We at the FDIC are looking at that also, but primarily we are focused today on capital, regulatory minimum capital standards.

As you know, we are a safety and soundness organization, so we are focused primarily on capital and that is where we enter into the process and the debate. There has been lots of dialogue exchanged between all the principals as it relates to that one particular issue. We believe that it is time for reform of capital standards. Obviously, the marketplaces move ahead. We should base capital on risk. We do not debate that at the FDIC.

What we do debate and we have lots of debates about is how we measure and validate certain models that are talked about within Basel. But fundamentally, we believe that there should be minimum regulatory capital as a final buffer if in fact some of the assumptions go awry or there are some other things that may happen in the marketplace that would cause banks to have some type of charge against their capital. So we are focused on the capital issue. That is not to say we do not have concern about the competitive nature within large institutions.

Mrs. MALONEY. On the capital issue, which is a very key issue in the whole discussion, some people have alleged that our banks are very heavily regulated, whereas foreign banks are not.

Mr. POWELL. Right.

Mrs. MALONEY. Therefore, possibly our banks or businesses would be put at a disadvantage. There are some allegations that the way that it is formulated, that the capital standards will be higher for our institutions than foreign institutions, therefore putting us at a disadvantage.

Mr. POWELL. Yes. Today, domestic banks, as you know, in the U.S. we have to have a higher capital than our European counterparts, and also Japanese banks. We have clearly a lot more capital than those institutions. More important, we perform better. We perform better, and I think they meet the needs of the business community.

So clearly, higher capital standards do not necessarily mean that the business needs are not going to be met, consumers's needs are

not going to be met. The institutions make more money and return on equity than our counterparts in Europe and in Asia.

Chairwoman KELLY. Thank you, Ms. Maloney.

Ms. Inslee?

Mr. INSLEE. Thank you.

Following up Ms. Maloney's questions about outsourcing and our regulatory reach on some of these functions that are outsourced off-shore, could you elaborate on what the regulatory climate is on those operations, particularly on what responsibility would be maintained by the parent bank for those operations? In other words, let's assume bank A outsources some bank function to the Philippines, not to pick on the Philippines, it is a great country, it just popped to mind, and that operation goes awry; there are violations of identity theft issues and the like. Do you believe you have the ability essentially that the bank maintains all obligations to the regulator in that context?

Mr. POWELL. Yes, sir. I think we have the ability and the will to examine that in the course of examination.

Mr. INSLEE. I am sorry. Would you say that again?

Mr. POWELL. I think we have the ability and the will to examine that in the normal examination process, like we would any outsourcing, technology outsourcing or whatever it may be.

Mr. INSLEE. So right now under the current regulatory structure, statutory and based on rules, do you think the bank would retain the same liability to the regulator whether they did that in-house, on-shore, or whether they did it in an operation off-shore outsourced? Would the bank retain the same liability to the regulator?

Mr. POWELL. I would want to be sure and check with the folks in the FDIC Legal Division, but it is my understanding absolutely we do. Counsel just said we do.

Mr. INSLEE. Okay. What is your greatest concern, if you have any, about this issue of outsourcing some of these bank functions?

Mr. POWELL. The integrity of the process. The peer integrity of the process.

Mr. INSLEE. Do you think that there is an inherent loss of some regulatory integrity from an implicit standpoint when that happens, or not?

Mr. POWELL. I am not sure. I do not have any experience in that. But I can assure you that clearly is one of the things that supervisors would look at, because it is integrity of the numbers. It is also dealing with customers's identity. It is very important. I know that institutions themselves ought to be sure that the integrity of the process is intact. They depend upon it. Their reputation depends upon it.

Mr. INSLEE. I am sorry, you may have talked about this in response to Mr. Gutierrez's questions, if he asked you questions about the payday loans situation. Could you tell me your reaction to that issue? What your institution's thinking is in this regard, and how it compares to some of the other regulators?

Mr. POWELL. We have issued guidance as it relates to payday lenders. As someone indicated, I think we supervise directly in excess of 5,500 institutions. There are 11 that we have identified that are in payday lending and we have issued specific guidance as it

relates to payday lenders: no violation of law; follow all the consumer protection laws in America; and in fact, is it fair? But more important, we have recognized that there is undue risk in payday lending. So we require capital allocations, one-to-one capital allocations against that undue risk. So it is very expensive from a capital process for an institution to be involved in payday lending. We looked at it from a safety and soundness issue, obviously.

Mr. INSLEE. Thank you.

Chairwoman KELLY. Thank you, Mr. Inslee.

Mr. Chairman, Mr. Oxley?

Mr. OXLEY. Thank you, Madam Chairman, and thank you for your efforts at oversight. I want to offer my opening statement as a matter of record.

Chairwoman KELLY. So moved.

[The prepared statement of Hon. Michael G. Oxley can be found on page 28 in the appendix.]

Mr. OXLEY. I thank the chair.

The fact is that we have had a busy 3 years on the legislative front, but one of the major goals of our committee is to conduct oversight, and that is why I think you are the first in the barrel, Mr. Chairman, and I want to welcome you back to the committee for what will be a series of oversight hearings with the regulators. I think it is always helpful for the committee to share views, and with your expertise and real-world experience, it is particularly helpful.

All of us on this side of the Capitol are very desirous of closing the loop and getting deposit insurance reform passed. As you know, Mr. Chairman, this House on two occasions has passed with large margins an overall deposit insurance portfolio, and particularly the merging of the BIF-SAIF and other very, very helpful reforms for the industry. We are increasingly frustrated with the other body. I am not allowed to use the "S" word, but we are particularly frustrated with the other body in that we have not been able to finish the job.

I am just wondering if you could comment on that. We want to work with you towards what we think will be a very, very positive development in passing this legislation. We have made it very clear on our side. Mr. Frank and I both, and the chairman of the Financial Institutions Subcommittee, Spencer Bachus, his Ranking Member, have made it very clear that we are willing to sit down with the Senate and work out a compromise on what is the only real contentious issue left, and that is the insurance numbers and how that affects us going forward.

So let me just throw that out to you. I know we are kindred spirits on this, but we just need to make our brethren in the other body aware of how important this area is to get completed.

Mr. POWELL. Thank you, Mr. Chairman. You were not here when I applauded the leadership that you and others have provided on this legislation and we thank you for that.

In my view, this is good for the American people. It is good for the banking industry. It is unfortunate that the debate is on that one particular part of the bill because the bill is about much more than just the coverage issue. It is critical that we merge the funds. It is critical that we have more flexibility at the FDIC. It is critical

that premiums be based upon risk. No other insurance company bases their premium the way we base our premiums. It should be based upon risk.

My concern is that we will react during a crisis. That is not the time to do that. I am confident and hopeful that the compromise on the coverage issue can come about. Our position has been very clear at the FDIC that we believe it should be indexed. We have listened to the voices that believe it should be increased, the voices that believe it should not be dealt with. We are hung up on that one issue, and other parts of the bill are going to go to the wayside, and that is not good for the American people and it is not good for the banking industry.

So we are going to work diligently with your friends in the Senate and with Chairman Shelby, and hopefully we can overcome those obstacles this year.

Mr. OXLEY. I thank you for that observation. Indeed, you and I have both had conversations with Chairman Shelby and other members of the Banking Committee over on the other side. We always receive a very warm welcome and a positive response. It is just that we need to get down to the nitty-gritty of legislating. Somebody said politics is the art of the possible, and we are ready to exercise that possibility, hopefully probability, that we can get this bill over the goal line.

Mr. POWELL. I will walk hand-in-hand with you.

Mr. OXLEY. Yes, to use a football analogy, which I know you are not particularly familiar with.

[Laughter.]

Let me ask you also your observations. We appear to be at least in the beginnings perhaps of a mega-merger that is going on out there with large banks, or large banks getting larger, that is with the Bank of America and Fleet, with the recent announcement with Bank One and J.P. Morgan. How will that, if at all, affect your responsibilities at the FDIC? Do you have the wherewithal to take care of the myriad responsibilities that you have as chairman of the FDIC? Is there something that we on the legislative side can help you with?

Mr. POWELL. Yes, there are some things. As I mention in my testimony, we are going to be presenting a package to the Congress as it relates to specific issues that we can believe will enable us to do our job better. It is very important that we continue to maintain and retain and hire competent people, and that we reward them based upon their merit pay performance. That is an issue that we struggle with at the FDIC. So we will come with the legislative package so that you can help us as it relates to that.

Mr. OXLEY. When can we expect that?

Mr. POWELL. Within 30 days.

Mr. OXLEY. Very good.

I see my time has expired. Mr. Chairman, again, it is good to have you with us and we appreciate your continued cooperation.

I yield back.

Chairwoman KELLY. Thank you very much, Mr. Chairman.

The Chair notes that some members may have additional questions, and certainly I believe that I do for this panel, so they may wish to submit them in writing. So without objection the hearing

record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

We thank you, Chairman Powell. We are very pleased that you were willing to give us some time this morning. Thank you so much.

Mr. POWELL. Thank you.

Chairwoman KELLY. And now I would like to call the second panel. On our second panel, we have the FDIC Inspector General Gaston Gianni, who was sworn in in 1996. Also on our second panel is Jeanette Franzel, the Director of Financial Management and Assurance at the General Accounting Office. I thank you both for your appearance before the subcommittee. Without objection, your written statements will be made part of the record. You will be each recognized for a 5-minute summary of your testimony. We begin with you, Mr. Gianni.

STATEMENT OF HON. GASTON L. GIANNI, JR., INSPECTOR GENERAL, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. GIANNI. Madam Chairman, thank you. I am pleased to testify today as you conduct oversight hearings on the FDIC. I want to compliment the committee for this format of oversight. I think it works very well. I had many years at GAO and the experience now of being the Inspector General. Bringing in GAO and the Inspector General, along with the head of the agency, I believe is a model for conducting oversight by the Hill. So I hope others would take after and emulate your practice here.

FDIC has a long and successful tradition of maintaining public confidence and stability in the nation's financial system. There are many important indicators that the banking system is healthy and the corporation can take pride in its contributions to that stability and confidence. Likewise, I am proud of the accomplishments of my office, seeking to help ensure the successful accomplishment of the FDIC mission.

At the outset, I would just like to acknowledge the congressional confirmation of Tom Curry, the corporation's fifth member of the board of directors in 2003. Our board is now operating at full strength, a very positive aspect to internal governance structure, for which I called in many of my past semiannual reports.

The role of the IG is unique to an agency. To illustrate, at FDIC, although we are an integral part of the corporation, unlike any of the other divisions or offices, our legislative underpinning requires us to operate as an independent and objective unit and report both to the chairman and to the Congress. We have two essential roles. Through a comprehensive program of audits, evaluations, and investigations, we independently analyze and report on significant management challenges and foster integrity and accountability, and excellence in FDIC's programs.

In this regard, an important aspect to the success of an IG office is the support of its agency top leadership. I am pleased to report to the subcommittee that both Chairman Powell and Vice Chairman Reich provide a supportive tone at the top that enables us to carry out our statutory responsibilities. As a result, we have an ex-

cellent working relationship with the corporation and we are committed to continuing that relationship in the future.

I believe that the OIG adds significant value to FDIC. Net savings from our work have averaged over $290 million a year over the past 5 years. We also provide substantial non-monetary value to the corporation through advice and recommendations. Last year, we had $96 million in actual and potential monetary benefits. We offered 190 plus non-monetary recommendations for improving the internal operations and controls within the corporation. We had 35 referrals to the Department of Justice, 43 indictments, 22 convictions, and additional actions.

In addition, in the spirit of the Reports Consolidation Act, we annually identify the top management and performance challenges facing the corporation. The challenges capture the risks and opportunities we see before the corporation and serve as a guide for our work. The first four challenges address the more global issues confronting the corporation: adequacy of corporate governance in the insured depository institutions; protection of consumer interests; management and analysis of risks to the insurance fund; and effectiveness of the resolution and receivership activities.

The other six focus internally on the corporation's operations: management of human capital; management and security of information technology resources; the security of critical infrastructure; management of major projects; cost containment and procurement integrity; and the assessment of corporate performance.

I have given examples of our work under each one of these risks in my statement, but I would like to focus on a couple. Last year, we have through our investigations identified people who were taking advantage of the elderly by using the FDIC logo, the imprimatur, or suggesting that their deposits were insured by the FDIC. As a result of our investigation, we were able to help identify and return over $9 million to these unfortunate elderly people.

As a result of several of these cases, we made recommendations to Chairman Oxley and to the committee to include in the Financial Services Regulatory Relief Act a provision that supports and gives the corporation added enforcement authority to protect our imprimatur and our insurance. I just want to thank the committee for its support in including it in its regulatory relief bill.

Another area that we are focused on remains the corporation's oversight of information technology security. It is a daunting challenge. Information technology continues to play an increasingly greater role in every aspect of FDIC's mission. Our work required under the Federal Information Security Management Act shows that the corporation has worked hard to implement many sound information system controls to help ensure adequate security. However, daunting challenges remain due to ever-increasing threats posed by hackers and other illegal activities. We have urged the FDIC to stay the course in developing an enterprise-wide architecture and map the current versus the new state of where they want to be on business processes and supporting information systems and data architecture. Additionally, we have emphasized completing system certification and accreditation processes to test the security of developing IT assets.

Again, Chairman Powell acknowledged the fact that we have appointed a new CIO. We still have many positions that need to be filled within our IT arena. That is one of the challenges that will need to be taken care of as we go forward.

Lastly, before I conclude, regarding the Government Performance and Results Act, while the corporation has made tremendous strides in improving and complying with the Act, we offer areas of suggestions for improving how they can comply and make that reporting more objective to accomplish the Chairman's priorities.

In closing, I would like to again thank you for holding the hearing. Members of my office are committed to continuing to carrying out our mission at the FDIC. We are privileged to be public servants with the responsibilities of doing so. I hope my remarks shed some light and I would be happy to answer any questions that the subcommittee might have.

[The prepared statement of Hon. Gaston L. Gianni, Jr. can be found on page 104 in the appendix.]

Chairwoman KELLY. Thank you, Mr. Gianni.

Ms. Franzel?

STATEMENT OF JEANETTE M. FRANZEL, DIRECTOR, FINANCIAL MANAGEMENT AND ASSURANCE, UNITED STATES GENERAL ACCOUNTING OFFICE

Ms. FRANZEL. Thank you, Madam Chairwoman. I am pleased to be here today to discuss the results of our recent audits of the financial statements at FDIC. I do believe you have a copy of our recently issued reports.

The FDIC actually administers three different funds, so we do three different audits: the Bank Insurance Fund, the BIF; the Savings Association Insurance Fund, the SAIF; and the FSLIC Resolution Fund, or the FRF. Regarding the financial statements for the BIF, SAIF and FRF, we issued unqualified or clean opinions for those audits. This means that the financial statements and the notes for each fund presented fairly in all material respects the financial position and the results of operations and cash flows in accordance with U.S. generally accepted accounting principles.

Regarding FDIC's internal control, we concluded that FDIC management maintained in all material respects effective control over financial reporting, safeguarding of assets, and compliance as of December 31, 2003. This is a very positive conclusion on internal controls. We did identify one reportable internal control weakness related to information systems security controls. This was not considered to be material, but is considered to be a deficiency in the design and operation of FDIC's controls. I will talk a little bit more about the significant improvements that FDIC has made in this area. During the course of our audit, we also did not note any instances of noncompliance with laws or regulations, so again, a very positive audit report.

I would now like to discuss FDIC's information systems security. We have reported weaknesses in FDIC's information systems security for a number of years. Although we continued to consider this to be a weakness in 2003, we also found that FDIC has made significant progress in this area. For instance, FDIC has completed almost all of its actions on the weaknesses detected in our prior au-

dits. Unfortunately, however, in 2003 we found additional information security weaknesses, some of which FDIC has already corrected. They were very specific instances where FDIC had not secured or limited access to its computer resources.

A key reason for these continuing weaknesses was because FDIC had still not completely implemented a program of security monitoring. That is, an ongoing review, testing and evaluation of its information security, to ensure that systems are in compliance with policies and procedures. FDIC has begun implementing such a program, but it was not quite fully implemented at the end of 2003.

We do believe that when FDIC fully implements this program, it should allow FDIC to identify and correct the types of problems that we found in 2003, so that when we come in hopefully FDIC's program can detect and correct any new weaknesses that have occurred and then in that case, hopefully we could clear the reportable condition going forward. FDIC management has shown a strong commitment to fully establishing this comprehensive security management program and we do believe that FDIC is on the right track in this area, and we will continue to work closely with FDIC to monitor this during 2004.

I will now briefly discuss the funds's financial condition. As you know, we have heard today that BIF and SAIF, the two insurance funds, have shown positive trends over the last couple of years. Both funds have reported positive net income, which increases the insurance reserves or net worth of the funds. Insured banks and savings institutions are also showing very positive trends in earnings and asset quality.

In addition, FDIC is required to maintain fund balances for the insurance funds at a designated ratio of 1.25 percent of estimated insured deposits, and the reserve ratios were well above those levels at December 31, 2003. It is very important, however, to note that all of these results reflect a point in time. This holds true for both our audit results and the positive financial trends that we are seeing with FDIC and the industry.

In summary, the results of our audits were very positive, clean opinions on the financial statements and overall effective internal control, with significant improvements in the area of computer security. In general, we have seen a strong commitment from FDIC management to promote excellence in financial reporting and internal control. FDIC continues to take important steps to monitor risk, modernize its systems, and adapt to change.

With the banking environment, though, constantly changing, FDIC needs to continually monitor its business environment and the related risks, and adapt its internal operations and internal controls and its external insurance and supervision and monitoring functions in order to manage this risk and maximize the value of its overall mission.

I would like to note that we have had a very productive and cooperative working relationship with FDIC management and staff at all levels. We also have very complementary roles and responsibilities with the IG and we do coordinate frequently on our work.

Madam Chairwoman, I would be happy to answer any questions that you have.

[The prepared statement of Jeanette M. Franzel can be found on page 32 in the appendix.]

Chairwoman KELLY. Thank you very much. I do have a couple of questions.

I am interested in the fact that you have made an effort to allow the FDIC to reduce the regulatory burden on banks by testing, rather than duplicating a lot of work on audit and control functions. I want to know how this is going and how effective you have been in reducing the burden. Are you able to quantify it and document that there has actually been a reduction?

Mr. Gianni?

Mr. GIANNI. Yes, Madam Chairwoman. This is the corporation's new, what they call the merit exam program. We were involved as an observer at the outset, as the corporation was designing the concept to streamline its supervisory oversight of banks under $250 million that met certain criteria. Conceptually, it is a sound concept that you are risk-focused on how you are carrying out your exam process. At any time, if an institution should fall outside of the parameters set up or the criteria that were set up—for example the continuation of management is one of the criteria—if you have a change in management, in high-level management within an institution, that throws that institution out of the criteria and you have to go in and do a more extensive examination process.

So conceptually, the process holds together. We have not examined the implementation of this new process. We plan to do so in our future work. However, the corporation does report that they have saved examiner time and freed up hours to direct to other important areas of activities within the corporation, but we have not analyzed it yet.

Chairwoman KELLY. Mr. Gianni, when you do analyze it, do you plan to do that fairly soon? If so, will you report that to the committee for us please?

Mr. GIANNI. The work is underway at the present time and we will report back to the committee, Madam Chairwoman.

Chairwoman KELLY. Thank you. I think that is something that is worth our having a report on from you.

Some of the smaller and more rural institutions that the FDIC monitors have had concerns with the increased Patriot Act requirements. We have heard from some of them. I wonder if you think that Congress should consider making any changes with regard to those rural and small institutions.

Mr. GIANNI. We have not looked at the reg burden of this. The corporation is currently in the process of developing proposals to the Congress that will address regulatory relief on reg burden. One of the concerns, and I have heard the concerns that you expressed or that have been expressed to you, one of the ideas that is being considered is whether there could be constructed a phased approach to providing the information to the Treasury Department. Perhaps if the Treasury Department would get a condensed set of information, which would reduce the burden on the part of the bank, and then when it went into the system and was analyzed and there was deemed a need for additional information, perhaps at that point in time they could go back out and ask for additional information. This is a concept that is being considered right now.

One of the frustrations that I have also heard has been that information goes into the Treasury Department and nothing comes back to the bankers to indicate whether this information that cost them money to generate, whether that has been helpful to the federal government. I believe that the new director of FinCEN has been out listening to people and has a number of studies underway to try to improve the operations of his organization.

Chairwoman KELLY. That is good to hear.

I want to ask also, your office has repeatedly found that one of the problems that really is at the heart of a lot of bank failures is the fact that we do not have adequate corporate governance at the top. Are the requirements of Sarbanes-Oxley being met here? And is there something that we need to tweak to make that more solid? How can we help you on that?

Mr. GIANNI. I think regarding Sarbanes-Oxley, although Sarbanes-Oxley is certainly helpful, there were requirements already passed by the Congress that required strong governance principles within our financial institutions. What we do is go back. As you know, we are required by law when a major institution fails, to conduct what is called a material loss review. If it is a loss of $25 million or more to the insurance fund and it is an FDIC-insured institution, we are required to conduct a study as to why that institution failed.

We have done so 10 times in the past 10 years. What we have recently done is we have gone back and we have analyzed those 10 studies that we had to see whether there were any trends that came out. Clearly, the top trend is that there were weak governance processes in place.

Now, 10 in relation to 5,000 is relatively small, but we think our analysis will give additional emphasis to the examiners, to the corporation, to focus in on governance because governance is extremely important. It is the amount of control that is being maintained over the financial institution, whether you have a good working audit committee that helps oversee the operation of the institution. That was our finding and it continues to be. I do not think we need additional legislation. I think what we want to make sure, though, is that we are vigilant as we carry out our exams in these institutions.

Chairwoman KELLY. Okay, thank you.

Ms. Franzel, I want to ask you a question. The FDIC has regional field offices, so that they are fairly close to the people that they monitor. I am wondering what you have seen when you looked at the FDIC in terms of how that worked and whether or not we can learn from the cooperation between the FDIC and the State regulators in a way that can be applied to the regulation of other entities.

Ms. FRANZEL. I think that taking a look at the current structure is probably a good idea, because with increases in technology, obviously, we have been able to do our work differently. It is important to have folks out there close to the people who are being regulated. We at GAO have the same type of structure. We have several field offices simply because we are covering federal expenditures all over the country, and we find that we need to have these types of offices out there.

So certainly I think that others can learn from this environment and this structure. We have not specifically studied whether the structure right now should be applied to other regulators, but I think that idea certainly has merit.

Chairwoman KELLY. Thank you.

Mr. GIANNI. If I might, Madam Chairwoman.

Chairwoman KELLY. Yes?

Mr. GIANNI. We have looked at the field. From an administrative standpoint, we have looked at the expenses incurred by the corporation among their regional offices. There was a wide disparity among the various regions as to the cost of the facilities. Since that time, the corporation has consolidated several of their regional offices and I believe are continuing to look at what is the right size and structure of their field organization. We do have individuals located in all 50 states, though, so that they can carry out their responsibilities.

Chairwoman KELLY. Have you found that it facilitates cooperation between the State regulators and the federal regulators to have those field offices?

Mr. GIANNI. Exactly. I think it is important because, as you know, we examine financial institutions in conjunction with the State examiners. So we have to really understand how the States are carrying out their responsibilities because every other exam cycle we are relying on the States to carry out an exam. We have to be knowledgeable about how they are carrying out their exams, what risks they are identifying. So there has to be a good communication and cooperation among the State examiners and the federal government. We have done some work in that area. We are continuing to monitor the activity and have some work underway at the present time.

Chairwoman KELLY. Thank you. Thank you for adding that.

I have other questions. I am going to submit them in writing. You have been very patient and I appreciate your being here. I think there are other members who may have additional questions for the panel. It is a very busy time on Capitol Hill, as you all know. So without objection, I am going to hold the hearing record open for 30 days for the members to submit written questions to these witnesses and place their responses in the record.

With that, this hearing is adjourned.

[Whereupon, at 11:30 a.m., the subcommittee was adjourned.]

A P P E N D I X

March 4, 2004

Opening Statement of Chairwoman Sue Kelly
Subcommittee on Oversight and Investigations
"Oversight of the Federal Deposit Insurance Corporation"
March 4, 2004

There are many important roles that Congress provides, but none is more important than protecting consumers through proactive and effective oversight – a commitment that the Financial Services Committee takes very seriously. The American people expect and deserve strong oversight of the regulators protecting their hard-earned money.

The Oversight & Investigations Subcommittee will continue to ensure that all Americans have the protection and security they need within their financial institutions. This is the first in a series of oversight hearings on the federal agencies within the jurisdiction of the Financial Services Committee. These hearings will enable the Committee to assess the state of the agencies, examine their performance, and ensure that they are acting in the public interest.

We begin this process by examining the Federal Deposit Insurance Corporation (FDIC), which serves as the supervisor of the safety and soundness practices for thousands of U.S. financial institutions. As an independent agency, the FDIC has been tasked by Congress with maintaining stability and confidence in the banking system. The Agency supervises the health of roughly 5,300 state-chartered institutions and manages the receivership of the few failed depository institutions under its care. In addition to its safety and soundness mission, the FDIC is the deposit insurer for more than 9000 of the nation's banks and savings associations, insuring over $3.4 trillion in deposits.

The Subcommittee welcomes FDIC Chairman Donald Powell and we look forward to his testimony. Last week, the FDIC issued its "quarterly banking profile" for the fourth quarter of 2003, which reported that FDIC-insured institutions enjoyed record-high earnings for the fourth consecutive quarter – including a 22-percent increase in profits during the fourth quarter of 2002. In addition, there were only three FDIC-insured institutions that failed in 2003, and the number of "problem institutions" was reduced from 136 at the end of 2002 to 116 at year-end 2003. We hope to hear about the steps the FDIC continues to take to improve efforts to identify and address systemic risks and other structural weaknesses in the financial sector.

We also are especially interested in the progress that financial institutions are making regarding implementation of the Bank Secrecy Act and the PATRIOT Act's reporting provisions. The PATRIOT Act required the FDIC to expand its supervisory role with regard to money-laundering.

This is vital to the nation's security and financial stability. It is imperative that we dry up this illicit money, and we would like to hear about the progress that the Agency has made working with the private sector to protect the American people.

The Subcommittee also welcomes FDIC Inspector General Gaston Gianni. In 1996, Mr. Gianni became the first Presidential-appointed Inspector General of the FDIC. The Inspector General's mission is to promote efficiency and effectiveness of FDIC programs, as well as protect consumers from fraud, waste and abuse in the programs – an important endeavor that promotes stability and public confidence in our institutions. The Subcommittee looks forward to hearing the Inspector General's findings on the programs and operations of the FDIC, including recommendations for improvements.

In addition, Ms. Jeanette Franzel, the Director of Financial Management and Assurance at the General Accounting Office, is here today to discuss the GAO's audits in 2002 and 2003. Ms. Franzel will discuss the GAO's findings that the agency maintains effective control over financial reporting and compliance. I would like to commend Chairman Powell for the clean report the FDIC has received, and for taking steps to improve targeted areas – including the addition of a newly created Chief Information Officer.

I thank all of our witnesses for their participation in this important hearing on FDIC oversight and we look forward to your testimony.

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Oversight and Investigations

March 4, 2004

Hearing on "Oversight of the Federal Deposit Insurance Corporation"

Thank you, Chairwoman Kelly, for convening the first in a series of oversight hearings that the Committee will hold in the coming year on the agencies within our jurisdiction. While this Committee has an enviable record of legislative accomplishments over the past three years – including the far-reaching corporate reforms of the Sarbanes-Oxley Act, the anti-terrorist financing provisions of the USA PATRIOT Act, and last year's reauthorization of the Fair Credit Reporting Act – an equally important part of our responsibilities as legislators is exercising rigorous oversight of Federal programs and regulations and the agencies that carry them out.

In that regard, I can think of no better agency with which to kick off this series of hearings than the Federal Deposit Insurance Corporation, which, for the past 70 years, has played a critical role in ensuring the safety and soundness of the banking system and instilling confidence in that system among America's depositors and savers. I am particularly pleased to welcome back FDIC Chairman Don Powell, who has been a good friend to this Committee since assuming his responsibilities in 2001. Chairman Powell, thank you again for the outstanding job you are doing at the FDIC, for your wise stewardship of the deposit insurance funds, and for the cooperative spirit in which you and your staff have worked with this Committee on deposit insurance reform and other public policy issues affecting banks and their customers.

As a Texas community banker for 30 years who saw his share of boom-and-bust cycles, Chairman Powell brings a "real world" perspective to his responsibilities at the FDIC that is all too often missing in our debates here in Washington. His common-sense regulatory approach was most recently on display in the revisions that the FDIC and the other Federal banking agencies proposed to the regulations implementing the Community Reinvestment Act (CRA).

Among other reforms, this proposal would increase the asset size limit for banks to qualify for streamlined CRA examinations from its current level of $250 million to $500 million. I commend Chairman Powell and his fellow regulators for this long overdue update to CRA, which will help to ensure that the law serves its intended purpose of encouraging investments in banks' local services areas, while not choking America's small community banks in the kind of red tape that hampers their efforts to meet the credit needs of their customers. I urge the regulators to

continue to study this issue, and to consider making a further upward adjustment to the CRA small bank exam threshold in their final regulation.

Finally, I want to once again thank Chairman Powell for all of his efforts on behalf of deposit insurance reform, which remains one of this Committee's highest legislative priorities. Having passed a strong package out of the House with well over 400 votes last April, we are hopeful that our Senate counterparts will act this year and allow us to get a bill to the President's desk that makes needed structural reforms to a system that has served America's consumers and economy well for some seven decades.

I yield back the balance of my time.

Representative Jeb Hensarling
Opening Statement for Financial Services Hearing
"Oversight of the FDIC"
Thursday, March 4, 2004

Madam Chairwoman, I want to thank you for holding this first in a series of oversight hearings on the federal banking regulators, and I look forward to the testimony of my friend from Texas, Chairman Powell.

Last week, the FDIC's fourth quarter banking profile stated that FDIC-insured institutions enjoyed record high earnings for 2003, with profits having increased 22 percent over what they were in the fourth quarter of 2002. Out of approximately 9,000 federally insured institutions only 3 failed in 2003, while the number of institutions considered to be in financial trouble declined as well.

From looking at these numbers and others it is clear to me that our federally insured banking system is strong and consumer confidence in their financial institution of choice remains high.

I do want to take a moment to commend Chairman Powell and the FDIC for what I believe have been actions taken in the last year that promote important and consumer friendly federal regulation. Encouraging free market principles over more regulation allows FDIC-insured banks to better serve their communities to the best of their abilities.

The FDIC's recently proposed rule to increase the small bank asset requirement from $250 million to $500 million for purposes of Community Reinvestment Act examinations is a good one. I believe that allowing banks to compete in the free market - with limited government and regulatory interference - is the most effective way to ensure that the banking needs of every community are consistently met. Every regulatory mandate placed upon financial institutions should be subject to serious review and scrutiny by this committee in order to ensure that what we require of our banks is valuable and serves a beneficial purpose for consumers.

I am one member of this committee who would like to explore further the real impact CRA has had on community investment, and I hope the testimony today answers some of those questions.

I would also like to note that the FDIC's issued guidelines regarding the payday lending industry were needed. I believe this industry provides a credit choice for consumers that many financial institutions choose not to provide, and I was pleased to see that the FDIC did not act in their guidelines to prevent consumers from having these choices.

When possible, fraudulent, unfair and deceptive practices should be combated by a regulatory agency. However, it is important that we do not punish an entire industry and take away a choice for consumers simply because of the actions of a few bad apples.

I look forward to the testimony here today and hope for some constructive debate over the role of the FDIC in the banking industry.

I thank the Chairwoman and yield back the balance of my time.

United States General Accounting Office

GAO

Testimony

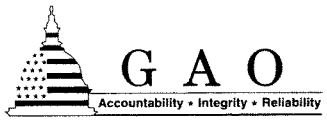
Before the Subcommittee on Oversight and Investigations, Committee on Financial Services, House of Representatives

For Release on Delivery
Expected at 10 a.m. EST
Thursday, March 4, 2004

FEDERAL DEPOSIT INSURANCE CORPORATION

Results of 2003 and 2002 Financial Audits

Statement of Jeanette Franzel, Director
Financial Management and Assurance



GAO-04-522T

GAO
Accountability · Integrity · Reliability

Highlights

Highlights of GAO-04-522T, testimony before the Subcommittee on Oversight and Investigations, Committee on Financial Services, House of Representatives

March 4, 2004

FEDERAL DEPOSIT INSURANCE CORPORATION

Results of 2003 and 2002 Financial Audits

Why GAO Did This Study

GAO is required to annually audit the financial statements of the three funds administered by the Federal Deposit Insurance Corporation (FDIC): the Bank Insurance Fund (BIF), the Savings Association Insurance Fund (SAIF), and the FSLIC (Federal Savings and Loan Insurance Corporation) Resolution Fund (FRF). GAO is responsible for obtaining reasonable assurance about whether FDIC's financial statements for BIF, SAIF, and FRF are presented fairly in all material respects, in conformity with U.S. generally accepted accounting principles, and whether FDIC maintains effective internal controls and FDIC has complied with selected laws and regulations.

Created in 1933 to insure bank deposits and promote sound banking practices, FDIC plays an important role in maintaining public confidence in the nation's financial system. In 1989, legislation to reform the federal deposit insurance system created three funds to be administered by FDIC: BIF and SAIF, which protect bank and savings deposits, and FRF, which was created to close out the business of the former Federal Savings and Loan Insurance Corporation.

GAO was asked by the Chairwoman of the House Subcommittee on Oversight and Investigations, Committee on Financial Services, to discuss the results of its February 13, 2004, report, *Financial Audit: Federal Deposit Insurance Corporation Funds' 2003 and 2002 Financial Statements* (GAO-04-429).

www.gao.gov/cgi-bin/getrpt?GAO-04-522T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Jeanette Franzel at (202) 512-9471 or franzelj@gao.gov.

What GAO Found

In reporting on the results of the 2003 and 2002 audits, GAO issued unqualified, or "clean," opinions on the three funds administered by the Federal Deposit Insurance Corporation (FDIC)—the Bank Insurance Fund (BIF), the Savings Association Insurance Fund (SAIF), and the FSLIC Resolution Fund (FRF). This means that the funds' financial statements presented fairly, in all material respects, their financial position as of December 31, 2003 and 2002. FDIC also maintained, in all material respects, effective control over financial reporting (including safeguarding of assets) and compliance with laws and regulations. GAO identified one reportable internal control weakness in the area of information system security controls, which although not considered material, is nevertheless considered a significant deficiency in the design or operation of controls.

GAO has reported weaknesses in FDIC's information systems security for a number of years. Although GAO continued to consider information security weaknesses to be a reportable condition for 2003, we also found that FDIC has made significant progress in correcting the computer security weaknesses we previously identified. FDIC took action to address current and prior-year weaknesses, including completing action on all of the 22 weaknesses that remained open from GAO's 2001 audit and 28 of the 29 weaknesses from our 2002 audit. However, GAO's work in 2003 identified 22 additional security weaknesses in FDIC's information systems. FDIC has made substantial progress in more fully implementing a computer security management program. However, it only recently established a program to test and evaluate its computer control environment and this program does not yet include all key areas. A mature, comprehensive, ongoing program of tests and evaluations of control would enable FDIC to better identify and correct information system security problems such as those found in our review.

FDIC has reported that banks and savings institutions it insures have experienced record earnings during 2003. The financial condition of BIF and SAIF are also showing positive trends. The fund balances, or net worth, for both BIF and SAIF increased during fiscal year 2003. And, the current level of estimated losses from probable failures of insured institutions is low relative to the estimated liabilities that FDIC has recorded over the last 10 years.

It is important to remember that GAO's opinions on FDIC's financial statements and its overall positive report on internal controls reflect a point in time. This also holds true for the positive financial trends that FDIC and insured financial institutions are currently experiencing. FDIC must continually monitor its business environment, assess the related risks, and adapt its internal operations as well as its insurance and supervision and monitoring functions to manage risk and maximize the value of its overall mission.

FDIC is taking action to improve its risk monitoring and operations in several areas, including financial risk management, future financial management and information needs, and information technology security and processes.

United States General Accounting Office

Madam Chairwoman and Members of the Subcommittee:

I am pleased to be here today to discuss the results of our audits of the Federal Deposit Insurance Corporation (FDIC) Funds' Financial Statements. We are required by the Federal Deposit Insurance Act[1] to annually audit the financial statements of the Bank Insurance Fund (BIF), the Savings Association Insurance Fund (SAIF), and the FSLIC Resolution Fund (FRF), which are administered by FDIC. Our recent report,[2] issued on February 13, 2004, presents the results of our audits of the funds' 2003 and 2002 financial statements.

Today, I will discuss the results of those audits, including the substantial progress that FDIC has made in the area of information security controls. In addition, I will provide some information on FDIC's financial condition and results and considerations for the future.

Audit Results

In our audits of the 2003 and 2002 financial statements for BIF, SAIF, and FRF, we found:

- the financial statements of each fund are presented fairly in all material respects in conformity with U.S. generally accepted accounting principles,
- although internal controls in the area of information system security should be improved, FDIC had effective internal control over financial reporting (including safeguarding of assets) and compliance with laws and regulations, and
- no reportable noncompliance with the laws and regulations we tested.

We issued unqualified or "clean" opinions on the financial statements for BIF, SAIF, and FRF. This means that the financial statements and accompanying notes for each fund presented fairly, in all material respects, the financial position as of December 31, 2003 and 2002, and the results of operations and cash flows for the years then ended and were in conformity

[1] 12 U.S.C. 1827(d).

[2] *Financial Audit: Federal Deposit Insurance Corporation Funds' 2003 and 2002 Financial Statements*, GAO-04-429 (Washington, D.C.: Feb. 13, 2004).

with U.S. generally accepted accounting principles. In order to reach our conclusions about the financial statements, we (1) tested evidence supporting the amounts and disclosures in the financial statements, (2) assessed the accounting principles used and significant estimates made by management, and (3) evaluated the presentation of the financial statements. We also considered the results of our work in internal control when designing the nature and extent of our audit tests.

Regarding FDIC's internal control, we concluded that FDIC management maintained, in all material respects, effective control over financial reporting (including safeguarding of assets) and compliance as of December 31, 2003. We identified one reportable internal control weakness related to information system security controls, which although not considered material, is nevertheless considered a significant deficiency in the design or operation of controls. We also noted that FDIC made substantial progress during 2003 in this area. I will discuss FDIC's progress and the remaining work that needs to be completed in more detail in a later section of this testimony.

Our evaluation of internal control covered FDIC's financial reporting controls, which are the policies, processes, and management in place to meet the financial reporting objectives of ensuring that transactions are

- properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles and assets are safeguarded against loss from unauthorized acquisition, use, or disposition and

- executed in accordance with laws and regulations that could have a direct and material effect on the financial statements.

In the course of performing our work on internal control, we obtained an understanding of FDIC's internal control, evaluated the design and operating effectiveness of internal control, and tested specific procedures and controls. We also considered FDIC's "control environment" and "tone at the top," which refer to management's commitment to setting and maintaining the organization's ethical tone and a positive and supportive attitude toward internal control and conscientious management.

During the course of our audit, we also tested compliance with selected provisions of laws and regulations that have a direct and material impact on the financial statements. For example, we tested for compliance with

sections of the Federal Deposit Insurance Act that require FDIC to monitor the designated reserve ratio, set semiannual assessments for each fund, and keep full and complete accounting records for all costs and expenses. Our tests for compliance with selected provisions of laws and regulations disclosed no instances of noncompliance.

This year's audit was notable in that it marked the first year that FDIC's audited financial statements were issued within 45 days of year end. FDIC's year end is December 31, and our audit report was issued on February 13, 2004. In contrast to other agencies that are making heroic efforts and using large amounts of resources to meet the accelerated reporting date, FDIC has achieved this milestone through solid financial processes and controls that help to ensure accurate and reliable financial reporting throughout the year, so that the preparation of the financial statements and the related audit can be completed in a short time after year end. We worked cooperatively with FDIC to begin accelerating the financial reporting and audit process in 2002. FDIC's accelerated reporting puts it in sync with the requirements for other federal agencies to issue their audited agency financial statements for fiscal year 2004 within 45 days of year end.[3]

FDIC Has Made Substantial Improvements in Information System Security Controls, but Weaknesses Remain

We have reported weaknesses in FDIC's information system security for a number of years. Although we continued to consider such weaknesses to be a reportable condition for 2003, we also found that FDIC has made substantial progress in correcting the security weaknesses we previously identified. FDIC took action to address current and prior-year weaknesses, including completing action on all of the 22 weaknesses that remained open from our 2001 audit,[4] and 28 of the 29 weaknesses from our 2002 audit.[5] In addition, FDIC has made substantial progress in more fully implementing an information system security management program to address the remaining weaknesses identified in our 2002 audit. Effective information system controls are essential to safeguarding financial data,

[3]Office of Management and Budget Bulletin No.01-09, *Form and Content of Agency Financial Statements* (as amended by Memorandum for Chief Financial Officers and Inspectors General dated December 21, 2001.)

[4]See U.S. General Accounting Office, *FDIC Information Security: Progress Made but Existing Weaknesses Place Data at Risk*, GAO-03-630 (Washington, D.C.: June 18, 2003).

[5]See U.S. General Accounting Office, *FDIC Information Security: Improvements Made but Weaknesses Remain*, GAO-02-689 (Washington, D.C.: July 15, 2002).

protecting computer application programs, providing for the integrity of system software, and ensuring continued operations in case of unexpected interruption.

Our work in 2003 identified 22 additional information security weaknesses in FDIC's information system. Specifically, FDIC had not adequately limited the access granted to all authorized users or completely secured access to its network. The risk created by these access weaknesses was heightened because FDIC had not completed a program to fully monitor access activity to identify and investigate unusual or suspicious access patterns that could indicate unauthorized access. Consequently, critical FDIC financial and sensitive personnel and bank examination information were at risk of unauthorized disclosure, disruption of operations, or loss of assets.

A key reason for FDIC's continuing weaknesses in information system security controls is that it has not yet fully implemented all of the elements of a comprehensive security management program. An effective program includes the following elements:

1. a central security management structure to provide overall security policy, guidance, and oversight;

2. policies and procedures that are based on risk assessments and reduction of risks to ensure that information security is addressed throughout the life cycle of each system and applicable requirements are met;

3. security awareness training to inform all users of information security risks and users' responsibilities in complying with information security policies and procedures;

4. periodic assessment of risk and magnitude of harm that could result from unauthorized access, use, or disruption of information systems; and

5. a program of testing and evaluating the effectiveness of information security policies, procedures, and practices relating to management, operational, and technical controls of every major system.

FDIC has made substantial progress in implementing a comprehensive information system security management program. Specifically, FDIC has (1) strengthened its central security management structure, (2) updated its

security policies and procedures, (3) enhanced security awareness training, and (4) developed and begun to implement a risk assessment program.

The fifth and final key element of an effective information security program is ongoing review, testing, and evaluation of information security to ensure that systems are in compliance with policies and procedures and to identify and correct weaknesses that may occur. FDIC began implementing this program during 2003. In October 2003, FDIC used a contractor to (1) develop a self-assessment process that includes annual general and application control reviews and (2) begin to perform ongoing quarterly tests of FDIC systems. While FDIC has done much to establish an ongoing program of tests and evaluations to review its computer control environment, this program does not yet address all key areas. Specifically, it does not include adequate provisions to ensure that (1) all key computer resources supporting FDIC's financial environment are routinely reviewed and tested, (2) weaknesses detected are analyzed for systemic solutions, (3) corrective actions are independently tested, and (4) newly identified weaknesses or emerging security threats are incorporated into the test and evaluation process. Incorporating these provisions into its test and evaluation process should allow FDIC to better identify and correct security problems, such as those identified in our 2003 audit.

FDIC management has shown a strong commitment to fully establishing a comprehensive security management program that includes a complete review, testing, and evaluation program. Fully establishing such a program should provide FDIC with a solid foundation for resolving computer security problems and managing its information security risks on an ongoing basis.

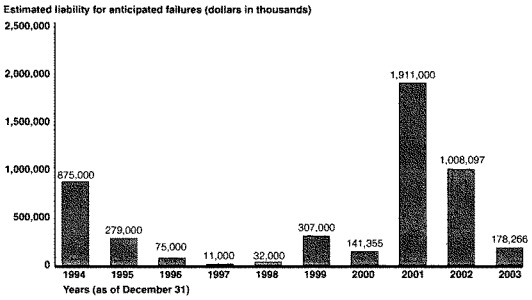
FDIC's Financial Condition and Results

The two deposit insurance funds administered by FDIC—BIF and SAIF—insured 9,182 commercial banks and savings institutions with over $9 trillion in assets and $3.5 trillion in insured deposits as of December 31, 2003. FDIC has reported that the banks and savings institutions it insures experienced record earnings during 2003. FDIC has also identified overall favorable trends in the loss provisions in the industry. However, within those trends, FDIC has noted risk and worsening asset quality in residential mortgage loans and credit cards loans.

During 2003, three BIF-insured institutions with assets of $1.1 billion failed, at an estimated cost of $103 million to the fund. At December 31, 2003, BIF had a recorded liability of $178 million in estimated losses for institutions

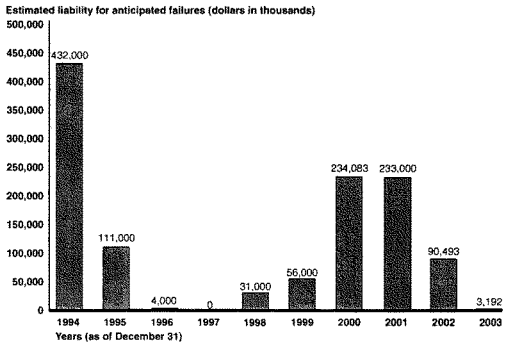
that are likely to fail within one year of the reporting date unless some favorable event occurs, such as obtaining additional capital or merging. As of December 31, 2003, SAIF had a recorded liability of $3.2 million in estimated losses for institutions that are likely to fail within one year. As shown in figures 1 and 2, the current level of estimated recorded liability for failures of insured institutions is relatively low, when compared to the estimated liabilities that FDIC recorded for probable bank failures over the past 10 years.

Figure 1: Bank Insurance Fund Estimated Liability for Anticipated Failures, December 31, 1994 through December 31, 2003



Source: BIF's audited financial statements, December 31, 1994 through December 31, 2003.

Figure 2: Savings Association Insurance Fund Estimated Liability for Anticipated Failures, December 31,1994 through December 31, 2003



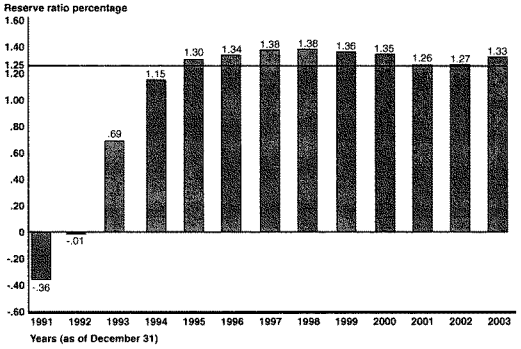
Source: SAIF's audited financial statements, December 31, 1994 through December 31, 2003.

The fund balances for both BIF and SAIF increased during fiscal year 2003. Fund balance represents the difference between assets and liabilities and is a basic measure of the funds' net worth. Fund balance also represents the cumulative net income of the funds, and each year fund balance changes by the amount of comprehensive income earned or losses incurred by the funds. As of December 31, 2003, BIF's fund balance had increased by $1.7 billion to $33.8 billion, and SAIF's fund balance had increased by $493 million to $12.2 billion. For the year ended 2003, BIF and SAIF had comprehensive income of $1.7 billion and $493 million, respectively. During 2003, assessments, interest revenue, and unrealized gains decreased from what was earned during 2002, but those decreases were more than offset in BIF and partially offset in SAIF by a reduction in the estimated losses for future failures.

The Federal Deposit Insurance Corporation Improvement Act of 1991 requires FDIC to maintain the fund balances for BIF and SAIF at a designated reserve ratio of at least 1.25 percent of estimated insured deposits. From lows significantly below 1.25 percent in 1991, the reserve

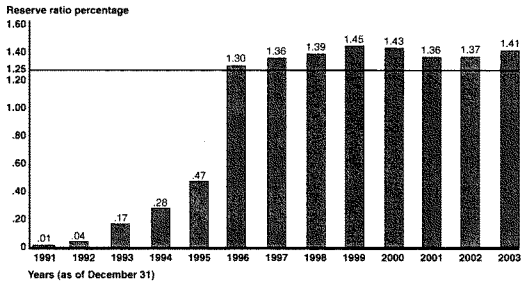
ratios of both BIF and SAIF had risen above that threshold by 1996. They have remained at or above 1.25 percent since 1996 and were at 1.33 percent for BIF and 1.41 percent for SAIF as of December 31, 2003. Figures 3 and 4 show the changes in the reserve ratio for both funds from 1991 through 2003.

Figure 3: Bank Insurance Fund Reserve Ratios from December 31, 1991 through December 31, 2003



Source: GAO calculated the reserve ratio by dividing the fund balance by the estimated insured deposits. Fund balances are from audited BIF financial statements as of December 31, 1991 through December 31, 2003. Estimated insured deposits were provided by FDIC and are unaudited.

Figure 4: Savings Association Insurance Fund Reserve Ratios from December 31, 1991 through December 31, 2003



Source: GAO calculated the reserve ratio by dividing the fund balance by the estimated insured deposits. Fund balances are from audited SAIF financial statements as of December 31, 1991 through December 31, 2003. Estimated insured deposits were provided by FDIC and are unaudited.

FDIC also manages FRF, which fulfills the obligations of the former Federal Savings and Loan Insurance Corporation and the former Resolution Trust Corporation (RTC). As of December 31, 2003, FRF had $3.5 billion in assets remaining. Of that total, $3.3 billion was in the form of cash and cash equivalents, and approximately $200 million represented estimated recoveries from receiverships for failed institutions. In contrast, FRF had $11.6 billion in assets at December 31, 1996, after it assumed the assets and liabilities of RTC. As of December 31, 2003, 52 of the 850 FRF receiverships remained active primarily due to unresolved litigation.

Considerations for the Future

It is important to remember that our opinions on FDIC's financial statements and our overall positive report on internal controls reflect a point in time. This also holds true for the positive financial trends that FDIC and insured financial institutions are currently experiencing. The banking and financial services environment is constantly changing, and in its role as insurer of financial institutions, FDIC must continually monitor its business environment, assess the related risks, and adapt its internal operations as well as its insurance and supervision and monitoring functions to manage risk and maximize the value of its overall mission.

To respond to the need to update and improve its risk monitoring and measurement process, FDIC has ongoing efforts in place to

- review and update its method for estimating the contingent liability for anticipated future failures of financial institutions;
- establish new processes to meet future financial management and financial information needs; and
- improve information technology (IT) processes, including its information system security management program.

During 2003, FDIC hired an outside consulting firm to review its financial risk management practices. The review focused on FDIC's methods and procedures for estimating the liability associated with future failures of financial institutions. FDIC initiated revisions to this methodology in the third quarter of 2003 and is planning additional revisions during 2004. FDIC last changed this methodology in 1997. The current and planned changes primarily relate to the methodology used to estimate potential failure and loss rates of insured financial institutions.

FDIC is also developing new financial systems to enhance its ability to meet future financial management and financial information needs. A related benefit of moving to more modernized systems is the ability to redirect staff resources from processing individual transactions to carrying out value-added accountability functions, such as financial analysis, decision making, and risk management functions. FDIC's current financial system was implemented in 1986, and it currently limits progress within FDIC because it is comprised of many stand-alone applications that need work-around and labor-intensive processes to interface with FDIC's core general ledger system. This current environment necessitates redundant data entry and requires the use of significant staff resources to gather and reconcile data and correct errors.

The constant changes to its operational environment require FDIC to identify opportunities to improve its computerized processes in support of operations while maintaining effective internal control and computer security. FDIC's computerized processes are key to its mission. They are critical to all of FDIC's internal operations and business lines, including insurance, supervision, consumer protection, and receivership management. With the constantly changing IT and business environment in which FDIC operates, it is critical that FDIC maintain sound IT systems,

with adequate internal control and security and applications, to effectively support and carry out its mission.

In summary, the results of our audits for 2003 were positive—clean opinions on the financial statements and overall effective internal control, with significant improvements in the area of information system security controls, which we have been reporting as a significant deficiency for several years. We have seen a strong commitment from FDIC management in promoting excellence in financial reporting and internal control. FDIC is continuing to take important steps to monitor risk, modernize its systems, and adapt to change. FDIC's mission of insuring deposits in our nation's financial institutions is critical to the citizens of this country and our nation's economy. With the banking and financial services environment constantly changing, FDIC must continually monitor its business environment and related risks, and adapt its internal operations as well as its insurance and supervision and monitoring functions to manage risk and maximize the value of its overall mission.

This testimony is based on our most recent audit of the FDIC funds' 2003 financial statements as well as our previous years' audits, which were conducted in accordance with generally accepted government auditing standards.

Madam Chairwoman, that concludes my prepared statement. I would be pleased to answer any questions you or the other members of the Subcommittee may have.

Contacts and Acknowledgments

Should you have any questions about this testimony, please contact me at (202) 512-9471 for financial issues or Robert Dacey at (202) 512-3317 for information technology issues. We can also be reached by e-mail at franzelj@gao.gov and daceyr@gao.gov. Other major contributors to this testimony were Ronald Bergman, Gary Chupka, Julia Duquette, Maxine Hattery, Dave Irvin, Meg Mills, Tim Murray, Ed Tanaka, and Charles Vrabel.

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United States General Accounting Office

GAO

Report to the Congress

February 2004

FINANCIAL AUDIT

Federal Deposit Insurance Corporation Funds' 2003 and 2002 Financial Statements

GAO-04-429

February 2004

GAO
Accountability · Integrity · Reliability

Highlights

Highlights of GAO-04-429, a report to the President of the Senate and the Speaker of the House of Representatives

FINANCIAL AUDIT

Federal Deposit Insurance Corporation Funds' 2003 and 2002 Financial Statements

Why GAO Did This Study

GAO is required to annually audit the financial statements of the Bank Insurance Fund (BIF), Savings Association Insurance Fund (SAIF), and FSLIC Resolution Fund (FRF), which are administered by the Federal Deposit Insurance Corporation (FDIC). GAO is responsible for obtaining reasonable assurance about whether FDIC's financial statements for BIF, SAIF, and FRF, are presented fairly in all material respects, in conformity with U.S. generally accepted accounting principles, whether it maintains effective internal controls, and whether FDIC has complied with selected laws and regulations.

Created in 1933 to insure bank deposits and promote sound banking practices, FDIC plays an important role in maintaining public confidence in the nation's financial system. In 1989, legislation to reform the federal deposit insurance system created three funds to be administered by FDIC: BIF and SAIF, which protect bank and savings deposits, and FRF, which was created to close out the business of the former Federal Savings and Loan Insurance Corporation.

What GAO Recommends

Because of the sensitive nature of the weaknesses in control over information systems, GAO will separately report the details, along with recommendations for corrective actions to FDIC management.

www.gao.gov/cgi-bin/getrpt?GAO-04-429.

To view the full report, including the scope and methodology, click on the link above. For more information, contact Jeanette M. Franzel at (202) 512-9406 or franzelj@gao.gov.

What GAO Found

In GAO's opinion, FDIC fairly presented the 2003 and 2002 financial statements for the three funds it administers—the Bank Insurance Fund, the Savings Association Insurance Fund, and the FSLIC Resolution Fund. GAO also found that, although certain controls should be improved, FDIC had effective control over financial reporting and compliance. GAO did not find reportable instances of noncompliance with the laws and regulations it tested.

Although FDIC made substantial progress during the past year it has not yet fully implemented a comprehensive corporatewide security management program. FDIC only recently established a program to test and evaluate its computer control environment and the program did not adequately address all key areas. GAO continued to identify information system control weaknesses that increased the risk of unauthorized disclosure of critical FDIC financial and sensitive personnel and bank information, disruption of critical operations, and loss of assets. A mature comprehensive ongoing program of tests and evaluations of controls would enable FDIC to better identify and correct security problems, such as those found in our review.

Source: GAO

As of September 30, 2003, FDIC insured deposits totaling over $3.4 trillion.

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Abbreviations

BIF	Bank Insurance Fund
CFO	Chief Financial Officer
FDIC	Federal Deposit Insurance Corporation
FMFIA	Federal Managers' Financial Integrity Act of 1982
FRF	FSLIC Resolution Fund
FSLIC	Federal Savings and Loan Insurance Corporation
SAIF	Savings Association Insurance Fund

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Comptroller General of the United States

United States General Accounting Office
Washington, D.C. 20548

February 13, 2004

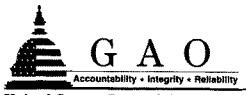
The President of the Senate
The Speaker of the House of Representatives

This report presents our opinions on whether the financial statements of the Bank Insurance Fund (BIF), the Savings Association Insurance Fund (SAIF), and the FSLIC Resolution Fund (FRF) are presented fairly for the years ended December 31, 2003 and 2002. These financial statements are the responsibility of the Federal Deposit Insurance Corporation (FDIC), the administrator of the three funds. This report also presents (1) our opinion on the effectiveness of FDIC's internal control as of December 31, 2003, (2) our evaluation of FDIC's compliance with selected laws and regulations during 2003, and (3) weaknesses in information system controls detected during our 2003 audits.

The provisions of section 17(d) of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1827(d)), requires GAO to conduct an annual audit of BIF, SAIF, and FRF in accordance with U.S. generally accepted government auditing standards.

We are sending copies of this report to the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing and Urban Affairs; the Chairman and Ranking Minority Member of the House Committee on Financial Services; the Chairman of the Board of Directors of the Federal Deposit Insurance Corporation; the Chairman of the Board of Governors of the Federal Reserve System; the Comptroller of the Currency; the Director of the Office of Thrift Supervision; the Secretary of the Treasury; the Director of the Office of Management and Budget; and other interested parties. In addition, this report will be available at no charge on GAO's Web Site at http://www.gao.gov.

David M. Walker
Comptroller General
of the United States



United States General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

To the Board of Directors
The Federal Deposit Insurance Corporation

We have audited the balance sheets as of December 31, 2003 and 2002, for the three funds administered by the Federal Deposit Insurance Corporation (FDIC), the related statements of income and fund balance (accumulated deficit), and the statements of cash flows for the years then ended. In our audits of the Bank Insurance Fund (BIF), the Savings Association Insurance Fund (SAIF), and the FSLIC Resolution Fund (FRF), we found

- the financial statements of each fund are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles;
- although certain internal controls should be improved, FDIC had effective internal control over financial reporting (including safeguarding of assets) and compliance with laws and regulations; and
- no reportable noncompliance with the laws and regulations that we tested.

The following sections discuss our conclusions in more detail. They also present information on (1) the scope of our audits, (2) a reportable condition[1] related to information system control weaknesses, and (3) our evaluation of FDIC management's comments on a draft of this report.

Opinion on BIF's Financial Statements

The financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, BIF's financial position as of December 31, 2003 and 2002, and the results of its operations and its cash flows for the years then ended.

[1]Reportable conditions involve matters coming to the auditor's attention that in the auditor's judgment, should be communicated because they represent significant deficiencies in the design or operation of internal control and could adversely affect FDIC's ability to meet the control objectives described in this report.

Opinion on SAIF's Financial Statements

The financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, SAIF's financial position as of December 31, 2003 and 2002, and the results of its operations and its cash flows for the years then ended.

Opinion on FRF's Financial Statements

The financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, FRF's financial position as of December 31, 2003 and 2002, and the results of its operations and its cash flows for the years then ended.

Opinion on Internal Control

Although certain internal controls should be improved, FDIC management maintained, in all material respects, effective internal control over financial reporting (including safeguarding assets) and compliance as of December 31, 2003, that provided reasonable but not absolute assurance that misstatements, losses, or noncompliance material in relation to FDIC's financial statements would be prevented or detected on a timely basis. Our opinion is based on criteria established under 31 U.S.C. 3512 (c), (d) [Federal Managers' Financial Integrity Act (FMFIA)].

Our work identified weaknesses in FDIC's information system controls, which we describe as a reportable condition in a later section of this report. The reportable condition in information system controls, although not considered material, represents a significant deficiency in the design or operation of internal control that could adversely affect FDIC's ability to meet its internal control objectives. Although the weaknesses did not materially affect the 2003 financial statements, misstatements may nevertheless occur in other FDIC-reported financial information as a result of the internal control weaknesses.

Compliance with Laws and Regulations

Our tests for compliance with selected provisions of laws and regulations disclosed no instances of noncompliance that would be reportable under U.S. generally accepted government auditing standards. However, the objective of our audits was not to provide an opinion on overall compliance with selected laws and regulations. Accordingly, we do not express such an opinion.

Objectives, Scope, and Methodology

FDIC management is responsible for (1) preparing the annual financial statements in conformity with U.S. generally accepted accounting principles; (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of FMFIA are met; and (3) complying with selected laws and regulations.

We are responsible for obtaining reasonable assurance about whether (1) the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, and (2) management maintained effective internal control, the objectives of which are

- financial reporting—transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition, and

- compliance with laws and regulations—transactions are executed in accordance with laws and regulations that could have a direct and material effect on the financial statements.

We are also responsible for testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements.

In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;

- assessed the accounting principles used and significant estimates made by management;

- evaluated the overall presentation of the financial statements;

- obtained an understanding of internal control related to financial reporting (including safeguarding assets) and compliance with laws and regulations;

- tested relevant internal controls over financial reporting and compliance, and evaluated the design and operating effectiveness of internal control;
- considered FDIC's process for evaluating and reporting on internal control based on criteria established by FMFIA; and
- tested compliance with selected provisions of the Federal Deposit Insurance Act, as amended, and the Chief Financial Officers Act of 1990.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to controls over financial reporting and compliance. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected. We also caution that projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate.

We did not test compliance with all laws and regulations applicable to FDIC. We limited our tests of compliance to those deemed applicable to the financial statements for the year ended December 31, 2003. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

We performed our work in accordance with U.S. generally accepted government auditing standards.

FDIC management provided comments on a draft of this report. They are discussed and evaluated in a later section of this report and are reprinted in appendix I.

Reportable Condition

In connection with the funds' financial statement audits, we reviewed FDIC's information system controls. Effective information system controls are essential to safeguarding financial data, protecting computer application programs, providing for the integrity of system software, and ensuring continued computer operations in case of unexpected interruption. These controls include the corporatewide security management program, access controls, system software, application

development and change control, segregation of duties, and service continuity controls.

Although FDIC made substantial progress during the past year it has not yet fully implemented a comprehensive corporatewide security management program. An effective program includes establishing a central security function, assessing risk, establishing policies, raising user security awareness of prevailing risks, and routinely testing and evaluating the effectiveness of established controls. While FDIC has done much to establish a computer security management program, FDIC only recently established a program to test and evaluate its computer control environment, and the program did not adequately address all key areas. For example, the program did not include adequate provisions to ensure that (1) all key computer resources supporting FDIC's financial environment are routinely reviewed and tested as appropriate, (2) weaknesses detected are analyzed for systemic solutions, (3) corrective actions are independently tested, or (4) newly identified weaknesses or emerging security threats are incorporated into the test and evaluation process. A mature comprehensive ongoing program of tests and evaluations of controls would enable FDIC to better identify and correct security problems, such as those found in our review.

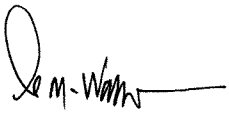
In our current review, we continued to identify information system control weaknesses that increased the risk of unauthorized disclosure of critical FDIC financial and sensitive personnel and bank information, disruption of critical operations, and loss of assets. Such weaknesses affected FDIC's ability to adequately ensure that users only had the access needed to perform their assigned duties and its network was sufficiently protected from unauthorized users. The risk created by these weaknesses are compounded because FDIC does not have a comprehensive monitoring program to identify unusual or suspicious access activities.

We determined that other management controls mitigated the effect of the information system control weaknesses on the preparation of the funds' financial statements. Because of their sensitive nature, the details surrounding these weaknesses are being reported separately to FDIC management, along with recommendations for corrective actions.

FDIC Comments and Our Evaluation

In commenting on a draft of this report, FDIC's Chief Financial Officer (CFO) was pleased to receive unqualified opinions on BIF's, SAIF's, and FRF's 2003 and 2002 financial statements. FDIC's CFO also acknowledged

both the current status as well as the substantial progress made during 2003 on the information system weaknesses we identified. FDIC said it would continue efforts to strengthen its ongoing information security program during 2004.



David M. Walker
Comptroller General
of the United States

January 30, 2004

Bank Insurance Fund's Financial Statements

Balance Sheets

Bank Insurance Fund

Federal Deposit Insurance Corporation

Bank Insurance Fund Balance Sheets at December 31

Dollars in Thousands

	2003	2002
Assets		
Cash and cash equivalents	$ 2,544,281	$ 4,606,896
Investment in U.S. Treasury obligations, net: (Note 3)		
Held-to-maturity securities	16,293,073	16,709,665
Available-for-sale securities	14,209,773	10,823,593
Interest receivable on investments and other assets, net	550,999	483,674
Receivables from bank resolutions, net (Note 4)	511,089	505,395
Property and equipment, net (Note 5)	287,380	303,084
Total Assets	**$ 34,396,595**	**$ 33,432,307**
Liabilities		
Accounts payable and other liabilities	$ 231,441	$ 148,573
Contingent liabilities for: (Note 6)		
Anticipated failure of insured institutions	178,266	1,008,097
Litigation losses and other	204,693	225,297
Total Liabilities	**614,400**	**1,381,967**
Commitments and off-balance-sheet exposure (Note 11)		
Fund Balance		
Accumulated net income	32,979,898	31,238,171
Unrealized gain on available-for-sale securities, net (Note 3)	802,297	812,169
Total Fund Balance	**33,782,195**	**32,050,340**
Total Liabilities and Fund Balance	**$ 34,396,595**	**$ 33,432,307**

The accompanying notes are an integral part of these financial statements.

Statements of Income and Fund Balance

Bank Insurance Fund

Federal Deposit Insurance Corporation

Bank Insurance Fund Statements of Income and Fund Balance for the Years Ended December 31

Dollars in Thousands

	2003	2002
Revenue		
Interest on U.S. Treasury obligations	$ 1,530,014	$ 1,692,381
Assessments (Note 7)	80,159	84,030
Other revenue	15,831	19,474
Total Revenue	**1,626,004**	**1,795,885**
Expenses and Losses		
Operating expenses (Note 8)	805,496	821,136
Provision for insurance losses (Note 9)	(928,468)	(86,970)
Insurance and other expenses	7,249	16,451
Total Expenses and Losses	**(115,723)**	**750,617**
Net Income	**1,741,727**	**1,045,268**
Unrealized (loss)/gain on available-for-sale securities, net	(9,872)	566,247
Comprehensive Income	**1,731,855**	**1,611,515**
Fund Balance - Beginning	**32,050,340**	**30,438,825**
Fund Balance - Ending	**$ 33,782,195**	**$ 32,050,340**

The accompanying notes are an integral part of these financial statements.

Statements of Cash Flows

Bank Insurance Fund

Federal Deposit Insurance Corporation

Bank Insurance Fund Statements of Cash Flows for the Years Ended December 31

Dollars in Thousands

	2003	2002
Operating Activities		
Provided by:		
Interest on U.S. Treasury obligations	$ 1,794,002	$ 1,858,852
Recoveries from bank resolutions	1,034,311	1,116,406
Assessments	80,496	81,971
Miscellaneous receipts	112,263	22,607
Used by:		
Operating expenses	(753,617)	(742,270)
Disbursements for bank resolutions	(935,602)	(2,168,187)
Miscellaneous disbursements	(31,861)	(38,311)
Net Cash Provided by Operating Activities (Note 13)	**1,299,992**	**131,068**
Investing Activities		
Provided by:		
Maturity of U.S. Treasury obligations, held-to-maturity	3,890,000	3,625,000
Maturity of U.S. Treasury obligations, available-for-sale	1,690,000	1,150,000
Used by:		
Purchase of property and equipment	(42,669)	(49,647)
Purchase of U.S. Treasury obligations, held-to-maturity	(3,659,868)	0
Purchase of U.S. Treasury obligations, available-for-sale	(5,240,070)	(1,686,138)
Net Cash (Used by) Provided by Investing Activities	**(3,362,607)**	**3,039,215**
Net (Decrease)/Increase in Cash and Cash Equivalents	**(2,062,615)**	**3,170,283**
Cash and Cash Equivalents - Beginning	**4,606,896**	**1,436,613**
Cash and Cash Equivalents - Ending	**$ 2,544,281**	**$ 4,606,896**

The accompanying notes are an integral part of these financial statements.

Notes to the Financial Statements

Notes to the Financial Statements
Bank Insurance Fund
December 31, 2003 and 2002

1. Operations of the Bank Insurance Fund

Overview
The Federal Deposit Insurance Corporation (FDIC) is the independent deposit insurance agency created by Congress in 1933 to maintain stability and public confidence in the nation's banking system. Provisions that govern the operations of the FDIC are generally found in the Federal Deposit Insurance (FDI) Act, as amended, (12 U.S.C. 1811, *et seq*). In carrying out the purposes of the FDI Act, as amended, the FDIC insures the deposits of banks and savings associations, and in cooperation with other federal and state agencies promotes the safety and soundness of insured depository institutions by identifying, monitoring and addressing risks to the deposit insurance funds established in the FDI Act, as amended. The FDIC is the administrator of the Bank Insurance Fund (BIF), the Savings Association Insurance Fund (SAIF), and the FSLIC Resolution Fund (FRF), which are maintained separately to carry out their respective mandates. The BIF and the SAIF are insurance funds responsible for protecting insured bank and thrift depositors from loss due to institution failures. These insurance funds must be maintained at not less than 1.25 percent of estimated insured deposits or a higher percentage as circumstances warrant. The FRF is a resolution fund responsible for the sale of remaining assets and satisfaction of liabilities associated with the former Federal Savings and Loan Insurance Corporation (FSLIC) and the Resolution Trust Corporation.

An active institution's insurance fund membership and primary federal supervisor are generally determined by the institution's charter type. Deposits of BIF-member institutions are generally insured by the BIF; BIF members are predominantly commercial and savings banks supervised by the FDIC, the Office of the Comptroller of the Currency, or the Federal Reserve Board. Deposits of SAIF-member institutions are generally insured by the SAIF; SAIF members are predominantly thrifts supervised by the Office of Thrift Supervision.

In addition to traditional banks and thrifts, several other categories of institutions exist. A member of one insurance fund may, with the approval of its primary federal supervisor, merge, consolidate with, or acquire the deposit liabilities of an institution that is a member of the other insurance fund without changing insurance fund status for the acquired deposits. These institutions with deposits insured by both insurance funds are referred to as Oakar financial institutions. In addition, SAIF-member thrifts can convert to a bank charter and retain their SAIF membership. These institutions are referred to as Sasser financial institutions. Likewise, BIF-member banks can convert to a thrift charter and retain their BIF membership.

Operations of the BIF
The primary purpose of the BIF is to: 1) insure the deposits and protect the depositors of BIF-insured institutions and 2) resolve BIF-insured failed institutions upon appointment of FDIC as receiver in a manner that will result in the least possible cost to the BIF. In addition, the FDIC, acting on behalf of the BIF, examines state-chartered banks that are not members of the Federal Reserve System.

The BIF is primarily funded from: 1) interest earned on investments in U.S. Treasury obligations and 2) deposit insurance assessments. Additional funding sources are U.S. Treasury and Federal Financing Bank (FFB) borrowings, if necessary. The FDIC has borrowing authority from the U.S. Treasury up to $30 billion for insurance purposes on behalf of the BIF and the SAIF.

A statutory formula, known as the Maximum Obligation Limitation (MOL), limits the amount of obligations the BIF can incur to the sum of its cash, 90% of the fair market value of other assets, and the amount authorized to be borrowed from the U.S. Treasury. The MOL for the BIF was $57.0 billion and $56.7 billion as of December 31, 2003 and 2002, respectively.

Receivership Operations
The FDIC is responsible for managing and disposing of the assets of failed institutions in an orderly and efficient manner. The assets held by receivership entities, and the claims against them, are accounted for separately from BIF assets and liabilities to ensure that receivership proceeds are distributed in accordance with applicable laws and regulations. Also, the income and expenses attributable to receiverships are accounted for as transactions of those receiverships. Receiverships are billed by the FDIC for services provided on their behalf.

Recent Legislative Initiatives
In April 2001, FDIC issued recommendations for deposit insurance reform. The FDIC recommendations included merging BIF and SAIF and improving FDIC's ability to manage the merged fund by permitting the FDIC Board of Directors to price insurance premiums properly to reflect risk, to set the reserve ratio in a *range* around 1.25 percent, establish a system for providing credits, rebates and surcharges, and to eliminate the SAIF exit fee reserve. FDIC also recommended that Congress consider indexing deposit insurance coverage for inflation. During the 107th Congress (2001-2002), hearings were held in the House and Senate and legislation was introduced containing major elements of FDIC's deposit insurance reform proposals. The legislation was not enacted prior to congressional adjournment. During the 108th Congress (2003 - 2004), the House and Senate are again considering deposit insurance reform legislation. If Congress enacts deposit insurance reform legislation that contains the above recommendations, the new law would have a significant impact on the BIF and SAIF. FDIC management, however, cannot predict which provisions, if any, will ultimately be enacted.

2. Summary of Significant Accounting Policies

General
These financial statements pertain to the financial position, results of operations, and cash flows of the BIF and are presented in conformity with U.S. generally accepted accounting principles (GAAP). These statements do not include reporting for assets and liabilities of closed banks for which the FDIC acts as receiver. Periodic and final accountability reports of the FDIC's activities as receiver are furnished to courts, supervisory authorities, and others as required.

Use of Estimates
Management makes estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates. Where it is reasonably possible that changes in estimates will cause a material change in the financial statements in the near term, the nature and extent of such changes in estimates have been disclosed. The more significant estimates include allowance for loss on receivables from bank resolutions, the estimated losses for anticipated failures and litigation, and the postretirement benefit obligation.

Cash Equivalents
Cash equivalents are short-term, highly liquid investments with original maturities of three months or less. Cash equivalents consist primarily of Special U.S. Treasury Certificates.

Investment in U.S. Treasury Obligations
BIF funds are required to be invested in obligations of the United States or in obligations guaranteed as to principal and interest by the United States; the Secretary of the U.S. Treasury must approve all such investments in excess of $100,000. The Secretary has granted approval to invest BIF funds only in U.S. Treasury obligations that are purchased or sold exclusively through the Bureau of the Public Debt's Government Account Series (GAS) program.

BIF's investments in U.S. Treasury obligations are either classified as held-to-maturity or available-for-sale. Securities designated as held-to-maturity are shown at amortized cost. Amortized cost is the face value of securities plus the unamortized premium or less the unamortized discount. Amortizations are computed on a daily basis from the date of acquisition to the date of maturity, except for callable U.S. Treasury securities, which are amortized to the first anticipated call date. Securities designated as available-for-sale are shown at market value, which approximates fair value. Unrealized gains and losses are included in Comprehensive Income. Realized gains and losses are included in the Statements of Income and Fund Balance as components of Net Income. Interest on both types of securities is calculated on a daily basis and recorded monthly using the effective interest method.

Cost Allocations Among Funds
Operating expenses not directly charged to the BIF, the SAIF, and the FRF are allocated to all funds using workload-based allocation percentages. These percentages are developed during the annual corporate planning process and through supplemental functional analyses.

Capital Assets and Depreciation
The FDIC has designated the BIF as administrator of property and equipment used in its operations. Consequently, the BIF includes the cost of these assets in its financial statements and provides the necessary funding for them. The BIF charges the other funds usage fees representing an allocated share of its annual depreciation expense. These usage fees are recorded as cost recoveries, which reduce operating expenses.

The FDIC buildings are depreciated on a straight-line basis over a 35 to 50 year estimated life. Leasehold improvements are capitalized and depreciated over the lesser of the remaining life of the lease or the estimated useful life of the improvements, if determined to be material. Capital assets depreciated on a straight-line basis over a five-year estimated life include mainframe equipment; furniture, fixtures, and general equipment; and internal-use software. Personal computer equipment is depreciated on a straight-line basis over a three-year estimated life.

Related Parties
The nature of related parties and a description of related party transactions are discussed in Note 1 and disclosed throughout the financial statements and footnotes.

Reclassifications
Reclassifications have been made in the 2002 financial statements to conform to the presentation used in 2003.

3. Investment in U.S. Treasury Obligations, Net

As of December 31, 2003 and 2002, the book value of investments in U.S. Treasury obligations, net, was $30.5 billion and $27.5 billion, respectively. As of December 31, 2003, the BIF held $6.4 billion of Treasury inflation-indexed securities (TIIS). These securities are indexed to increases or decreases in the Consumer Price Index for All Urban Consumers (CPI-U). Additionally, the BIF held $6.8 billion of callable U.S. Treasury bonds at December 31, 2003. Callable U.S. Treasury bonds may be called five years prior to the respective bonds' stated maturity on their semi-annual coupon payment dates upon 120 days notice.

U.S. Treasury Obligations at December 31, 2003

Dollars in Thousands

Maturity (a)	Yield at Purchase (b)	Face Value	Net Carrying Amount	Unrealized Holding Gains	Unrealized Holding Losses (c)	Market Value
Held-to-Maturity						
Within 1 year	5.05%	$ 3,365,000	$ 3,449,985	$ 65,110	$ (275)	$ 3,514,820
After 1 year through 5 years	5.66%	9,985,000	10,284,862	830,414	0	11,075,276
After 5 years through 10 years	5.42%	1,910,000	1,936,450	191,954	0	2,168,404
Treasury Inflation-Indexed						
After 5 years through 10 years	3.82%	620,450	621,776	78,947	0	700,723
Total		$ 15,880,450	$ 16,293,073	$ 1,166,425	$ (275)	$ 17,459,223
Available-for-Sale						
Within 1 year	2.31%	$ 5,810,000	$ 6,050,064	$ 32,642	$ (230)	$ 6,082,476
After 1 year through 5 years	4.88%	1,995,000	2,229,143	114,071	0	2,343,214
Treasury Inflation-Indexed						
After 1 year through 5 years	3.88%	1,225,321	1,215,319	139,813	0	1,355,132
After 5 years through 10 years	3.75%	3,887,611	3,912,950	516,001	0	4,428,951
Total		$ 12,917,932	$ 13,407,476	$ 802,527	$ (230)	$ 14,209,773
Total Investment in U.S. Treasury Obligations, Net						
Total		**$ 28,798,382**	**$ 29,700,549**	**$ 1,968,952**	**$ (505)**	**$ 31,668,996**

(a) For purposes of this table, all callable securities are assumed to mature on their first call dates. Their yields at purchase are reported as their yield to first call date.

(b) For TIIS, the yields in the above table are stated at their real yields at purchase, not their effective yields. Effective yields on TIIS include a long-term annual inflation assumption as measured by the CPI-U. The long-term CPI-U consensus forecast is 2.4%, based on figures issued by the Office of Management and Budget and the Congressional Budget Office in early 2003.

(c) All unrealized losses occurred during the last 12 months as a result of changes in market interest rates. FDIC has the ability and intent to hold the related securities until maturity within the coming year. As a result, all losses are considered temporary and will be eliminated upon redemption of the securities.

U.S. Treasury Obligations at December 31, 2002

Dollars in Thousands

Maturity (a)	Yield at Purchase (b)	Face Value	Net Carrying Amount	Unrealized Holding Gains	Market Value
Held-to-Maturity					
Within 1 year	5.98%	$ 2,690,000	$ 2,737,188	$ 63,325	$ 2,800,513
After 1 year through 5 years	6.24%	10,265,000	10,404,894	1,166,295	11,571,189
After 5 years through 10 years	5.39%	2,895,000	2,961,035	376,281	3,337,316
Treasury Inflation-Indexed					
After 5 years through 10 years	3.82%	607,987	609,548	68,169	677,717
Total		$ 16,457,987	$ 16,709,665	$ 1,673,070	$ 18,380,735
Available-for-Sale					
Within 1 year	5.31%	$ 1,390,000	$ 1,389,723	$ 27,614	$ 1,417,337
After 1 year through 5 years	4.91%	3,355,000	3,595,734	235,538	3,831,272
Treasury Inflation-Indexed					
After 5 years through 10 years	3.78%	5,010,245	5,025,967	549,017	5,574,984
Total		$ 9,755,245	$ 10,011,424	$ 812,169	$ 10,823,593
Total Investment in U.S. Treasury Obligations, Net					
Total		**$ 26,213,232**	**$ 26,721,089**	**$ 2,483,239**	**$ 29,204,328**

(a) For purposes of this table, all callable securities are assumed to mature on their first call dates. Their yields at purchase are reported as their yield to first call date.

(b) For TIIS, the yields in the above table are stated at their real yields at purchase, not their effective yields. Effective yields on TIIS include a long-term annual inflation assumption as measured by the CPI-U. The long-term CPI-U consensus forecast is 2.4%, based on figures issued by the Office of Management and Budget and the Congressional Budget Office in early 2002.

As of December 31, 2003 and 2002, the unamortized premium, net of the unamortized discount, was $902 million and $508 million, respectively.

4. Receivables From Bank Resolutions, Net

The receivables from bank resolutions include payments made by the BIF to cover obligations to insured depositors, advances to receiverships for working capital, and administrative expenses paid on behalf of receiverships. Any related allowance for loss represents the difference between the funds advanced and/or obligations incurred and the expected repayment. Assets held by BIF receiverships are the main source of repayment of the BIF's receivables from closed banks. As of December 31, 2003, there were 31 active receiverships, including three failures in the current year, with assets at failure of $1.1 billion and BIF outlays of $889 million.

As of December 31, 2003 and 2002, BIF receiverships held assets with a book value of $756 million and $1.1 billion, respectively (including cash, investments, and miscellaneous receivables of $436 million and $479 million at December 31, 2003 and 2002, respectively). The estimated cash recoveries from the management and disposition of these assets that are used to derive the allowance for losses are based on a sampling of receivership assets. The sampled assets are generally valued by estimating future cash recoveries, net of applicable liquidation cost estimates, and then discounting these net cash recoveries using current market-based risk factors

based on a given asset's type and quality. Resultant recovery estimates are extrapolated to the non-sampled assets in order to derive the allowance for loss on the receivable. These estimated recoveries are regularly evaluated, but remain subject to uncertainties because of potential changes in economic and market conditions. Such uncertainties could cause the BIF's actual recoveries to vary from the level currently estimated.

Receivables From Bank Resolutions, Net at December 31

Dollars in Thousands

	2003	2002
Receivables from closed banks	$ 4,914,901	$ 6,055,613
Allowance for losses	(4,403,812)	(5,550,218)
Total	**$ 511,089**	**$ 505,395**

As of December 31, 2003, an allowance for loss of $4.4 billion, or 90% of the gross receivable, was recorded. Of the remaining 10% of the gross receivable, the amount of credit risk is limited since over three-fourths of the receivable will be repaid from receivership cash and investments.

5. Property and Equipment, Net

Property and Equipment, Net at December 31

Dollars in Thousands

	2003	2002
Land	$ 37,352	$ 37,352
Buildings (includes construction-in-process)	180,187	171,362
Application software (includes work-in-process)	177,111	155,196
Furniture, fixtures, and equipment	97,682	98,497
Accumulated depreciation	(204,952)	(159,323)
Total	**$ 287,380**	**$ 303,084**

The depreciation expense was $55 million and $47 million for 2003 and 2002, respectively.

6. Contingent Liabilities for:

Anticipated Failure of Insured Institutions

The BIF records a contingent liability and a loss provision for banks (including Oakar and Sasser financial institutions) that are likely to fail within one year of the reporting date, absent some favorable event such as obtaining additional capital or merging, when the liability becomes probable and reasonably estimable.

The contingent liability is derived by applying expected failure rates and historical loss rates to groups of institutions with certain shared characteristics. In addition, institution-specific analysis is performed on those banks where failure is imminent absent institution management resolution of existing problems. As of December 31, 2003 and 2002, the contingent liabilities for anticipated failure of insured institutions were $178 million and $1.0 billion, respectively.

In addition to these recorded contingent liabilities, the FDIC has identified additional risk in the financial services industry that could result in a material loss to the BIF should potentially vulnerable financial institutions ultimately fail. This risk is evidenced by the level of problem bank assets and the presence of various high-risk banking business models that are particularly vulnerable to adverse economic and market conditions. Due to the uncertainty surrounding future economic and market conditions, there are other banks for which the risk of failure is less certain, but still considered reasonably possible. As a result of these risks, the FDIC believes that it is reasonably possible that the BIF could incur additional estimated losses up to $2.2 billion.

The accuracy of these estimates will largely depend on future economic and market conditions. The FDIC's Board of Directors has the statutory authority to consider the contingent liability from anticipated failures of insured institutions when setting assessment rates.

Litigation Losses
The BIF records an estimated loss for unresolved legal cases to the extent that those losses are considered probable and reasonably estimable. In addition to the amount recorded as probable, the FDIC has determined that losses from unresolved legal cases totaling $111.3 million are reasonably possible.

Other Contingencies

Representations and Warranties
As part of the FDIC's efforts to maximize the return from the sale of assets from bank resolutions, representations and warranties, and guarantees are offered on certain loan sales. In general, the guarantees, representations, and warranties on loans sold relate to the completeness and accuracy of loan documentation, the quality of the underwriting standards used, the accuracy of the delinquency status when sold, and the conformity of the loans with characteristics of the pool in which they were sold. The total amount of loans sold subject to unexpired representations and warranties, and guarantees was $7.4 billion as of December 31, 2003. The contingent liability from all outstanding claims asserted in connection with representations and warranties was zero and $11.6 million at December 31, 2003 and 2002, respectively.

In addition, future losses on representations and warranties, and guarantees could be incurred over the remaining life of the loans sold, which is generally 20 years or more. Consequently, the FDIC believes it is possible that additional losses may be incurred by the BIF from the universe of outstanding contracts with unasserted representation and warranty claims. However, because of the uncertainties surrounding the timing of when claims may be asserted, the FDIC is unable to reasonably estimate a range of loss to the BIF from outstanding contracts with unasserted representation and warranty claims.

7. Assessments

In compliance with provisions of the FDI Act, as amended, the FDIC uses a risk-based assessment system that charges higher rates to those institutions that pose greater risks to the BIF. To arrive at a risk-based assessment for a particular institution, the FDIC places each institution in one of nine risk categories based on capital ratios and supervisory examination

data. The majority of the financial institutions are not assessed. Of those assessed, the assessment rate averaged approximately 20 cents and 22 cents per $100 of assessable deposits for 2003 and 2002, respectively. During 2003 and 2002, $80 million and $84 million were collected from BIF-member institutions, respectively. On November 4, 2003, the Board voted to retain the BIF assessment schedule at the annual rate of 0 to 27 cents per $100 of assessable deposits for the first semiannual period of 2004. The Board reviews assessment rates semiannually to ensure that funds are available to satisfy the BIF's obligations. If necessary, the Board may impose more frequent rate adjustments or emergency special assessments.

The FDIC is required to maintain the insurance funds at a designated reserve ratio (DRR) of not less than 1.25 percent of estimated insured deposits (or a higher percentage as circumstances warrant). If the reserve ratio falls below the DRR, the FDIC is required to set semiannual assessment rates that are sufficient to increase the reserve ratio to the DRR not later than one year after such rates are set, or in accordance with a recapitalization schedule of fifteen years or less. As of September 30, 2003, the BIF reserve ratio was 1.31 percent of estimated insured deposits.

Assessments are also levied on institutions for payments of the interest on obligations issued by the Financing Corporation (FICO). The FICO was established as a mixed-ownership government corporation to function solely as a financing vehicle for the FSLIC. The annual FICO interest obligation of approximately $790 million is paid on a pro rata basis using the same rate for banks and thrifts. The FICO assessment has no financial impact on the BIF and is separate from the regular assessments. The FDIC, as administrator of the BIF and the SAIF, acts solely as a collection agent for the FICO. During 2003 and 2002, $627 million and $621 million, respectively, were collected from BIF-member institutions and remitted to the FICO.

8. Operating Expenses

Operating expenses were $805 million for 2003, compared to $821 million for 2002. The decrease of $16 million is primarily attributable to lower salary/benefit expenses resulting from the workforce reduction programs in 2002.

During 2002, the FDIC offered voluntary employee buyout incentives to a majority of its employees and conducted a reduction-in-force (RIF) in 2002 and 2003 in an effort to reduce identified staffing excesses and skill imbalances. As a result, approximately 750 employees left by December 31, 2003. Termination benefits included compensation of fifty percent of the employee's current base salary and locality adjustment for voluntary departures. The total cost of this buyout was $33.1 million for 2002, with BIF's pro rata share totaling $28.9 million, which is included in the "Salaries and benefits" category in the chart below, as well as the "Separation Incentive Payment" line item in Note 10. Through 2003, BIF paid $20.8 million of this compensation benefit and the remaining unpaid amount is recorded as a liability in the "Accounts payable and other liabilities" line item.

Bank Insurance Fund

Operating Expenses for the Years Ended December 31

Dollars in Thousands

	2003	2002
Salaries and benefits	$ 555,683	$ 599,930
Outside services	81,851	77,935
Travel	41,773	37,880
Buildings and leased space	61,582	60,613
Equipment (not capitalized)	15,111	14,923
Depreciation of property and equipment	54,947	47,042
Other	20,689	20,560
Services billed to receiverships	(26,140)	(37,747)
Total	**$ 805,496**	**$ 821,136**

9. Provision for Insurance Losses

Provision for insurance losses was a negative $928 million for 2003 and a negative $87 million for 2002. The following chart lists the major components of the provision for insurance losses.

Provision for Insurance Losses for the Years Ended December 31

Dollars in Thousands

	2003	2002
Valuation Adjustments:		
Closed banks	$ (108,309)	$ 616,844
Open bank assistance and other assets	2,534	6,006
Total Valuation Adjustments	**(105,775)**	**622,850**
Contingent Liabilities Adjustments:		
Anticipated failure of insured institutions	(829,831)	(902,903)
Litigation losses	345	180,458
Other contingencies	6,793	12,625
Total Contingent Liabilities Adjustments	**(822,693)**	**(709,820)**
Total	**$ (928,468)**	**$ (86,970)**

10. Employee Benefits

Pension Benefits, Savings Plans and Postemployment Benefits

Eligible FDIC employees (permanent and term employees with appointments exceeding one year) are covered by the federal government retirement plans, either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). Although the BIF contributes a portion of pension benefits for eligible employees, it does not account for the assets of either retirement system. The BIF also does not have actuarial data for accumulated plan benefits or the unfunded liability relative to eligible employees. These amounts are reported on and accounted for by the U.S. Office of Personnel Management.

Eligible FDIC employees also may participate in a FDIC-sponsored tax-deferred 401(k) savings plan with matching contributions up to five percent. The BIF pays its share of the employer's portion of all related costs.

Pension Benefits, Savings Plans Expenses and Postemployment Benefits for the Years Ended December 31
Dollars in Thousands

	2003	2002
Civil Service Retirement System	$ 7,740	$ 13,365
Federal Employees Retirement System (Basic Benefit)	29,477	30,366
FDIC Savings Plan	17,397	18,956
Federal Thrift Savings Plan	12,066	12,235
Separation Incentive Payment (see Note 8)	91	29,085
Total	**$ 66,771**	**$ 104,007**

Postretirement Benefits Other Than Pensions
The FDIC provides certain life and dental insurance coverage for its eligible retirees, the retirees' beneficiaries, and covered dependents. Retirees eligible for life insurance coverage are those who have qualified due to: 1) immediate enrollment upon appointment or five years of participation in the plan and 2) eligibility for an immediate annuity. The life insurance program provides basic coverage at no cost to retirees and allows converting optional coverages to direct-pay plans. Dental coverage is provided to all retirees eligible for an immediate annuity.

Prior to 2003, the BIF funded its liability for postretirement benefits other than pensions directly to a separate entity, which was established to restrict the funds and to provide for the accounting and administration of these benefits. As of January 1, 2003, the FDIC changed its funding policy for these benefits and eliminated the separate entity in order to simplify the investment, accounting, and reporting for the obligation. The change does not impact any benefit entitlements to employees and retirees or the accrual of this liability pursuant to the provisions of SFAS No. 106. The BIF received $89 million, of the total $103 million, as its proportionate share of the plan assets and recognized a liability of $90 million, of the total $104 million, in the "Accounts payable and other liabilities" line item on its Balance Sheets.

The net cumulative effect of this accounting change for the periods prior to 2003 was $787 thousand which is included in the "Insurance and other expenses" line item on BIF's Statements of Income and Fund Balance. In addition to the cumulative effect, the BIF's expense for such benefits in 2003 was $11 million, which is included in the current year operating expenses. In the absence of the accounting change, BIF would have recognized an expense of $6 million.

At December 31, 2003, the BIF's net postretirement benefit liability recognized in the "Accounts payable and other liabilities" line item in the Balance Sheet was $98 million. At December 31, 2002, the BIF's net postretirement benefit asset recognized in the "Interest receivable on investments and other assets, net" line item in the Balance Sheet was $130 thousand. Key actuarial assumptions used in the accounting for the plan include the discount rate, the rate of compensation increase, and the dental coverage trend rate.

11. Commitments and Off-Balance-Sheet Exposure

Commitments:

Leased Space
The BIF's allocated share of the FDIC's lease commitments totals $124 million for future years. The lease agreements contain escalation clauses resulting in adjustments, usually on an annual basis. The allocation to the BIF of the FDIC's future lease commitments is based upon current relationships of the workloads among the BIF and the SAIF. Changes in the relative workloads could cause the amounts allocated to the BIF in the future to vary from the amounts shown below. The BIF recognized leased space expense of $38 million and $37 million for the years ended December 31, 2003 and 2002, respectively.

Lease Space Commitments

Dollars in Thousands

2004	2005	2006	2007	2008	2009/Thereafter
$37,345	$32,666	$22,484	$13,652	$8,887	$9,052

Off-Balance-Sheet Exposure:

Asset Securitization Guarantees
As part of the FDIC's efforts to maximize the return from the sale or disposition of assets from bank resolutions, the FDIC has securitized some receivership assets. To facilitate the securitizations, the BIF provided limited guarantees to cover certain losses on the securitized assets up to a specified maximum. In exchange for backing the limited guarantees, the BIF received assets from the receiverships in an amount equal to the expected exposure under the guarantees. One deal terminated in 2003 with a cumulative gain to the BIF of $6 million. Although the remaining term of the limited guaranty for the last deal is 23 years, this deal will be evaluated for possible termination in 2004. As of December 31, 2003 and 2002, the maximum off-balance-sheet exposure was $81 million and $202 million, respectively.

Deposit Insurance
As of September 30, 2003, deposits insured by the BIF totaled approximately $2.5 trillion. This would be the accounting loss if all depository institutions were to fail and the acquired assets provided no recoveries.

12. Disclosures About the Fair Value of Financial Instruments

Cash equivalents are short-term, highly liquid investments and are shown at current value. The fair market value of the investment in U.S. Treasury obligations is disclosed in Note 3 and is based on current market prices. The carrying amount of interest receivable on investments, short-term receivables, and accounts payable and other liabilities approximates their fair market value, due to their short maturities and/or comparability with current interest rates.

The net receivables from bank resolutions primarily include the BIF's subrogated claim arising from payments to insured depositors. The receivership assets that will ultimately be used to pay

the corporate subrogated claim are valued using discount rates that include consideration of market risk. These discounts ultimately affect the BIF's allowance for loss against the net receivables from bank resolutions. Therefore, the corporate subrogated claim indirectly includes the effect of discounting and should not be viewed as being stated in terms of nominal cash flows.

Although the value of the corporate subrogated claim is influenced by valuation of receivership assets (see Note 4), such receivership valuation is not equivalent to the valuation of the corporate claim. Since the corporate claim is unique, not intended for sale to the private sector, and has no established market, it is not practicable to estimate its fair market value.

The FDIC believes that a sale to the private sector of the corporate claim would require indeterminate, but substantial, discounts for an interested party to profit from these assets because of credit and other risks. In addition, the timing of receivership payments to the BIF on the subrogated claim does not necessarily correspond with the timing of collections on receivership assets. Therefore, the effect of discounting used by receiverships should not necessarily be viewed as producing an estimate of market value for the net receivables from bank resolutions.

13. Supplementary Information Relating to the Statements of Cash Flows

Reconciliation of Net Income to Net Cash Provided by Operating Activities for the Years Ended December 31

Dollars in Thousands

	2003	2002
Net Income	**$ 1,741,727**	**$ 1,045,268**
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities		
Income Statement Items:		
Amortization of U.S. Treasury obligations	455,628	217,742
TIIS inflation adjustment	(115,150)	(110,679)
Depreciation on property and equipment	54,947	47,484
Retirement of property and equipment	852	2,149
Change in Assets and Liabilities:		
(Increase) Decrease in interest receivable on investments and other assets	(67,460)	63,688
(Increase) in receivables from bank resolutions	(5,694)	(426,239)
Increase in accounts payable and other liabilities	85,577	14,218
(Decrease) in contingent liabilities for anticipated failure of insured institutions	(829,831)	(902,903)
(Decrease) Increase in contingent liabilities for litigation losses and other	(20,604)	180,340
Net Cash Provided by Operating Activities	**$ 1,299,992**	**$ 131,068**

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Savings Association Insurance Fund's Financial Statements

Balance Sheets

Savings Association Insurance Fund

Federal Deposit Insurance Corporation

Savings Association Insurance Fund Balance Sheets at December 31

Dollars in Thousands

	2003	2002
Assets		
Cash and cash equivalents	$ 827,141	$ 1,907,353
Cash and other assets: Restricted for SAIF-member exit fees (Note 3) *(Includes cash and cash equivalents of $231.9 million and $187.7 million at December 31, 2003 and 2002, respectively)*	319,286	311,864
Investment in U.S. Treasury obligations, net: (Note 4)		
Held-to-maturity securities	6,823,709	5,726,840
Available-for-sale securities	4,152,048	3,769,576
Interest receivable on investments and other assets, net	188,189	153,320
Receivables from thrift resolutions, net (Note 5)	273,242	287,855
Total Assets	**$ 12,583,615**	**$ 12,156,808**
Liabilities		
Accounts payable and other liabilities	$ 20,540	$ 7,100
Contingent liabilities for: (Note 6)		
Anticipated failure of insured institutions	3,192	90,493
Litigation losses	532	613
SAIF-member exit fees and investment proceeds held in escrow (Note 3)	319,286	311,864
Total Liabilities	**343,550**	**410,070**
Commitments and off-balance-sheet exposure (Note 11)		
Fund Balance		
Accumulated net income	11,965,776	11,465,716
Unrealized gain on available-for-sale securities, net (Note 4)	274,289	281,022
Total Fund Balance	**12,240,065**	**11,746,738**
Total Liabilities and Fund Balance	**$ 12,583,615**	**$ 12,156,808**

The accompanying notes are an integral part of these financial statements.

Statements of Income and Fund Balance

Savings Association Insurance Fund

Federal Deposit Insurance Corporation

Savings Association Insurance Fund Statements of Income and Fund Balance for the Years Ended December 31

Dollars in Thousands

	2003	2002
Revenue		
Interest on U.S. Treasury obligations	$ 532,474	$ 564,259
Assessments (Note 7)	14,594	23,783
Other revenue	192	779
Total Revenue	**547,260**	**588,821**
Expenses and Losses		
Operating expenses (Note 8)	129,584	124,363
Provision for insurance losses (Note 9)	(82,489)	(156,494)
Insurance and other expenses	105	751
Total Expenses and Losses	**47,200**	**(31,380)**
Net Income	**500,060**	**620,201**
Unrealized (loss)/gain on available-for-sale securities, net	(6,733)	191,613
Comprehensive Income	**493,327**	**811,814**
Fund Balance - Beginning	**11,746,738**	**10,934,924**
Fund Balance - Ending	**$ 12,240,065**	**$ 11,746,738**

The accompanying notes are an integral part of these financial statements.

Statements of Cash Flows

Savings Association Insurance Fund

Federal Deposit Insurance Corporation

Savings Association Insurance Fund Statements of Cash Flows for the Years Ended December 31

Dollars in Thousands

	2003	2002
Operating Activities		
Provided by:		
Interest on U.S. Treasury obligations	$ 620,842	$ 576,192
Assessments	15,327	23,709
Entrance and exit fees, including interest on exit fees (Note 3)	4,305	15,811
Recoveries from thrift resolutions	13,419	1,126,940
Miscellaneous receipts	15,344	73
Used by:		
Operating expenses	(130,495)	(125,159)
Disbursements for thrift resolutions	(6,541)	(119,993)
Miscellaneous disbursements	(108)	(103)
Net Cash Provided by Operating Activities (Note 13)	**532,093**	**1,497,470**
Investing Activities		
Provided by:		
Maturity of U.S. Treasury obligations, held-to-maturity	1,170,000	1,070,000
Maturity of U.S. Treasury obligations, available-for-sale	575,000	150,000
Used by:		
Purchase of U.S. Treasury obligations, held-to-maturity	(2,305,056)	0
Purchase of U.S. Treasury obligations, available-for-sale	(1,008,066)	(970,813)
Net Cash (Used by) Provided by Investing Activities	**(1,568,122)**	**249,187**
Net (Decrease)/Increase in Cash and Cash Equivalents	**(1,036,029)**	**1,746,657**
Cash and Cash Equivalents - Beginning	**2,095,081**	**348,424**
Unrestricted Cash and Cash Equivalents - Ending	**827,141**	**1,907,353**
Restricted Cash and Cash Equivalents - Ending	**231,911**	**187,728**
Cash and Cash Equivalents - Ending	**$ 1,059,052**	**$ 2,095,081**

The accompanying notes are an integral part of these financial statements.

Notes to the Financial Statements

Notes to the Financial Statements
Savings Association Insurance Fund
December 31, 2003 and 2002

1. Operations of the Savings Association Insurance Fund

Overview
The Federal Deposit Insurance Corporation (FDIC) is the independent deposit insurance agency created by Congress in 1933 to maintain stability and public confidence in the nation's banking system. Provisions that govern the operations of the FDIC are generally found in the Federal Deposit Insurance (FDI) Act, as amended, (12 U.S.C. 1811, *et seq*). In carrying out the purposes of the FDI Act, as amended, the FDIC insures the deposits of banks and savings associations, and in cooperation with other federal and state agencies promotes the safety and soundness of insured depository institutions by identifying, monitoring and addressing risks to the deposit insurance funds established in the FDI Act, as amended. FDIC is the administrator of the Savings Association Insurance Fund (SAIF), the Bank Insurance Fund (BIF), and the FSLIC Resolution Fund (FRF), which are maintained separately to carry out their respective mandates. The SAIF and the BIF are insurance funds responsible for protecting insured thrift and bank depositors from loss due to institution failures. These insurance funds must be maintained at not less than 1.25 percent of estimated insured deposits or a higher percentage as circumstances warrant. The FRF is a resolution fund responsible for the sale of remaining assets and satisfaction of liabilities associated with the former Federal Savings and Loan Insurance Corporation (FSLIC) and the Resolution Trust Corporation.

An active institution's insurance fund membership and primary federal supervisor are generally determined by the institution's charter type. Deposits of SAIF-member institutions are generally insured by the SAIF; SAIF members are predominantly thrifts supervised by the Office of Thrift Supervision (OTS). Deposits of BIF-member institutions are generally insured by the BIF; BIF members are predominantly commercial and savings banks supervised by the FDIC, the Office of the Comptroller of the Currency, or the Federal Reserve Board.

In addition to traditional thrifts and banks, several other categories of institutions exist. A member of one insurance fund may, with the approval of its primary federal supervisor, merge, consolidate with, or acquire the deposit liabilities of an institution that is a member of the other insurance fund without changing insurance fund status for the acquired deposits. These institutions with deposits insured by both insurance funds are referred to as Oakar financial institutions. In addition, SAIF-member thrifts can convert to a bank charter and retain their SAIF membership. These institutions are referred to as Sasser financial institutions. Likewise, BIF-member banks can convert to a thrift charter and retain their BIF membership.

Operations of the SAIF
The primary purpose of the SAIF is to: 1) insure the deposits and protect the depositors of SAIF-insured institutions and 2) resolve SAIF-insured failed institutions upon appointment of FDIC as receiver in a manner that will result in the least possible cost to the SAIF.

The SAIF is primarily funded from: 1) interest earned on investments in U.S. Treasury obligations and 2) deposit insurance assessments. Additional funding sources are borrowings from the U.S. Treasury, the Federal Financing Bank (FFB), and the Federal Home Loan Banks, if necessary. The FDIC has borrowing authority from the U.S. Treasury up to $30 billion for insurance purposes on behalf of the SAIF and the BIF.

A statutory formula, known as the Maximum Obligation Limitation (MOL), limits the amount of obligations the SAIF can incur to the sum of its cash, 90% of the fair market value of other assets, and the amount authorized to be borrowed from the U.S. Treasury. The MOL for the SAIF was $20.3 billion and $19.9 billion as of December 31, 2003 and 2002, respectively.

Receivership Operations
The FDIC is responsible for managing and disposing of the assets of failed institutions in an orderly and efficient manner. The assets held by receivership entities, and the claims against them, are accounted for separately from SAIF assets and liabilities to ensure that receivership proceeds are distributed in accordance with applicable laws and regulations. Also, the income and expenses attributable to receiverships are accounted for as transactions of those receiverships. Receiverships are billed by the FDIC for services provided on their behalf.

Recent Legislative Initiatives
In April 2001, FDIC issued recommendations for deposit insurance reform. The FDIC recommendations included merging SAIF and BIF and improving FDIC's ability to manage the merged fund by permitting the FDIC Board of Directors to price insurance premiums properly to reflect risk, to set the reserve ratio in a *range* around 1.25 percent, establish a system for providing credits, rebates and surcharges, and to eliminate the SAIF exit fee reserve. FDIC also recommended that Congress consider indexing deposit insurance coverage for inflation. During the 107th Congress (2001-2002), hearings were held in the House and Senate and legislation was introduced containing major elements of FDIC's deposit insurance reform proposals. The legislation was not enacted prior to congressional adjournment. During the 108th Congress (2003 - 2004), the House and Senate are again considering deposit insurance reform legislation. If Congress enacts deposit insurance reform legislation that contains the above recommendations, the new law would have a significant impact on the SAIF and BIF. FDIC management, however, cannot predict which provisions, if any, will ultimately be enacted.

2. Summary of Significant Accounting Policies

General
These financial statements pertain to the financial position, results of operations, and cash flows of the SAIF and are presented in conformity with U.S. generally accepted accounting principles (GAAP). These statements do not include reporting for assets and liabilities of closed thrift institutions for which the FDIC acts as receiver. Periodic and final accountability reports of the FDIC's activities as receiver are furnished to courts, supervisory authorities, and others as required.

Use of Estimates
Management makes estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates. Where it is reasonably possible that changes in estimates will cause a material change in the financial statements in the near term, the nature and extent of such changes in estimates have been disclosed. The more significant estimates include allowance for loss on receivables from thrift resolutions, the estimated losses for anticipated failures and litigation, and the postretirement benefit obligation

Cash Equivalents
Cash equivalents are short-term, highly liquid investments with original maturities of three months or less. Cash equivalents consist primarily of Special U.S. Treasury Certificates.

Investment in U.S. Treasury Obligations
SAIF funds are required to be invested in obligations of the United States or in obligations guaranteed as to principal and interest by the United States; the Secretary of the U.S. Treasury must approve all such investments in excess of $100,000. The Secretary has granted approval to invest SAIF funds only in U.S. Treasury obligations that are purchased or sold exclusively through the Bureau of the Public Debt's Government Account Series (GAS) program.

SAIF's investments in U.S. Treasury obligations are either classified as held-to-maturity or available-for-sale. Securities designated as held-to-maturity are shown at amortized cost. Amortized cost is the face value of securities plus the unamortized premium or less the unamortized discount. Amortizations are computed on a daily basis from the date of acquisition to the date of maturity, except for callable U.S. Treasury securities, which are amortized to the first anticipated call date. Securities designated as available-for-sale are shown at market value, which approximates fair value. Unrealized gains and losses are included in Comprehensive Income. Realized gains and losses are included in the Statements of Income and Fund Balance as components of Net Income. Interest on both types of securities is calculated on a daily basis and recorded monthly using the effective interest method.

Cost Allocations Among Funds
Operating expenses not directly charged to the SAIF, the BIF, and the FRF are allocated to all funds using workload-based allocation percentages. These percentages are developed during the annual corporate planning process and through supplemental functional analyses.

Related Parties
The nature of related parties and a description of related party transactions are discussed in Note 1 and disclosed throughout the financial statements and footnotes.

Reclassifications
Reclassifications have been made in the 2002 financial statements to conform to the presentation used in 2003.

3. Cash and Other Assets: Restricted for SAIF-Member Exit Fees

The SAIF collects entrance and exit fees for conversion transactions when an insured depository institution converts from the BIF to the SAIF (resulting in an entrance fee) or from the SAIF to the BIF (resulting in an exit fee). Regulations approved by the FDIC's Board of Directors (Board) and published in the *Federal Register* on March 21, 1990, directed that exit fees paid to the SAIF be held in escrow.

The FDIC and the Secretary of the Treasury will determine when it is no longer necessary to escrow such funds for the payment of interest on obligations previously issued by the FICO. These escrowed exit fees are invested in U.S. Treasury securities pending determination of ownership. The interest earned is also held in escrow. There were no conversion transactions during 2003 and 2002 that resulted in an entrance/exit fee to the SAIF.

Savings Association Insurance Fund

Cash and Other Assets: Restricted for SAIF-Member Exit Fees at December 31

Dollars in Thousands

	2003	2002
Cash and cash equivalents	$ 231,911	$ 187,728
Investment in U.S. Treasury obligations, net	86,471	122,402
Interest receivable on U.S. Treasury obligations	904	1,734
Total	**$ 319,286**	**$ 311,864**

U.S. Treasury Obligations at December 31, 2003 (Restricted for SAIF-Member Exit Fees)

Dollars in Thousands

	Held-to-Maturity				
Maturity	Yield at Purchase	Face Value	Net Carrying Amount	Unrealized Holding Gains	Market Value
Within 1 year	5.79%	$ 20,000	$ 20,267	$ 683	$ 20,950
After 1 year through 5 years	5.20%	64,000	66,204	5,349	71,553
Total		**$ 84,000**	**$ 86,471**	**$ 6,032**	**$ 92,503**

U.S. Treasury Obligations at December 31, 2002 (Restricted for SAIF-Member Exit Fees)

Dollars in Thousands

	Held-to-Maturity				
Maturity	Yield at Purchase	Face Value	Net Carrying Amount	Unrealized Holding Gains	Market Value
Within 1 year	6.59%	$ 35,000	$ 34,986	$ 222	$ 35,208
After 1 year through 5 years	5.45%	64,000	66,830	6,298	73,128
After 5 years through 10 years	4.99%	20,000	20,586	2,108	22,694
Total		**$ 119,000**	**$ 122,402**	**$ 8,628**	**$ 131,030**

As of December 31, 2003 and 2002, the unamortized premium, net of the unamortized discount, was $2.5 million and $3.4 million, respectively.

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4. Investment in U.S. Treasury Obligations, Net

As of December 31, 2003 and 2002, the book value of investments in U.S. Treasury obligations, net, was $11.0 billion and $9.5 billion, respectively. As of December 31, 2003, the SAIF held $2.2 billion of Treasury inflation-indexed securities (TIIS). These securities are indexed to increases or decreases in the Consumer Price Index for All Urban Consumers (CPI-U). Additionally, the SAIF held $2.5 billion of callable U.S. Treasury bonds at December 31, 2003. Callable U.S. Treasury bonds may be called five years prior to the respective bonds' stated maturity on their semi-annual coupon payment dates upon 120 days notice.

U.S. Treasury Obligations at December 31, 2003 (Unrestricted)

Dollars in Thousands

Maturity (a)	Yield at Purchase (b)	Face Value	Net Carrying Amount	Unrealized Holding Gains	Unrealized Holding Losses (c)	Market Value
Held-to-Maturity						
Within 1 year	2.86%	$ 1,670,000	$ 1,742,136	$ 12,009	$ (122)	$ 1,754,023
After 1 year through 5 years	5.59%	3,185,000	3,250,611	284,578	0	3,535,189
After 5 years through 10 years	5.54%	1,575,000	1,603,674	169,813	0	1,773,487
Treasury Inflation-Indexed						
After 1 year through 5 years	3.86%	229,032	227,288	26,008	0	253,296
Total		$ 6,659,032	$ 6,823,709	$ 492,408	$ (122)	$ 7,315,995
Available-for-Sale						
Within 1 year	3.15%	$ 1,360,000	$ 1,413,730	$ 16,265	$ (99)	$ 1,429,896
After 1 year through 5 years	4.43%	655,000	756,058	34,530	0	790,588
Treasury Inflation-Indexed						
After 1 year through 5 years	4.11%	280,564	276,009	34,278	0	310,287
After 5 years through 10 years	3.79%	1,429,332	1,431,862	189,315	0	1,621,277
Total		$ 3,724,916	$ 3,877,759	$ 274,388	$ (99)	$ 4,152,048
Total Investment in U.S. Treasury Obligations, Net						
Total		$ 10,383,948	$ 10,701,468	$ 766,796	$ (221)	$ 11,468,043

(a) For purposes of this table, all callable securities are assumed to mature on their first call dates. Their yields at purchase are reported as their yield to first call date.

(b) For TIIS, the yields in the above table are stated at their real yields at purchase, not their effective yields. Effective yields on TIIS include a long-term annual inflation assumption as measured by the CPI-U. The long-term CPI-U consensus forecast is 2.4%, based on figures issued by the Office of Management and Budget and the Congressional Budget Office in early 2003.

(c) All unrealized losses occurred during the last 12 months as a result of changes in market interest rates. FDIC has the ability and intent to hold the related securities until maturity within the coming year. As a result, all losses are considered temporary and will be eliminated upon redemption of the securities.

Savings Association Insurance Fund

U.S. Treasury Obligations at December 31, 2002 (Unrestricted)

Dollars in Thousands

Maturity (a)	Yield at Purchase (b)	Face Value	Net Carrying Amount	Unrealized Holding Gains	Market Value
Held-to-Maturity					
Within 1 year	6.23%	$ 535,000	$ 541,662	$ 12,242	$ 553,904
After 1 year through 5 years	5.91%	2,880,000	2,941,199	317,167	3,258,366
After 5 years through 10 years	5.78%	2,030,000	2,021,651	298,277	2,319,928
Treasury Inflation-Indexed After 5 years through 10 years	3.85%	224,432	222,328	23,917	246,245
Total		$ 5,669,432	$ 5,726,840	$ 651,603	$ 6,378,443
Available-for-Sale					
Within 1 year	5.77%	$ 475,000	$ 473,317	$ 9,660	$ 482,977
After 1 year through 5 years	4.81%	1,235,000	1,342,263	82,983	1,425,246
Treasury Inflation-Indexed After 5 years through 10 years	3.84%	1,675,573	1,672,974	188,379	1,861,353
Total		$ 3,385,573	$ 3,488,554	$ 281,022	$ 3,769,576
Total Investment in U.S. Treasury Obligations, Net					
Total		**$ 9,055,005**	**$ 9,215,394**	**$ 932,625**	**$ 10,148,019**

(a) For purposes of this table, all callable securities are assumed to mature on their first call dates. Their yields at purchase are reported as their yield to first call date.

(b) For TIIS, the yields in the above table are stated at their real yields at purchase, not their effective yields. Effective yields on TIIS include a long-term annual inflation assumption as measured by the CPI-U. The long-term CPI-U consensus forecast is 2.4%, based on figures issued by the Office of Management and Budget and the Congressional Budget Office in early 2002.

As of December 31, 2003 and 2002, the unamortized premium, net of the unamortized discount, was $317.5 million and $160.4 million, respectively.

5. Receivables From Thrift Resolutions, Net

The receivables from thrift resolutions include payments made by the SAIF to cover obligations to insured depositors, advances to receiverships for working capital, and administrative expenses paid on behalf of receiverships. Any related allowance for loss represents the difference between the funds advanced and/or obligations incurred and the expected repayment. Assets held by SAIF receiverships are the main source of repayment of the SAIF's receivables from closed thrifts. During 2003, there were no thrift failures, leaving two active receiverships.

As of December 31, 2003 and 2002, SAIF receiverships held assets with a book value of $449 million and $490 million, respectively (including cash, investments, and miscellaneous receivables of $117 million and $93 million at December 31, 2003 and 2002, respectively). The estimated cash recoveries from the management and disposition of these assets that are used to derive the allowance for losses are based on a sampling of receivership assets. The sampled

assets are generally valued by estimating future cash recoveries, net of applicable liquidation cost estimates, and then discounting these net cash recoveries using current market-based risk factors based on a given asset's type and quality. Resultant recovery estimates are extrapolated to the non-sampled assets in order to derive the allowance for loss on the receivable. These estimated recoveries are regularly evaluated, but remain subject to uncertainties because of potential changes in economic and market conditions. Such uncertainties could cause the SAIF's actual recoveries to vary from the level currently estimated.

Receivables From Thrift Resolutions, Net at December 31

Dollars in Thousands

	2003	2002
Receivables from closed thrifts	$ 709,389	$ 721,572
Allowance for losses	(436,147)	(433,717)
Total	**$ 273,242**	**$ 287,855**

At December 31, 2003, about 99% of the SAIF's $273 million net receivable will be repaid from assets related to the Superior receivership (which failed in July 2001), primarily, cash, investments, and a promissory note arising from a settlement with the owners of the failed institution. The credit risk related to the promissory note is limited since half of the outstanding note is secured by a letter of credit and the remaining half is subject to the creditworthiness of the payor of the note. Annual monitoring of the creditworthiness of the payor is performed and currently indicates a low risk of non-performance.

6. Contingent Liabilities for:

Anticipated Failure of Insured Institutions

The SAIF records a contingent liability and a loss provision for thrifts (including Oakar and Sasser financial institutions) that are likely to fail within one year of the reporting date, absent some favorable event such as obtaining additional capital or merging, when the liability becomes probable and reasonably estimable.

The contingent liability is derived by applying expected failure rates and historical loss rates to groups of institutions with certain shared characteristics. In addition, institution-specific analysis is performed on those thrifts where failure is imminent absent institution management resolution of existing problems. As of December 31, 2003 and 2002, the contingent liabilities for anticipated failure of insured institutions were $3 million and $90 million, respectively.

In addition to these recorded contingent liabilities, the FDIC has identified additional risk in the financial services industry that could result in a material loss to the SAIF should potentially vulnerable financial institutions ultimately fail. This risk is evidenced by the level of problem thrift assets and the presence of various high-risk banking business models that are particularly vulnerable to adverse economic and market conditions. Due to the uncertainty surrounding future economic and market conditions, there are other thrifts for which the risk of failure is less certain, but still considered reasonably possible. As a result of these risks, the FDIC believes that it is reasonably possible that the SAIF could incur additional estimated losses up to $143 million.

The accuracy of these estimates will largely depend on future economic and market conditions. The FDIC's Board of Directors has the statutory authority to consider the contingent liability from anticipated failures of insured institutions when setting assessment rates.

Litigation Losses
The SAIF records an estimated loss for unresolved legal cases to the extent those losses are considered probable and reasonably estimable. In addition to the amount recorded as probable, the FDIC has determined that losses from unresolved legal cases totaling $53.4 million are reasonably possible.

Other Contingencies

Representations and Warranties
As part of the FDIC's efforts to maximize the return from the sale of assets from thrift resolutions, representations and warranties, and guarantees were offered on certain loan sales. In general, the guarantees, representations, and warranties on loans sold relate to the completeness and accuracy of loan documentation, the quality of the underwriting standards used, the accuracy of the delinquency status when sold, and the conformity of the loans with characteristics of the pool in which they were sold. The total amount of loans sold subject to unexpired representations and warranties, and guarantees was $5.2 billion as of December 31, 2003. SAIF did not establish a liability for all outstanding claims asserted in connection with representations and warranties because the receiverships have sufficient funds to pay for such claims.

In addition, future losses on representations and warranties, and guarantees could be incurred over the remaining life of the loans sold, which is generally 20 years or more. Consequently, the FDIC believes it is possible that additional losses may be incurred by the SAIF from the universe of outstanding contracts with unasserted representation and warranty claims. However, because of the uncertainties surrounding the timing of when claims may be asserted, the FDIC is unable to reasonably estimate a range of loss to the SAIF from outstanding contracts with unasserted representation and warranty claims.

7. Assessments

In compliance with provisions of the FDI Act, as amended, the FDIC uses a risk-based assessment system that charges higher rates to those institutions that pose greater risks to the SAIF. To arrive at a risk-based assessment for a particular institution, the FDIC places each institution in one of nine risk categories based on capital ratios and supervisory examination data. The majority of the financial institutions are not assessed. Of those assessed, the assessment rate averaged approximately 14 cents and 26 cents per $100 of assessable deposits for 2003 and 2002, respectively. During 2003 and 2002, $15 million and $24 million were collected from SAIF-member institutions, respectively. On November 4, 2003, the Board voted to retain the SAIF assessment schedule at the annual rate of 0 to 27 cents per $100 of assessable deposits for the first semiannual period of 2004. The Board reviews assessment rates semiannually to ensure that funds are available to satisfy the SAIF's obligations. If necessary, the Board may impose more frequent rate adjustments or emergency special assessments.

The FDIC is required to maintain the insurance funds at a designated reserve ratio (DRR) of not less than 1.25 percent of estimated insured deposits (or a higher percentage as circumstances

warrant). If the reserve ratio falls below the DRR, the FDIC is required to set semiannual assessment rates that are sufficient to increase the reserve ratio to the DRR not later than one year after such rates are set, or in accordance with a recapitalization schedule of fifteen years or less. As of September 30, 2003, the SAIF reserve ratio was 1.40 percent of estimated insured deposits.

Assessments are also levied on institutions for payments of the interest on obligations issued by the Financing Corporation (FICO). The FICO was established as a mixed-ownership government corporation to function solely as a financing vehicle for the FSLIC. The annual FICO interest obligation of approximately $790 million is paid on a pro rata basis using the same rate for banks and thrifts. The FICO assessment has no financial impact on the SAIF and is separate from the regular assessments. The FDIC, as administrator of the SAIF and the BIF, acts solely as a collection agent for the FICO. During 2003 and 2002, $162 million and $161 million, respectively, were collected from SAIF-member institutions and remitted to the FICO.

8. Operating Expenses

Operating expenses totaled $130 million for 2003 compared to $124 million for 2002. Salaries and benefits expenses are lower due to the workforce reduction programs in 2002. The chart below lists the major components of operating expenses.

During 2002, the FDIC offered voluntary employee buyout incentives to a majority of its employees and conducted a reduction-in-force (RIF) in 2002 and 2003 in an effort to reduce identified staffing excesses and skill imbalances. As a result, approximately 750 employees left by December 31, 2003. Termination benefits included compensation of fifty percent of the employee's current base salary and locality adjustment for voluntary departures. The total cost of this buyout was $33.1 million for 2002, with SAIF's pro rata share totaling $4.2 million, which is included in the "Salaries and benefits" category in the chart below, as well as the "Separation Incentive Payment" line item in Note 10.

Operating Expenses for the Years Ended December 31

Dollars in Thousands

	2003	2002
Salaries and benefits	$ 87,963	$ 92,192
Outside services	15,038	12,196
Travel	5,801	5,473
Buildings and leased space	12,132	10,163
Equipment	9,374	7,858
Other	3,189	2,254
Services billed to receiverships	(3,913)	(5,773)
Total	**$ 129,584**	**$ 124,363**

9. Provision for Insurance Losses

Provision for insurance losses was a negative $82 million for 2003 and a negative $156 million for 2002. In both 2003 and 2002, the negative provision was primarily due to lower estimated losses for anticipated failures which resulted from the improved financial condition of a few large thrifts. The following chart lists the major components of the provision for insurance losses.

Provision for Insurance Losses for the Years Ended December 31
Dollars in Thousands

	2003	2002
Valuation Adjustments:		
Closed thrifts	$ 4,684	$ (10,113)
Total Valuation Adjustments	**4,684**	**(10,113)**
Contingent Liabilities Adjustments:		
Anticipated failure of insured institutions	(87,301)	(142,507)
Litigation losses	128	(3,874)
Total Contingent Liabilities Adjustments	**(87,173)**	**(146,381)**
Total	**$ (82,489)**	**$ (156,494)**

10. Employee Benefits

Pension Benefits, Savings Plans and Postemployment Benefits
Eligible FDIC employees (permanent and term employees with appointments exceeding one year) are covered by the federal government retirement plans, either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). Although the SAIF contributes a portion of pension benefits for eligible employees, it does not account for the assets of either retirement system. The SAIF also does not have actuarial data for accumulated plan benefits or the unfunded liability relative to eligible employees. These amounts are reported on and accounted for by the U.S. Office of Personnel Management.

Eligible FDIC employees also may participate in a FDIC-sponsored tax-deferred 401(k) savings plan with matching contributions up to five percent. The SAIF pays its share of the employer's portion of all related costs.

Pension Benefits, Savings Plans Expenses and Postemployment Benefits for the Years Ended December 31
Dollars in Thousands

	2003	2002
Civil Service Retirement System	$ 1,258	$ 1,715
Federal Employees Retirement System (Basic Benefit)	4,682	4,765
FDIC Savings Plan	2,788	2,951
Federal Thrift Savings Plan	1,900	1,913
Separation Incentive Payment (see Note 8)	14	4,276
Total	**$ 10,642**	**$ 15,620**

Postretirement Benefits Other Than Pensions
The FDIC provides certain life and dental insurance coverage for its eligible retirees, the retirees' beneficiaries, and covered dependents. Retirees eligible for life insurance coverage are those who have qualified due to: 1) immediate enrollment upon appointment or five years of participation in the plan and 2) eligibility for an immediate annuity. The life insurance program provides basic coverage at no cost to retirees and allows converting optional coverages to direct-pay plans. Dental coverage is provided to all retirees eligible for an immediate annuity.

Prior to 2003, the SAIF funded its liability for postretirement benefits other than pensions directly to a separate entity, which was established to restrict the funds and to provide for the accounting and administration of these benefits. As of January 1, 2003, the FDIC changed its

funding policy for these benefits and eliminated the separate entity in order to simplify the investment, accounting, and reporting for the obligation. The change does not impact any benefit entitlements to employees and retirees or the accrual of this liability pursuant to the provisions of SFAS No. 106. The SAIF received $14 million, of the total $103 million, as its proportionate share of the plan assets and recognized a liability of $14 million, of the total $104 million, in the "Accounts payable and other liabilities" line item on its Balance Sheets.

The net cumulative effect of this accounting change for the periods prior to 2003 was a negative $43 thousand which is included in the "Insurance and other expenses" line item on the SAIF's Statements of Income and Fund Balance. In addition to the cumulative effect, the SAIF's expense for such benefits in 2003 was $1 million, which is included in the current year operating expenses. In the absence of the accounting change, the SAIF would have recognized an expense of $925 thousand.

At December 31, 2003 and 2002, the SAIF's net postretirement benefit liability recognized in the "Accounts payable and other liabilities" line item in the Balance Sheet was $15 million and $145 thousand, respectively. Key actuarial assumptions used in the accounting for the plan include the discount rate, the rate of compensation increase, and the dental coverage trend rate.

11. Commitments and Off-Balance-Sheet Exposure

Commitments:

Leased Space
The SAIF's allocated share of the FDIC's lease commitments totals $19.4 million for future years. The lease agreements contain escalation clauses resulting in adjustments, usually on an annual basis. The allocation to the SAIF of the FDIC's future lease commitments is based upon current relationships of the workloads among the SAIF and the BIF. Changes in the relative workloads could cause the amounts allocated to the SAIF in the future to vary from the amounts shown below. The SAIF recognized leased space expense of $7.9 million and $6.5 million for the years ended December 31, 2003 and 2002, respectively.

Leased Space Commitments

Dollars in Thousands

2004	2005	2006	2007	2008	2009/Thereafter
$5,849	$5,117	$3,522	$2,138	$1,392	$1,418

Off-Balance-Sheet Exposure:

Deposit Insurance
As of September 30, 2003, deposits insured by the SAIF totaled approximately $868 billion. This would be the accounting loss if all depository institutions were to fail and the acquired assets provided no recoveries.

12. Disclosures About the Fair Value of Financial Instruments

Cash equivalents are short-term, highly liquid investments and are shown at current value. The fair market value of the investment in U.S. Treasury obligations is disclosed in Note 3 and 4 and is based on current market prices. The carrying amount of interest receivable on investments, short-term receivables, and accounts payable and other liabilities approximates their fair market value, due to their short maturities and/or comparability with current interest rates.

The net receivables from thrift resolutions primarily include the SAIF's subrogated claim arising from payments to insured depositors. The receivership assets that will ultimately be used to pay the corporate subrogated claim are valued using discount rates that include consideration of market risk. These discounts ultimately affect the SAIF's allowance for loss against the net receivables from thrift resolutions. Therefore, the corporate subrogated claim indirectly includes the effect of discounting and should not be viewed as being stated in terms of nominal cash flows.

Although the value of the corporate subrogated claim is influenced by valuation of receivership assets (see Note 5), such receivership valuation is not equivalent to the valuation of the corporate claim. Since the corporate claim is unique, not intended for sale to the private sector, and has no established market, it is not practicable to estimate its fair market value.

The FDIC believes that a sale to the private sector of the corporate claim would require indeterminate, but substantial, discounts for an interested party to profit from these assets because of credit and other risks. In addition, the timing of receivership payments to the SAIF on the subrogated claim does not necessarily correspond with the timing of collections on receivership assets. Therefore, the effect of discounting used by receiverships should not necessarily be viewed as producing an estimate of market value for the net receivables from thrift resolutions.

13. Supplementary Information Relating to the Statements of Cash Flows

Reconciliation of Net Income to Net Cash Provided by Operating Activities for the Years Ended December 31

Dollars in Thousands

	2003	2002
Net Income	$ 500,060	$ 620,201
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities		
Income Statement Items:		
Amortization of U.S. Treasury obligations (unrestricted)	155,993	47,333
THS inflation adjustment	(38,943)	(37,429)
Change in Assets and Liabilities:		
Decrease in amortization of U.S. Treasury obligations (restricted)	931	811
(Increase) Decrease in entrance and exit fees receivable, including interest receivable on investments and other assets	(34,040)	5,317
Decrease in receivables from thrift resolutions	14,613	997,295
Increase (Decrease) in accounts payable and other liabilities	13,440	(1,011)
(Decrease) in contingent liability for anticipated failure of insured institutions	(87,301)	(142,507)
(Decrease) in contingent liability for litigation losses	(82)	(5,029)
Increase in exit fees and investment proceeds held in escrow	7,422	12,489
Net Cash Provided by Operating Activities	$ 532,093	$ 1,497,470

FSLIC Resolution Fund's Financial Statements

Balance Sheets

FSLIC Resolution Fund

Federal Deposit Insurance Corporation

FSLIC Resolution Fund Balance Sheets at December 31

Dollars in Thousands

	2003	2002
Assets		
Cash and cash equivalents	$ 3,278,532	$ 3,618,330
Receivables from thrift resolutions and other assets, net (Note 3)	198,432	251,929
Total Assets	**$ 3,476,964**	**$ 3,870,259**
Liabilities		
Accounts payable and other liabilities	$ 19,381	$ 14,408
Contingent liabilities for litigation losses and other (Note 4)	1,169	546
Total Liabilities	**20,550**	**14,954**
Resolution Equity (Note 6)		
Contributed capital	126,377,851	126,827,821
Accumulated deficit	(122,962,936)	(123,015,273)
Unrealized gain on available-for-sale securities, net (Note 3)	41,499	42,757
Accumulated deficit, net	(122,921,437)	(122,972,516)
Total Resolution Equity	**3,456,414**	**3,855,305**
Total Liabilities and Resolution Equity	**$ 3,476,964**	**$ 3,870,259**

The accompanying notes are an integral part of these financial statements.

Statements of Income and Accumulated Deficit

FSLIC Resolution Fund

Federal Deposit Insurance Corporation

FSLIC Resolution Fund Statements of Income and Accumulated Deficit for the Years Ended December 31

Dollars in Thousands

	2003	2002
Revenue		
Interest on U.S. Treasury obligations	$ 32,902	$ 46,835
Realized gain on investment in securitization-related assets acquired from receiverships (Note 3)	756	352,486
Other revenue	16,849	33,756
Total Revenue	**50,507**	**433,077**
Expenses and Losses		
Operating expenses	27,828	45,684
Provision for losses (Note 5)	(57,832)	(149,359)
Expenses for goodwill settlements and litigation (Note 4)	15,324	40,351
Other expenses	12,850	5,856
Total Expenses and Losses	**(1,830)**	**(57,468)**
Net Income	**52,337**	**490,545**
Unrealized loss on available-for-sale securities, net (Note 3)	(1,258)	(263,590)
Comprehensive Income	**51,079**	**226,955**
Accumulated Deficit - Beginning	**(122,972,516)**	**(123,199,471)**
Accumulated Deficit - Ending	**$ (122,921,437)**	**$ (122,972,516)**

The accompanying notes are an integral part of these financial statements.

Statements of Cash Flows

FSLIC Resolution Fund

Federal Deposit Insurance Corporation

FSLIC Resolution Fund Statements of Cash Flows for the Years Ended December 31

Dollars in Thousands

	2003	2002
Operating Activities		
Provided by:		
Interest on U.S. Treasury obligations	$ 32,902	$ 46,835
Recoveries from thrift resolutions	115,437	316,439
Miscellaneous receipts	39,079	32,607
Used by:		
Operating expenses	(31,643)	(44,421)
Disbursements for thrift resolutions	(11,842)	(30,373)
Disbursements for goodwill settlements and judgments	(30)	(21,459)
Disbursements for goodwill litigation expenses	(35,274)	(18,892)
Miscellaneous disbursements	(4,286)	(9,119)
Net Cash Provided by Operating Activities (Note 8)	**104,343**	**271,617**
Investing Activities		
Investment in securitization-related assets acquired from receiverships	5,829	1,101,525
Net Cash Provided by Investing Activities	**5,829**	**1,101,525**
Financing Activities		
Provided by:		
U.S. Treasury payments for goodwill settlements	30	21,459
Used by:		
Payments to Resolution Funding Corporation (Note 6)	(450,000)	(1,266,667)
Net Cash Used by Financing Activities	**(449,970)**	**(1,245,208)**
Net (Decrease)/Increase in Cash and Cash Equivalents	**(339,798)**	**127,934**
Cash and Cash Equivalents - Beginning	**3,618,330**	**3,490,396**
Cash and Cash Equivalents - Ending	**$ 3,278,532**	**$ 3,618,330**

The accompanying notes are an integral part of these financial statements.

Notes to the Financial Statements

Notes to the Financial Statements
FSLIC Resolution Fund
December 31, 2003 and 2002

1. Legislative History and Operations/Dissolution of the FSLIC Resolution Fund

Legislative History

The Federal Deposit Insurance Corporation (FDIC) is the independent deposit insurance agency created by Congress in 1933 to maintain stability and public confidence in the nation's banking system. Provisions that govern the operations of the FDIC are generally found in the Federal Deposit Insurance (FDI) Act, as amended, (12 U.S.C. 1811, *et seq*). In carrying out the purposes of the FDI Act, as amended, the FDIC insures the deposits of banks and savings associations, and in cooperation with other federal and state agencies promotes the safety and soundness of insured depository institutions by identifying, monitoring and addressing risks to the deposit insurance funds established in the FDI Act, as amended. In addition, FDIC is charged with responsibility for the sale of remaining assets and satisfaction of liabilities associated with the former Federal Savings and Loan Insurance Corporation (FSLIC) and the Resolution Trust Corporation (RTC).

The U.S. Congress created the FSLIC through the enactment of the National Housing Act of 1934. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) abolished the insolvent FSLIC, created the FSLIC Resolution Fund (FRF), and transferred the assets and liabilities of the FSLIC to the FRF-except those assets and liabilities transferred to the RTC-effective on August 9, 1989.

The FIRREA was enacted to reform, recapitalize, and consolidate the federal deposit insurance system. In addition to the FRF, FIRREA created the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). It also designated the FDIC as the administrator of these funds. All three funds are maintained separately to carry out their respective mandates.

The FIRREA created the RTC to manage and resolve all thrifts previously insured by the FSLIC for which a conservator or receiver was appointed during the period January 1, 1989, through August 8, 1992. Resolution responsibility was subsequently extended and ultimately transferred from the RTC to the SAIF on July 1, 1995. The FIRREA established the Resolution Funding Corporation (REFCORP) to provide part of the initial funds used by the RTC for thrift resolutions.

The RTC Completion Act of 1993 (RTC Completion Act) terminated the RTC as of December 31, 1995. All remaining assets and liabilities of the RTC were transferred to the FRF on January 1, 1996. Today, the FRF consists of two distinct pools of assets and liabilities: one composed of the assets and liabilities of the FSLIC transferred to the FRF upon the dissolution of the FSLIC (FRF-FSLIC), and the other composed of the RTC assets and liabilities (FRF-RTC). The assets of one pool are not available to satisfy obligations of the other.

Operations/Dissolution of the FRF
The FRF will continue operations until all of its assets are sold or otherwise liquidated and all of its liabilities are satisfied. Any funds remaining in the FRF-FSLIC will be paid to the U.S. Treasury. Any remaining funds of the FRF-RTC will be distributed to the REFCORP to pay the interest on the REFCORP bonds. In addition, the FRF-FSLIC has available until expended $602.2 million in appropriations to facilitate, if required, efforts to wind up the resolution

activity of the FRF-FSLIC.

The FDIC has conducted an extensive review and cataloging of FRF's remaining assets and liabilities and is continuing to explore approaches for concluding FRF's activities. An executive-level Steering Committee was established in 2003 to facilitate the FRF dissolution. Some of the issues and items that remain open in FRF are: 1) criminal restitution orders (generally have from 5 to 10 years remaining); 2) litigation claims and judgments obtained against officers and directors and other professionals responsible for causing thrift losses (judgments generally vary from 5 to 10 years); 3) numerous assistance agreements entered into by the former FSLIC (FRF could continue to receive tax sharing benefits through year 2020); 4) goodwill and Guarini litigation (no final date for resolution has been established; see Note 4); and 5) environmentally impaired owned real estate assets. FDIC is considering whether enabling legislation or other measures may be needed to accelerate liquidation of the remaining FRF assets and liabilities. The FRF could realize substantial recoveries from item 3 ranging from $235 million to $760 million; however, any associated recoveries are not reflected in FRF's financial statements given the significant uncertainties surrounding the ultimate outcome.

Receivership Operations
The FDIC is responsible for managing and disposing of the assets of failed institutions in an orderly and efficient manner. The assets held by receivership entities, and the claims against them, are accounted for separately from FRF assets and liabilities to ensure that receivership proceeds are distributed in accordance with applicable laws and regulations. Also, the income and expenses attributable to receiverships are accounted for as transactions of those receiverships. Receiverships are billed by the FDIC for services provided on their behalf.

2. Summary of Significant Accounting Policies

General
These financial statements pertain to the financial position, results of operations, and cash flows of the FRF and are presented in conformity with U.S. generally accepted accounting principles (GAAP). These statements do not include reporting for assets and liabilities of closed thrift institutions for which the FDIC acts as receiver. Periodic and final accountability reports of the FDIC's activities as receiver are furnished to courts, supervisory authorities, and others as required.

Use of Estimates
Management makes estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates. Where it is reasonably possible that changes in estimates will cause a material change in the financial statements in the near term, the nature and extent of such changes in estimates have been disclosed. The more significant estimates include allowance for losses on receivables from thrift resolutions and the estimated losses for litigation.

Fair Value of Financial Instruments
Cash equivalents, which consist of Special U.S. Treasury Certificates, are short-term, highly liquid investments with original maturities of three months or less and are shown at fair value. The carrying amount of short-term receivables and accounts payable and other liabilities

approximates their fair market value, due to their short maturities.

The investment in securitization-related assets acquired from receiverships is adjusted to fair value at each reporting date using a valuation model that estimates the present value of estimated expected future cash flows discounted for market and credit risks. Additionally, the credit enhancement reserves, which resulted from swap transactions, are valued by applying a historical loss rate to estimate loss amounts (see Note 3).

The net receivable from thrift resolutions is influenced by the underlying valuation of receivership assets. This corporate receivable is unique and the estimate presented is not indicative of the amount that could be realized in a sale to the private sector. Such a sale would require indeterminate, but substantial, discounts for an interested party to profit from these assets because of credit and other risks. Consequently, it is not practicable to estimate its fair market value.

Cost Allocations Among Funds
Operating expenses not directly charged to the FRF, the BIF, and the SAIF are allocated to all funds using workload-based allocation percentages. These percentages are developed during the annual corporate planning process and through supplemental functional analyses.

Related Parties
The nature of related parties and a description of related party transactions are discussed in Note 1 and disclosed throughout the financial statements and footnotes.

Reclassifications
Reclassifications have been made in the 2002 financial statements to conform to the presentation used in 2003.

3. Receivables From Thrift Resolutions and Other Assets, Net

Receivables From Thrift Resolutions

The receivables from thrift resolutions include payments made by the FRF to cover obligations to insured depositors, advances to receiverships for working capital, and administrative expenses paid on behalf of receiverships. Any related allowance for loss represents the difference between the funds advanced and/or obligations incurred and the expected repayment. Assets held by the FDIC in its receivership capacity for the former FSLIC and SAIF-insured institutions are a significant source of repayment of the FRF's receivables from thrift resolutions. As of December 31, 2003, 52 of the 850 FRF receiverships remain active primarily due to unresolved litigation, including Goodwill and Guarini matters.

As of December 31, 2003 and 2002, FRF receiverships held assets with a book value of $215 million and $290 million, respectively (including cash, investments, and miscellaneous receivables of $114 million and $146 million at December 31, 2003 and 2002, respectively). The estimated cash recoveries from the management and disposition of these assets that are used to derive the allowance for losses are based on a sampling of receivership assets. The sampled assets are generally valued by estimating future cash recoveries, net of applicable liquidation cost estimates, and then discounting these net cash recoveries using current market-

based risk factors based on a given asset's type and quality. Resultant recovery estimates are extrapolated to the non-sampled assets in order to derive the allowance for loss on the receivable. These estimated recoveries are regularly evaluated, but remain subject to uncertainties because of potential changes in economic and market conditions. Such uncertainties could cause the FRF's actual recoveries to vary from the level currently estimated.

Investment in Securitization-Related Assets Acquired from Receiverships

This investment is classified as available-for-sale with unrealized gains and losses included in Resolution Equity. Realized gains and losses are recorded based upon the difference between the proceeds at termination of the deal and the book value of the investment and are included as components of Net Income. As of December 31, 2003, this investment includes credit enhancement reserves valued at $69 million and residual certificates valued at $21 million. The last securitization deal, valued at $60 million (including $39 million in credit enhancement reserves and $21 million in residual certificates), is expected to terminate in 2004. The remaining $30 million in credit enhancement reserves resulted from swap transactions where the former RTC received mortgage-backed securities in exchange for single-family mortgage loans. The former RTC supplied credit enhancement reserves for the mortgage loans in the form of cash collateral to cover future credit losses over the remaining life of the loans. These reserves may cover future credit losses through 2018.

Receivables From Thrift Resolutions and Other Assets, Net at December 31
Dollars in Thousands

	2003	2002
Receivables from closed thrifts	$ 27,940,793	$ 27,636,213
Allowance for losses	(22,846,309)	(27,504,909)
Receivables from Thrift Resolutions, Net	**94,484**	**131,304**
Investment in securitization-related assets acquired from receiverships	$ 90,272	$ 98,114
Other assets	13,676	22,511
Total	**$ 198,432**	**$ 251,929**

Gross receivables from thrift resolutions and the investment in securitization-related assets subject the FRF to credit risk. An allowance for loss of $22.8 billion, or 99.6% of the gross receivable, was recorded as of December 31, 2003. Of the remaining 0.4% of the gross receivable, over three-fourths of the receivable is expected to be repaid from receivership cash, investments, and pledged cash reserves. The credit risk related to the pledged cash reserves is limited since the majority of these assets are evaluated annually and have experienced minimal losses.

The value of the investment in securitization-related assets is influenced by the economy of the area relating to the underlying loans. Of this investment, $42.4 million of the underlying mortgages are located in California and $27.2 million of loans are located in New Jersey. No other state accounted for a material portion of the investment.

4. Contingent Liabilities for:

Litigation Losses
The FRF records an estimated loss for unresolved legal cases to the extent those losses are considered probable and reasonably estimable. In addition to the amount recorded as probable, the FDIC has determined that losses from unresolved legal cases totaling $39 million are reasonably possible.

Additional Contingency
Goodwill Litigation
In *United States v. Winstar Corp.*, 518 U.S. 839 (1996), the Supreme Court held that when it became impossible following the enactment of FIRREA in 1989 for the federal government to perform certain agreements to count goodwill toward regulatory capital, the plaintiffs were entitled to recover damages from the United States. Approximately 61 cases are pending against the United States based on alleged breaches of these agreements.

On July 22, 1998, the Department of Justices (DOJ's) Office of Legal Counsel (OLC) concluded that the FRF is legally available to satisfy all judgments and settlements in the Goodwill Litigation involving supervisory action or assistance agreements. OLC determined that nonperformance of these agreements was a contingent liability that was transferred to the FRF on August 9, 1989, upon the dissolution of the FSLIC. Under the analysis set forth in the OLC opinion, as liabilities transferred on August 9, 1989, these contingent liabilities for future nonperformance of prior agreements with respect to supervisory goodwill were transferred to the FRF-FSLIC, which is that portion of the FRF encompassing the obligations of the former FSLIC. The FRF-RTC, which encompasses the obligations of the former RTC and was created upon the termination of the RTC on December 31, 1995, is not available to pay any settlements or judgments arising out of the Goodwill Litigation. On July 23, 1998, the U.S. Treasury determined, based on OLC's opinion, that the FRF is the appropriate source of funds for payments of any such judgments and settlements.

The lawsuits comprising the Goodwill Litigation are against the United States and as such are defended by the DOJ. On December 1, 2003, the DOJ again informed the FDIC that it is "unable at this time to provide a reasonable estimate of the likely aggregate contingent liability resulting from the Winstar-related cases." This uncertainty arises, in part, from the existence of significant unresolved issues pending at the appellate or trial court level, as well as the unique circumstances of each case.

The FDIC believes that it is probable that additional amounts, possibly substantial, may be paid from the FRF-FSLIC as a result of judgments and settlements in the Goodwill Litigation. Based on the response from the DOJ, the FDIC is unable to estimate a range of loss to the FRF-FSLIC from the Goodwill Litigation. However, the FRF can draw from an appropriation provided by Section 110 of the Department of Justice Appropriations Act, 2000 (Public Law 106-113, Appendix A, Title I, 113 Stat. 1501A-3, 1501A-20) such sums as may be necessary for the payment of judgments and compromise settlements in the Goodwill Litigation. This appropriation is to remain available until expended. Because an appropriation is available to pay such judgments and settlements, any liabilities for the Goodwill Litigation should have no impact on the financial condition of the FRF-FSLIC.

In addition, the FRF-FSLIC pays the goodwill litigation expenses incurred by DOJ based on a Memorandum of Understanding (MOU) dated October 2, 1998, between the FDIC and DOJ. Under the terms of the MOU, the FRF-FSLIC paid $33.3 million and $17.5 million to DOJ for fiscal years 2004 and 2003, respectively. DOJ returns any unused fiscal year funding to the FRF unless special circumstances warrant these funds be carried over and applied against current fiscal year charges. In April 2003, DOJ returned $20 million of unused fiscal year funds. At September 30, 2003, DOJ had $19.9 million in unused funds that were applied against FY 2004 charges of $53.2 million.

Guarini Litigation
Paralleling the goodwill cases are eight similar cases alleging that the government breached agreements regarding tax benefits associated with certain FSLIC-assisted acquisitions. These agreements allegedly contained the promise of tax deductions for losses incurred on the sale of certain thrift assets purchased by plaintiffs, from the FSLIC, even though the FSLIC provided the plaintiffs with tax-exempt reimbursement. A provision in the Omnibus Budget Reconciliation Act of 1993 (popularly referred to as the "Guarini legislation") eliminated the tax deductions for these losses.

To date, there have been liability determinations in six of the eight "Guarini" cases. The United States Court of Federal Claims has entered an award for the plaintiffs in three of these cases and appeals have been filed by DOJ. A decision on liability has not been made in the seventh case, and the eighth case was settled during 2002 for $20 thousand.

The FDIC believes that it is possible that substantial amounts may be paid from the FRF-FSLIC as a result of the judgments and settlements from the "Guarini litigation." However, because the litigation of damages computation is still ongoing, the amount of the damages is not estimable at this time.

Representations and Warranties
As part of the RTC's efforts to maximize the return from the sale of assets from thrift resolutions, representations and warranties, and guarantees were offered on certain loan sales. The majority of loans subject to these agreements have most likely been paid off or refinanced due to the current interest rate climate or the period for filing claims has expired. However, there is no reporting mechanism to determine the aggregate amount of remaining loans. Therefore, the FDIC is unable to provide an estimate of maximum exposure to the FRF. Based on the above and our history of claims processed, the FDIC believes that any future representation and warranty liability to the FRF would be minimal.

5. Provision for Losses

The provision for losses was a negative $58 million and a negative $149 million for 2003 and 2002, respectively. In 2003, the negative provision was primarily due to lower estimated losses for assets in liquidation and recoveries of net tax benefits sharing from assistance agreements. The negative provision in 2002 was primarily due to the recoveries of net tax benefits sharing from assistance agreements.

6. Resolution Equity

As stated in the Legislative History section of Note 1, the FRF is comprised of two distinct pools: the FRF-FSLIC and the FRF-RTC. The FRF-FSLIC consists of the assets and liabilities of the former FSLIC. The FRF-RTC consists of the assets and liabilities of the former RTC. Pursuant to legal restrictions, the two pools are maintained separately and the assets of one pool are not available to satisfy obligations of the other.

The following table shows the contributed capital, accumulated deficit, and resulting resolution equity for each pool.

Resolution Equity at December 31, 2003
Dollars in Thousands

	FRF-FSLIC	FRF-RTC	FRF Consolidated
Contributed capital - beginning	$ 44,178,484	$ 82,649,337	$ 126,827,821
Add: U.S. Treasury payments for goodwill settlement	30	0	30
Less: REFCORP payments	0	(450,000)	(450,000)
Contributed capital - ending	**44,178,514**	**82,199,337**	**126,377,851**
Accumulated deficit	(41,241,633)	(81,721,303)	(122,962,936)
Less: Unrealized gain on available-for-sale securities	0	41,499	41,499
Accumulated deficit, net	**(41,241,633)**	**(81,679,804)**	**(122,921,437)**
Total	**$ 2,936,881**	**$ 519,533**	**$ 3,456,414**

Contributed Capital
To date, the FRF-FSLIC and the former RTC received $43.5 billion and $60.1 billion from the U.S. Treasury, respectively. These payments were used to fund losses from thrift resolutions prior to July 1, 1995. Additionally, the FRF-FSLIC issued $670 million in capital certificates to the FICO and the RTC issued $31.3 billion of these instruments to the REFCORP. FIRREA prohibited the payment of dividends on any of these capital certificates. Through December 31, 2003, the FRF-RTC has returned $4.556 billion to the U.S. Treasury and made payments of $4.572 billion to the REFCORP. These actions serve to reduce contributed capital.

Accumulated Deficit
The accumulated deficit represents the cumulative excess of expenses over revenue for activity related to the FRF-FSLIC and the FRF-RTC. Approximately $29.8 billion and $87.9 billion were brought forward from the former FSLIC and the former RTC on August 9, 1989, and January 1, 1996, respectively. The FRF-FSLIC accumulated deficit has increased by $11.4 billion, whereas the FRF-RTC accumulated deficit has decreased by $6.3 billion, since their dissolution dates.

7. Employee Benefits

Pension Benefits
Eligible FDIC employees (permanent and term employees with appointments exceeding one year) are covered by the federal government retirement plans, either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). Although the FRF contributes a portion of pension benefits for eligible employees, it does not account for the assets of either retirement system. The FRF also does not have actuarial data for

accumulated plan benefits or the unfunded liability relative to eligible employees. These amounts are reported on and accounted for by the U.S. Office of Personnel Management.

The FRF's pro rata share of pension-related expenses was $2.2 million and $4.6 million, as of December 31, 2003 and 2002, respectively.

Postretirement Benefits Other Than Pensions
Beginning in 2003, the FRF no longer records a liability for the postretirement benefits of life and dental insurance as a result of FDIC's change in funding policy for these benefits and elimination of the separate entity. In implementing this change, management decided not to allocate either the plan assets or the revised net accumulated postretirement benefit obligation (a long-term liability) to FRF due to the expected dissolution of the Fund in the short-term. However, FRF does continue to pay its proportionate share of the yearly claim expenses associated with these benefits.

8. Supplementary Information Relating to the Statements of Cash Flows

Reconciliation of Net Income to Net Cash Provided by Operating Activities for the Years Ended December 31
Dollars in Thousands

	2003	2002
Net Income	$ 52,337	$ 490,545
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities		
Change in Assets and Liabilities:		
Decrease (Increase) in receivables from thrift resolutions and other assets	46,410	(213,791)
Increase (Decrease) in accounts payable and other liabilities	4,973	(379)
Increase (Decrease) in contingent liabilities for litigation losses and other	623	(4,758)
Net Cash Provided by Operating Activities	$ 104,343	$ 271,617

Appendix I

Comments from the Federal Deposit Insurance Corporation

FDIC
Federal Deposit Insurance Corporation
550 17th St. NW Washington DC, 20429
Deputy to the Chairman & Chief Financial Officer

February 9, 2004

Mr. David M. Walker
Comptroller General of the United States
U. S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Re: FDIC Management Response on the GAO 2003 Financial Statements Audit Report

Dear Mr. Walker:

Thank you for the opportunity to comment on the U. S. General Accounting Office's (GAO) draft audit report titled, Financial Audit: Federal Deposit Insurance Corporation Funds' 2003 and 2002 Financial Statements, GAO-04-429. The report presents GAO's opinions on the calendar year 2003 financial statements of the Bank Insurance Fund (BIF), the Savings Association Insurance Fund (SAIF), and the Federal Savings and Loan Insurance Corporation Resolution Fund (FRF). The report also presents GAO's opinion on the effectiveness of FDIC's internal controls as of December 31, 2003 and GAO's evaluation of FDIC's compliance with applicable laws and regulations.

We are pleased to accept GAO's unqualified opinions on the BIF, SAIF, and FRF financial statements and to note that there were no material weaknesses identified during the 2003 audits. The GAO reported that: the funds' financial statements were presented fairly and in conformity with U. S. generally accepted accounting principles; FDIC had effective internal control over financial reporting (including safeguarding of assets) and compliance with laws and regulations; and there were no instances of noncompliance with selected provisions of laws and regulations.

GAO identified the need to improve internal control over FDIC's information systems (IS) and issued a reportable condition. Although GAO identified weaknesses in FDIC's IS controls, the audit team noted that significant improvements had been made during the past year, and that the weaknesses did not materially affect the 2003 financial statements. We acknowledge GAO's assessment of both the status and the substantial progress made in addressing the IS control environment. During 2003, FDIC's accomplishments included implementation of a recurring IS controls self assessment program, implementation of more stringent contractor personnel clearance and site security policies and procedures, and establishment of an aggressive patch management program. The FDIC will continue efforts to strengthen its ongoing, comprehensive information security program during 2004.

If you have any questions or concerns, please let me know.

Sincerely,

Steven O. App

Steven O. App
Deputy to the Chairman
and Chief Financial Officer

Appendix II

GAO Contacts and Staff Acknowledgments

GAO Contacts

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Acknowledgments

In addition to those named above, the following staff made key contributions to this report: Ronald A. Bergman, Gary P. Chupka, John C. Craig, Anh Dang, Kristen A. Kociolek, Wing Y. Lam, Timothy J. Murray, Saurav B. Prasad, Lori Ryza, Ed Tanaka, Stacey L. Volis, and Gregory J. Ziombra.

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Testimony

Before the Subcommittee on Oversight and Investigations
Committee on Financial Services
U.S. House of Representatives

Oversight Hearing of the FDIC: Perspective of the Office of Inspector General

Statement of Gaston L. Gianni, Jr.
Inspector General

Madam Chairwoman and Members of the Subcommittee, I am pleased to testify before you today as you conduct this oversight hearing on the Federal Deposit Insurance Corporation (FDIC).

The FDIC has a long and successful tradition of maintaining public confidence and stability in the nation's financial system. The Corporation reports that financial institutions have recently had record earnings. The rate of bank failures has remained at a relatively low level over the past 10 years, and the Corporation has substantially reduced its estimates of future losses from failures. Assets held in receiverships are at comparatively low levels, and significant progress has been made at closing out older receiverships. The insurance funds are now comfortably above the designated reserve ratio that could otherwise trigger increases in premiums assessed on insured depository institutions. These are important indicators of a healthy banking system, and the Corporation can take pride in its positive contributions to each of these areas.

Likewise, I am proud of the accomplishments of the Office of Inspector General (OIG) in seeking to ensure the Corporation's successful accomplishment of its mission. The FDIC OIG was established in 1989, pursuant to the Inspector General (IG) Act Amendments of 1988. The Congress amended the IG Act in 1993 to designate the IG position at the FDIC as a Presidential appointment. Since April 1996 I have served as the first FDIC IG appointed by the President. Thus, my perspective spans many key developments in the FDIC's recent history, and today I offer my thoughts on current challenges at the Corporation and the results of some of our FDIC mission-related work. At the outset I would like to acknowledge a very significant recent event: the Congressional confirmation of Thomas J. Curry as the Corporation's fifth member of the Board of Directors in December 2003. With this appointment, the Board is now operating at full-strength for the first time since September 1998—a very positive aspect of its internal governance structure.

Role of the OIG and Relationship With the Corporation

The role of an IG in any agency is unique. To illustrate—at the FDIC, although we are an integral part of the Corporation, unlike any other FDIC division or office, our legislative underpinning requires us to operate as an independent and objective unit at the same time. Within that framework, we have two essential roles: through a comprehensive program of audits, evaluations, and investigations, we (1) independently analyze and report on significant management and performance challenges facing the Corporation and (2) foster integrity, accountability, and excellence in FDIC programs and operations. Both the Chairman and Vice Chairman of the FDIC provide a supportive "tone at the top" that enables us to carry out our statutory responsibilities. In doing so, we coordinate extensively not only with the Corporation, but with other federal Offices of Inspector General, the U.S. General Accounting Office, the Office of Management and Budget (OMB), and for investigations, with the Department of Justice, Federal Bureau of Investigation (FBI), Secret Service, Internal Revenue Service (IRS), and other law enforcement agencies. We report our results both to the Chairman of the Corporation and to the congressional committees with related oversight responsibilities.

We have an excellent working relationship with the Corporation and are committed to continuing that relationship into the future. This relationship has been established over the years through

such efforts as issuance of audit reports with recommendations in response to which the Corporation takes corrective action; monthly meetings with the FDIC's Audit Committee, where we present the results of our work to seniormost management; cooperative investigative efforts and "lessons learned" sharing among OIG special agents and FDIC division and office staffs regarding their investigations; OIG advisory involvement with major corporate initiatives such as the redesign of the bank examination process, the new interagency Central Data Repository for bank call reporting and other regulatory reports, the new solution to better manage bank and thrift asset servicing functions, and the Chief Information Officer's Council; OIG review and comment on proposed corporate policy and strategic planning documents and initiatives; and frequent and honest communication between OIG management and corporate senior management in the FDIC's headquarters and field offices.

Fiscal Year 2003 OIG Program Accomplishments

The OIG continues to add significant value to the FDIC. Net savings to the Corporation, comparing actual and potential monetary benefits from OIG work to OIG expenses, have averaged about $294 million annually over the last 5 years. The OIG also provides substantial non-monetary value to the FDIC with advice and recommendations related to management practices and the results of our law enforcement operations. In fiscal year 2003, overall results of OIG audits, investigations, and evaluations included:

- $96.8 million in actual and potential monetary benefits (investigations/audits/evaluations)
- 193 non-monetary recommendations to FDIC management (audits/evaluations)
- 35 referrals to the Department of Justice
- 43 indictments/informations
- 22 convictions
- 5 employee/disciplinary actions

The more specific major OIG accomplishments for fiscal year 2003 include the following:

- Opened 40 investigative cases and closed 43. The investigations during the year led to indictments or criminal charges against 43 individuals and 35 referrals to the Department of Justice, 22 convictions, 5 employee disciplinary actions, and 1 contractor action. This resulted in fines, court-ordered restitution, and recoveries of approximately $94 million.

- Referred 24 substantive Hotline allegations for review or investigation and closed 13 cases of which 2 were substantiated.

- Issued 40 audit reports on the results of OIG audit work. These final products identified $431,473 in questioned costs and approximately $2.1 million in funds that could be put to better use. The audit reports contained 169 non-monetary recommendations to FDIC management to improve internal controls and operational effectiveness in diverse aspects of the Corporation's operations, including automated systems, contracting, bank supervision, financial management, and asset disposition. The reports also covered legislatively mandated reviews of failed financial institutions that resulted in material

losses to the insurance fund and an independent evaluation of the FDIC's information security program for 2003.

- Issued 7 evaluation reports. These final products identified $127,396 in funds that could be put to better use. The scope of work covered a wide range of issues, which included studies of the FDIC's progress in implementing the Gramm-Leach-Bliley Act; the FDIC's corporate readiness plan; life-cycle management of information technology assets; and business continuity planning at FDIC-supervised institutions. The evaluation reports contained 24 recommendations for improvements that were accepted by the Corporation. Subjects of evaluations originated from FDIC management requests and congressional inquiries and within the OIG.

Management and Performance Challenges

Today I would like to present the overall framework under which we carry out the IG mission at the FDIC—that is, the OIG-identified management and performance challenges. I will also discuss more specifically the results of some of our efforts to address those challenges. My remarks are intended to underscore our overarching goal of assisting the Corporation in accomplishing its mission; explain the extent and focus of OIG coverage; and attest to the Corporation's responsiveness to our audit, investigative, and other work.

In the spirit of the Reports Consolidation Act of 2000, we annually identify the top management and performance challenges facing the FDIC. We have worked with the FDIC to prepare our annual assessment. These challenges are included in the FDIC's annual consolidated performance and accountability report. Our update of the challenges as of December 19, 2003, was included in the FDIC's performance and accountability report dated February 13, 2004. The challenges capture the risks and opportunities we see before the Corporation in the coming year or more. In addition, these challenges serve as a guide for our work. Notwithstanding the current strength of the banking industry, the Corporation must continue to be vigilant because challenges are ever-present and can threaten the Corporation's success. The OIG identified the following ten:

Adequacy of Corporate Governance in Insured Depository Institutions
Protection of Consumer Interests
Management and Analysis of Risks to the Insurance Funds
Effectiveness of Resolution and Receivership Activities
Management of Human Capital
Management and Security of Information Technology Resources
Security of Critical Infrastructure
Management of Major Projects
Cost Containment and Procurement Integrity
Assessment of Corporate Performance

The first four challenges address the more global issues confronting the Corporation. I will focus on our work in these areas followed by more summary coverage of the other six items listed

which relate more to corporate management and operational challenges. Examples of our work in all of these areas include audit, evaluation, investigation, and other efforts.

Adequacy of Corporate Governance in Insured Depository Institutions

Corporate governance is broadly defined as the fulfillment of the broad stewardship responsibilities entrusted to the Board of Directors, Officers, and internal and external auditors of a corporation. Pubic outcry over recent failures of, and scandals at, major U.S. corporations attributed at least in part to lax corporate governance led to the passage of the Sarbanes-Oxley Act of 2002. I was pleased to testify before then Chairman Sarbanes and the Senate Committee on Banking, Housing and Urban Affairs on February 7, 2002, concerning one such failure, Superior Bank, Hinsdale, Illinois. The FDIC was appointed as receiver of this failed institution on July 27, 2001, at which time the Corporation recorded an estimated loss to the Savings Association Insurance Fund of $426 million. We found that the:

- Board of Directors and Officers did not require adequate risk management and diversification, failed to ensure adherence to laws and regulations, disregarded bank examiner recommendations, and used flawed accounting practices to overstate the value of assets.
- External auditors did not detect material misstatements in the financial statements resulting from improper accounting.

As a result, dividends and other fund transfers to shareholders totaling over $200 million were made based on overstated income, substantially increasing the loss recorded by the FDIC at the time of failure.

We have repeatedly found that inadequate corporate governance at an institution is at the heart of the most costly bank failures. As mandated by the Federal Deposit Insurance Act, we perform reviews to ascertain among other things why a bank's problems result in material loss to the insurance funds. (A material loss is generally defined as one exceeding the greater of $25 million or 2 percent of the institution's total assets at the time the FDIC is appointed receiver.) In two material loss reviews completed last year involving the Connecticut Bank of Commerce, Stamford, Connecticut, and Southern Pacific Bank, Torrance, California, we concluded that ineffective corporate governance was the primary cause of failures that led to an estimated loss of almost $200 million to the insurance funds.

Our work on eight other material loss reviews we have conducted since 1993 also identified inadequate corporate governance as the primary cause of each failure. We found that institutions pursued high-risk business strategies, implemented lax lending policies, understated loan loss allowances, ignored auditor and bank examiner findings, and disregarded or circumvented various laws and banking regulations. Generally, independent public accountants continued to issue clean opinions even after bank examiners detected potentially material misstatements in financial statements.

The FDIC's mission to help ensure the safety and soundness of the Nation's financial system is partly dependent on the reliability of the assertions and financial reporting by institutions.

Problems with corporate governance can compromise the integrity of information provided to the FDIC and result in significant losses to the insurance funds.

For its part, the Corporation reports that in response to questions about the applicability of the Sarbanes-Oxley Act to insured depository institutions that are not public companies, it issued comprehensive guidance in March 2003, describing significant provisions of the Act and related rules of implementation adopted by the Securities and Exchange Commission. The guidance explained how adopting sound corporate governance practices outlined in the Act may benefit banking organizations, including those that are not public companies, and how several of the Act's requirements mirror existing banking agency policy guidance related to corporate governance. We have an active program of coverage related to corporate governance within the banking industry that will include a review of the implementation of the Sarbanes-Oxley Act and related banking regulations this year.

I turn now to some of our investigative work. In a number of cases, financial institution fraud is a principal contributing factor to an institution's failure. Unfortunately, the principals of some of these institutions—that is, those most expected to ensure safe and sound corporate governance—are at times the parties perpetrating the fraud. Our Office of Investigations plays a critical role in investigating such activity. A recent OIG investigative case illustrates the extent to which fraud wrecks havoc on an institution.

Oakwood Deposit Bank Company: The FDIC closed Oakwood Deposit Bank on February 1, 2002, after the discovery of information indicating irregularities in the amount of deposits reported in the records of the bank. The FDIC OIG, IRS, and FBI began an investigation shortly thereafter. On September 5, 2003, the former president and chief executive officer of Oakwood was sentenced for his role in a bank embezzlement and money laundering scheme that caused the failure of the 99-year old bank. According to his plea agreement, the former president began embezzling funds from the bank in 1993. He admitted that he altered bank records and created paperwork to conceal the embezzlement, which resulted in losses to the bank of approximately $48.7 million and led to the bank's insolvency. The former president was sentenced to 14 years' imprisonment to be followed by 5 years of supervised release and was ordered to pay $48.7 million in restitution.

As part of his guilty plea, the former president forfeited any and all of his interest in property controlled by Stardancer Casinos Inc. and its subsidiaries as he was an investor and part owner of Stardancer. He forfeited bank accounts relating to Stardancer and two other companies; real estate and investments in Florida, Ohio, Texas, and South Carolina; his interest in any of the Stardancer vessels and equipment; $520,450 in currency seized by the government; and other properties he owned but that were not identified in the investigation as the proceeds of criminal activities. As a part of this ongoing investigation, search and seizure warrants were executed on multiple Stardancer properties, bank accounts, vessels, and offices. Much of the property was later sold at a Treasury Department auction for a total of approximately $2.2 million.

The FDIC's Legal Division and Division of Resolutions and Receiverships have provided invaluable assistance throughout the investigation.

In the interest of effective communication and information-sharing, our office engages in frequent dialog with the Corporation regarding these types of ongoing investigations of fraud at failed and open institutions. We meet with corporate officials in headquarters and field offices to review the cases highlighted in these reports, discuss trends and findings, and offer ways in which our work can facilitate enforcement actions that the FDIC may be pursuing. We also coordinate closely with the Corporation when working with U.S. Attorneys' Offices on plea agreements with defendants who have defrauded financial institutions. In such cases, we attempt to have language included in the plea agreement to have the defendant stipulate to a prohibition from future participation in the banking industry. We also share with the Corporation "lessons learned" from such cases of financial institution fraud.

Protection of Consumer Interests

The availability of deposit insurance to protect consumer interests is a very visible way in which the FDIC maintains public confidence in the financial system. Additionally, as a regulator, the FDIC oversees a variety of statutory and regulatory requirements aimed at protecting consumers from unfair and unscrupulous banking practices. The FDIC, together with other primary Federal regulators, has responsibility to help ensure bank compliance with statutory and regulatory requirements related to consumer protection, civil rights, and community reinvestment. Our recent coverage in this area includes the following:

Gramm-Leach-Bliley Act (GLBA) Compliance: Title V of the GLBA established major privacy provisions under two important subtitles, A and B. One provides a mechanism to protect the confidentiality of a consumer's nonpublic personal information. The other prohibits "pretext calling," which is a deceptive practice used to obtain information on the financial assets of consumers. The FDIC had made progress in implementing GLBA Title V provisions related to safeguarding customer information and privacy notice requirements and modest progress in implementing provisions related to fraudulent access to financial information, and in particular identity theft and pretext calling. We recommended modifications to related examination procedures to ensure full implementation of GLBA Title V privacy provisions and issuance of standardized guidance for reporting institution compliance with standards for safeguarding customer information. The Corporation issued guidance addressing our findings in a Regional Directors Memorandum.

Fair Lending: The Fair Lending Act is generally intended to eliminate discrimination in bank lending practices. The FDIC performs compliance examinations to help ensure that the institutions it supervises comply with this Act and other statutory requirements. We found that interagency fair lending procedures used in these examinations did not provide adequate guidance for conducting reviews of FDIC-supervised institutions, particularly on issues related to conducting reviews of small banks, banks that are not otherwise required to collect certain personal information, or commercial loan products. Also, due to the lack of available monitoring and demographic data, examiners were often unable to determine the potential for discrimination for many of the prohibited bases covered by the Fair Housing Act and the Equal Credit Opportunity Act. The Corporation issued supplemental guidance, conducted workshops, and initiated a referral and consultation program for its examiners to address the issues identified in our report.

Another area where the OIG is involved with Consumer Protection relates to our investigative cases regarding misrepresentations of FDIC insurance or affiliation to unsuspecting consumers. Recently our Electronic Crimes Team has been involved in investigating emerging e-mail "phishing" identity theft schemes that have used the FDIC's name in an attempt to obtain personal data from unsuspecting consumers who receive the emails. Our investigations have also uncovered multiple schemes to defraud depositors by offering them misleading rates of returns on deposits. These abuses are effected through the misuse of the FDIC's name, logo, abbreviation, or other indicators suggesting that the products are fully insured deposits. Such misrepresentations induce the targets of schemes to invest on the strength of FDIC insurance while misleading them as to the true nature of the investments being offered. These depositors, who are often elderly and dependent on insured savings, have lost millions of dollars in such schemes. In one case, $9.1 million worth of certificates of deposit were misrepresented to about 90 investors, most of whom were elderly. Abuses of this nature not only harm innocent victims but may also erode public confidence in federal deposit insurance.

Our experience with such cases prompted us on March 4, 2003, to submit to Chairman Oxley a legislative proposal to prevent misuse of the Corporation's guarantee of insurance. This proposal was incorporated in H.R. 1375: Financial Services Regulatory Relief Act of 2003, approved by the House Financial Services Committee by voice vote on May 20, 2003. Section 615 of H.R. 1375, as we suggested, would provide the FDIC with enforcement tools to limit misrepresentations regarding FDIC deposit insurance coverage. We appreciate the Committee's support of this proposal.

Management and Analysis of Risks to the Insurance Funds

The FDIC seeks to ensure that failed financial institutions are and continue to be resolved within the amounts available in the insurance funds and without recourse to the U.S. Treasury for additional funds. Achieving this goal is a significant challenge because the insurance funds generally average just over 1.25 percent of insured deposits and the FDIC supervises only a portion of the insured institutions. In fact, the preponderance of insured assets are in institutions supervised by other Federal regulators. Therefore, the FDIC has established strategic relationships with the other regulators surrounding their shared responsibility of helping to ensure the safety and soundness of the Nation's financial system. Economic factors also can pose a considerable risk to the insurance funds. The FDIC actively monitors such factors as interest rate margins and earnings in the financial sector in an effort to anticipate and respond to emerging risks.

One of the key tools used by the FDIC is its safety and soundness examination process which, when combined with off-site monitoring and extensive industry risk analysis, generally provides an early warning and corrective action process for emerging risks to the funds. The FDIC examiners operate in a rapidly changing risk environment due to such factors as technology, the routine introduction of new and more complex banking products, and the threat of terrorist activity. Therefore, we focus considerable audit resources on the various examination processes used by the FDIC to achieve its mission. Our recent coverage in this area includes the following audits:

Prompt Corrective Action (PCA): Capital is an important part of reducing or eliminating losses to the insurance funds in the event of a failing or failed financial institution. The Federal Deposit Insurance Act and implementing regulations require progressive action to be taken in the event institution capital declines below a "well-capitalized" level up to and including closing the institution in the event it is critically undercapitalized without a sound plan for recovery. We concluded that because of PCA provisions, insurance fund losses were prevented in cases where the sufficiency of remaining capital facilitated the sale of the institution, and losses were reduced when institutions were closed before they became insolvent.

We identified a number of factors that delay the use of PCA and impact the effectiveness of its capital-related provisions. We also observed that the FDIC seldom used the non-capital provisions of PCA. These provisions would permit regulators to take progressive action based on factors other than capital. Our analyses of these provisions indicated that they do not provide objective or measurable criteria for implementation and, in some instances, placed restrictions on their use. We concluded that legislative and regulatory changes were required if the Congress desires to add uniform bank performance ratings or some other objective criteria as the trigger for implementing the non-capital provisions or allow earlier implementation of corrective action. We included several options to improve the effectiveness of PCA in our semiannual report to the Congress.

USA PATRIOT Act Implementation: The USA PATRIOT Act broadens the authority and required regulations to combat money laundering that were already established under the Bank Secrecy Act of 1970, as amended. The Bank Secrecy Act was intended to deter banks and other financial service providers from being used as intermediaries for, or to hide the transfer or deposit of money derived from, criminal activity. Among other provisions, the USA PATRIOT Act expanded the: due diligence requirements related to customer identification; the anti-money laundering umbrella to include industries not previously subject to these provisions such as sellers and redeemers of money orders; and criminal sanctions for money laundering.

We determined that the FDIC's existing Bank Secrecy Act examination procedures covered the USA PATRIOT Act requirements to some degree, and the FDIC had advised the institutions it supervises of the new requirements in cases in which the Department of the Treasury had issued final rules. However, the FDIC had not issued guidance to its examiners for those provisions requiring new or revised examination procedures. This delay in issuing examination guidance was of particular concern where Treasury had issued final rules addressing money laundering deterrents and verification of customer identification. The FDIC took swift action to issue interim examiner guidance as a result of our audit.

Effectiveness of Resolution and Receivership Activities

One of the FDIC's primary corporate responsibilities includes planning and efficiently handling the resolutions of failing FDIC-insured institutions and providing prompt, responsive, and efficient administration of failing and failed financial institutions. In this regard, protecting the

depositors of insured banks and savings associations is a unique responsibility for the FDIC. Notably, since the FDIC's inception over 70 years ago, no depositor has ever experienced a loss of insured deposits at an FDIC-insured institution due to a failure.

During 2003, the FDIC resolved three financial institution failures. These failed institutions had a total of $1.1 billion in assets and $908.6 million in deposits. Within 1 business day after each failure, the FDIC had issued payout checks to insured depositors, or worked with open institutions to ensure that depositors had access to their insured funds. In addition, the FDIC continues to manage over $800 million in total assets in liquidation from these and past institution failures.

Given the importance of this aspect of the FDIC mission, we performed recent reviews covering several significant areas. Of particular note, we evaluated the **FDIC Corporate Readiness Plan** for responding to a series of institution failures. We found that the FDIC readiness planning was sufficient to handle a wide range of institution failures without significantly disrupting the accomplishment of other key aspects of the corporate mission. This means that insured depositors will likely receive prompt access to their deposits in the event of one or a series of smaller bank failures. The FDIC is also working on plans to resolve the failure of a megabank that we plan to evaluate in the near future. The OIG's other work in the resolution and receivership area includes the following:

Insurance Determinations: We found that the FDIC was making accurate insurance determinations for over 99 percent of the dollars reviewed. In the interest of process improvement and possible cost savings, we recommended a process be established to test the accuracy of insurance determinations and evaluate the test results in relationship to established benchmarks. The Corporation will be addressing our recommendation as part of its ongoing deposit insurance claims reengineering process.

Receivership Management: The FDIC uses a Service Costing System to ensure that FDIC-established receiverships are properly billed for their fair share of indirect expenses. In the 10-month period ended October 31, 2003, the FDIC billed 120 receiverships over $33 million. We found that during 2003, the FDIC process for billing receiverships had improved. However, we identified opportunities to enhance the FDIC's ability to document that established rates were fair and reasonable. The Corporation will be improving analyses, enhancing reports and cost data, and conducting training to provide greater assurance that receiverships are properly billed.

Asset Valuations: We found that for the two FDIC-insured depository institutions that we reviewed, asset valuations for traditional assets sold were reasonably accurate. Valuations for non-traditional, or unique, assets varied substantially from the actual net sales proceeds. We recommended measures to improve the Corporation's valuation of non-traditional assets. In response to our audit, the Corporation modified its performance reporting and has established a strategic goal for reviewing best practices and developing procedures for valuing unique assets.

The FDIC initiated a number of projects in 2003 to better manage and leverage its resources to meet potential challenges in the resolution of future financial institution failures. These projects include the Corporate Readiness Plan discussed above, the Asset Servicing Technology Enhancement Project, a lessons learned from bank failures symposium, and a Web site to provide instant access to the most current information available to institutions via the Internet.

As referenced earlier, the OIG's Office of Investigations coordinates closely with the FDIC's Division of Resolutions and Receiverships and with the Legal Division regarding ongoing investigations involving fraud at failed institutions, fraud by FDIC debtors, and fraud in the sale or management of FDIC assets. In particular, investigators coordinate closely with the Corporation to address issues arising in connection with the prosecution of individuals who have illegally concealed assets in an attempt to avoid payment of criminal restitution to the FDIC. As of September 30, 2003, the FDIC was owed approximately $1.7 billion in criminal restitution. In most cases, the convicts subject to restitution orders do not have the means to pay. We focus our investigations on those individuals who do have the means to pay but hide their assets from and/or lie about their ability to pay. We are having success in this area, as evidenced by the recent charging of the former Chief Executive Officer of Sunbelt Savings in a 21-count indictment, which included seven counts of concealing assets from the FDIC. This individual engaged in a scheme to defraud the FDIC of its payments under a $7.5 million restitution order and an $8.5 million civil judgment. If convicted, he faces a maximum sentence of 125 years' imprisonment and a $5.5 million fine and restitution.

We meet quarterly with corporate representatives to discuss developments in these cases of mutual interest. We are currently working with the Corporation on a project to establish a common methodology for preservation of records, including electronic records, at bank closings. Through our Electronic Crimes Team, we share data we have imaged at bank closings and provide advice on technology that could be useful to the FDIC at bank closings.

Corporate Management and Operational Challenges

I now will speak to more internal management and operational challenges facing the Corporation.

In August 2001, President Bush launched the "President's Management Agenda" (PMA) targeted to address the most apparent deficiencies in government where the opportunity to improve performance was the greatest. The President called for a government that is active but limited, that focuses on priorities and does them well. The FDIC, to its credit, has given priority attention to improving operational efficiency and effectiveness, consistent with the principles set forth in the PMA. That being said, the Corporation faces several continuing challenges, most notably in the areas of human capital, management and security of information technology resources, and stewardship of resources. The Corporation also needs to continue to focus on performance measures to track progress on all of its corporate goals and objectives.

Human capital issues pose significant elements of risk that interweave all the management and performance challenges facing the FDIC. The FDIC has been in a downsizing mode for the past 10 years as the workload from the banking and thrift crises has been accomplished. As a result,

FDIC executives and managers must be diligent and continually assess the goals and objectives, workload, and staffing of their organizations and take appropriate steps to ensure that the workforce has the right experience and skills to fulfill its mission. The Corporation has created the Corporate University to address skill levels and preserve institutional knowledge in its five main lines of business. The Corporation is also in the process of revamping its compensation program to place greater emphasis on performance-based incentives.

We recently completed an evaluation in which we concluded that the Corporation's human capital framework addresses the underlying human capital concepts that the Office of Personnel Management, Office of Management and Budget, and the U.S. General Accounting Office consider vital to successful human capital management. We did, however, recommend and the FDIC agreed to strengthen its human capital program by institutionalizing the Human Resources Committee, an element of its human capital framework, and developing a human capital blueprint. Taking these actions will sustain the FDIC's long-term commitment and focus on strategic human capital management and will maintain transparency in the development, implementation, and monitoring of human capital initiatives. We have a series of reviews planned to address the various components of the Corporation's human capital program, with the next being strategic workforce planning.

Management and security of information technology resources remains one of the Corporation's most expensive and daunting challenges. Information technology (IT) continues to play an increasingly greater role in every aspect of the FDIC mission. Our work required under the Federal Information Security Management Act of 2002 has shown that the Corporation has worked hard to implement many sound information system controls to help ensure adequate security. However, daunting challenges remain due to the ever-increasing threat posed by hackers and other illegal activity. We have urged the FDIC to stay the course in developing an enterprise-wide IT architecture that maps the current and "to be" states of business processes and the supporting information systems and data architecture. Additionally, we have emphasized completing system certification and accreditation processes to test the security of deployed IT assets. We have completed and ongoing assignments covering the IT capital planning and investment control process to assist the Corporation in this area. Finally, we are pleased that the Corporation has appointed a permanent Chief Information Officer to guide its IT efforts, particularly from a strategic standpoint, but many key IT security positions remain to be filled, and the Corporation is in the midst of an internal assessment aimed at improving the skill mix of its IT personnel and business processes.

Stewardship of resources has been a focus of the FDIC's current Chairman. As steward for the insurance funds, the Chairman has embarked on a campaign to identify and implement measures to contain and reduce costs, either through more careful spending or assessing and making changes to business processes to increase efficiency. We are initiating a number of audits in the near future to assist the Chairman in his efforts.

A key challenge to containing costs relates to the contracting area. The Corporation has taken a number of steps to strengthen controls and oversight of contracts. However, our work in this area continues to show further improvement is needed to reduce risks, such as consideration of contractor security in acquisition planning and oversight of contractor security practices. We

also have a contract audit program that looks at the reasonableness and support for billings on significant Corporation contracts and, as needed, evaluates contract award processes. Over the past 2 years, we have issued 15 reports with potential monetary benefits of $4.2 million, and we have recommended various means for protecting the Corporation's interests in the contracting arena.

An emerging risk that we have identified is project management. The FDIC is engaged in several complex multi-million dollar software development projects as well as the construction of Phase II of its Virginia Square facility. We have done several reviews of these projects, and each pointed to the need for improved defining, planning, scheduling, and controlling of resources and tasks to reach goals and milestones. The Corporation has included a project management initiative in its 2004 performance goals and established a program management office to address the risks and challenges that these kinds of projects pose.

Assessment of corporate performance is a key challenge because good intentions and good beginnings are not the measure of success. What matters in the end is completion: performance and results. To that end, the Government Performance and Results Act (Results Act) of 1993 was enacted to improve the efficiency, effectiveness, and accountability of federal programs by establishing a system for setting goals, measuring performance, and reporting on accomplishments. The current administration has raised the bar further in this area. Specifically, OMB is using an Executive Branch Management Scorecard to track how well departments and agencies are executing the management initiatives, and where they stand at a given point in time against the overall standards for success. OMB has also introduced the Program Assessment Rating Tool (PART) to evaluate program performance, determine the causes for strong or weak performance, and take action to remedy deficiencies and achieve better results.

The Corporation has made significant progress in implementing the Results Act, with which it is required to comply. Over the years, it has developed more outcome-oriented performance measures, better linked performance goals and budgetary resources, and improved processes for verifying and validating reported performance. While the FDIC is not included on the Management Scorecard nor required to submit a PART to the OMB, some of the Corporation's divisions have begun using a "scorecard" approach to monitoring and evaluating performance, and we encourage broader use of these tools.

My office has played an active role in evaluating the Corporation's efforts in this area. We have conducted reviews of the processes used for verifying and validating data and made recommendations that the Corporation adopted. We have also evaluated the Corporation's budget and planning process and intend to do so again because significant changes have been made to bring down the cost of formulating and executing the budget and more effectively link it to performance goals. Finally, as part of the Corporation's overall planning process, we provide input and our perspective annually on the FDIC's strategic goals and objectives. In doing so, we have pointed to the need to better align the strategic and annual planning process under the Results Act with the separate process used to develop detailed annual corporate performance objectives and initiatives designed to accomplish the Chairman's priorities.

Conclusion

Madam Chairwoman, in closing, I would like to reiterate several points I made earlier. Members of my office are committed to continuing to carry out the IG mission at the FDIC and privileged to be public servants with the responsibility for doing so. The OIG has an excellent working relationship with the Corporation. I hope my remarks have served to shed light on the types of issues we have been raising and resolving with the Corporation over the last several years, and I appreciate this Subcommittee's support of our efforts. I invite you to visit our Web site: www.fdicig.gov for further information about the OIG and for the full text of reports discussed in my testimony today. I would be pleased at this time to answer any questions that you or the other Subcommittee Members may have.

STATEMENT OF

DONALD E. POWELL
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

OVERSIGHT HEARING

on the

FEDERAL DEPOSIT INSURANCE CORPORATION

before the

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

of the

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

March 4, 2004
Room 2128, Rayburn House Office Building

Chairwoman Kelly, Congressman Gutierrez and members of the Subcommittee, thank you for the opportunity to testify at today's oversight hearing on the Federal Deposit Insurance Corporation. My testimony will briefly discuss the condition of the deposit insurance funds, the need for deposit insurance reform, the condition of the banking industry, and our efforts to reshape the FDIC for the future. Much of my testimony will focus on the issues facing the industry and the regulatory community and the initiatives the FDIC is taking to address these issues.

The Condition of the Deposit Insurance Funds

The strong performance of FDIC-insured institutions is reflected in the strength and soundness of the FDIC insurance funds. As of December 31, 2003, the balance in the Bank Insurance Fund (BIF) represented 1.32 percent of estimated BIF-insured deposits, well above the statutory target reserve ratio of 1.25 percent. The Savings Association Insurance Fund (SAIF) ratio stood at 1.37 percent at yearend 2003. The BIF reserve ratio rose during 2003 as expected losses fell, while the SAIF reserve ratio remained essentially unchanged from yearend 2002.

In November 2003, the FDIC Board of Directors voted to maintain the existing BIF and SAIF premium rate schedules for the first-half of 2004. The FDIC's analysis indicates that it is unlikely the reserve ratio for either fund will fall below 1.25 percent during this period. As a result, most FDIC insured institutions will not pay deposit insurance premiums during the first-half of 2004.

However, the FDIC does not expect the BIF and SAIF reserve ratios to continue to rise going forward. Although the FDIC forecasts little in the way of insurance losses in the near term, we expect at least moderate deposit growth. BIF and SAIF reserves for

expected bank failures are already at low levels and the funds will not benefit from unrealized gains on their portfolios of Treasury securities in a moderately increasing or stable interest rate environment. Thus, it is likely that the interest income generated by the funds will not support the expected rate of BIF- and SAIF-insured deposit growth, and the reserve ratios will decline even in the absence of significant bank failure activity.

Deposit Insurance Reform

An effective deposit insurance system contributes to America's economic and financial stability by protecting depositors. For more than three generations, our deposit insurance system has played a key role in maintaining public confidence.

While the current system is not in need of a radical overhaul, flaws in the system could actually prolong an economic downturn, rather than promote the conditions necessary for recovery. As you know, there are three elements of deposit insurance reform that the FDIC regards as most critical: merging the funds, improving the FDIC's ability to manage the fund and pricing premiums properly to reflect risk. These changes are needed to provide the right incentives to insured institutions and to improve the deposit insurance system's role as a stabilizing economic factor, while also preserving the obligation of banks and thrifts to fund the system. There is widespread general agreement among the bank and thrift regulators for these reforms and the House of Representatives has demonstrated its agreement twice by passing reform legislation. I am hopeful that deposit insurance reform legislation will be enacted this year, and I thank you for your efforts in this regard.

The Condition of the Industry

FDIC-insured institutions are as healthy and sound as they have ever been. The industry earned a record $31.1 billion in the fourth quarter of 2003, marking the fourth quarter in a row that earnings set a new high. The results for the fourth quarter also brought the industry's earnings for the full year to a record $120.6 billion, surpassing the previous annual record of $105.1 billion set in 2002. The return on assets (ROA) in the fourth quarter and for the entire year was 1.38 percent, equaling the quarterly record set earlier in the year and easily surpassing the previous all-time annual high of 1.30 percent in 2002.

Underlying the current financial strength of the industry has been the cumulative effects of the ten-year economic expansion of the 1990s and certain factors that tended to insulate banks from the most severe effects of the 2001 recession. Improvements in underwriting and risk management practices helped to limit the effect of credit losses on industry earnings during and after the recession. Meanwhile, strong growth in mortgage loans and a steep yield curve helped boost the net operating income of the industry. As a result, the banking industry has been one of the leading sectors of the economy in the current economic recovery.

But we cannot simply assume that the economic environment of the next decade will necessarily be as favorable to the industry as our recent experience. The world is changing in unprecedented ways.

The FDIC sees several trends that could pose difficulties for the banking industry in the future. One potential difficulty arises from future higher interest rates. It is inevitable that interest rates will eventually rise from their current, historically low levels, and this will pose a particular challenge to mortgage lenders. The sharp slowdown in

mortgage refinancing in recent months has the effect of making mortgage lenders even more vulnerable than usual to the effects of higher interest rates.

Another potential difficulty for the industry arises from a rapid increase in household indebtedness. The lowest mortgage rates in more than a generation have prompted households to take out $1.4 trillion in new mortgage debt since the end of 2001. This unprecedented level of borrowing raises concerns not about credit quality, but about the sustainability of growth in consumer spending. Associated with these concerns is the possibility that low mortgage rates could be contributing to home price volatility in some housing markets that have outperformed the rest of the nation in recent years.

Household indebtedness also has increased as a result of a revolution in consumer lending. This revolution, brought about by advancements in technology and market-based financing, has created a system with unprecedented access to credit and convenience in its use. These changes helped make it possible for the household sector to largely support the U.S. economy during and after the 2001 recession. However, one side effect of this revolution is a world where personal bankruptcy filings exceed 1.5 million a year. This trend is not solely a consequence of the recession—bankruptcies averaged over 1.1 million per year in the late 1990s when the economy was booming. The challenge for consumer and mortgage lenders is to identify the changes that have occurred in household finances and effectively manage the new risks inherent in these lines of business.

In addition to the potential problems raised by these macroeconomic trends, the FDIC is closely monitoring the economic fundamentals of certain commercial real estate markets, principally in the Southeast and the West. Some institutions have high loan

concentrations in these markets, although overall bank loan performance in this sector remains very solid at this stage.

FDIC Financial Statement and Annual Budget

The FDIC takes very seriously its stewardship responsibilities for the deposit insurance funds. The General Accounting Office audits the financial statements of the BIF, SAIF, and FSLIC Resolution Fund in accordance with statutory requirements. For 2003, the FDIC received a clean financial opinion for the twelfth consecutive year.

In addition, the FDIC has aggressively sought to reduce personnel, leasing and information technology costs. The FDIC's 2004 Corporate Operating Budget of $1.1 billion is slightly below the 2003 budget. When combined with anticipated investment spending of $115 million in 2004 for multi-year investment projects previously approved by the Board, total 2004 spending is expected to total approximately $1.2 billion. The approved budget will provide funds for the projected 2004 workload of the Corporation's three major business lines—Insurance, Supervision, and Receivership Management—as well as its major program support functions. It provides increased funding next year for policy and banking research, financial risk measurement, and the FDIC's newly-established Corporate University.

Reshaping the FDIC for the Future

In response to the banking and thrift crisis of the late 1980s and early 1990s, the FDIC substantially increased its workforce. However, the FDIC has been in a period of downsizing for the past ten years, declining from a peak of 23,000 employees in 1992 (FDIC and Resolution Trust Corporation combined) to about 5,300 employees today.

Having come through a long period of downsizing, the FDIC is now in an era of constant change. The number of banks, for example, continues to decrease while their average size and complexity increases. These changes mean that the FDIC must continually adjust the size of its workforce and the composition of the skills among its employees. We have taken the following steps to position the FDIC as a flexible organization with a forward looking posture:

Building a Flexible, Permanent Workforce. The FDIC has streamlined its organizational structure over the past two years and delegated greater decision making authority throughout the corporation to allow for quicker and more effective decisions. Further, in order to have the greatest flexibility in reassigning employees where they are needed, the FDIC established a training program as part of our "Corporate University." Employees cross-train in other areas and gain a corporate perspective on the different activities conducted by the FDIC as deposit insurer, regulator and receiver of failed institutions.

Establishing Clear Performance Expectations and Incentives. If the FDIC is to keep pace with the challenges posed by a rapidly evolving financial sector, we must maintain a highly skilled workforce that is performing at the highest levels. This requires that appropriate incentives are in place to recognize and reward performance. The FDIC has taken considerable steps over the past two years toward establishing a culture that provides a direct link between performance and rewards. We instituted a "pay for performance" program for all employees in the organization that links the amount of compensation to an employee's achievement of corporate goals. FDIC's executives no longer receive automatic pay increases for satisfactory performance, but are subject to "pay at risk" completely dependent on their accomplishments.

As I have noted, the FDIC's statutory framework has a number of flexibilities in the pay, benefits and job classification areas that we are already putting to good use. But there is far more that we could do if we had the flexibility to fine tune that package so it promotes the utmost in performance and excellence. In January, the GAO issued a report, *Implementing Pay for Performance at Selected Personnel Demonstration Projects*. The report notes that there is a growing understanding that the federal government needs to fundamentally rethink its current approach to pay and better link pay to individual and organizational performance. GAO notes that Congress has taken important steps to implement results oriented pay reform and modern performance management systems across the government. The FDIC is carefully analyzing the current flexibilities we have, and the additional authorities that we could use, to best complete our mission of preserving the public's trust in the nation's banks and the deposit insurance system. At a later time, we will propose legislation that will allow us to hire employees for specific needs with more flexibility, hire executives with the same flexibilities enjoyed by other agencies, retain employees with an increased emphasis on performance and more closely link compensation to contributions.

FDIC Advisory Committee

One of my priorities as Chairman was to establish an advisory committee at the FDIC. The FDIC Advisory Committee on Banking Policy was chartered in February 2002 and, just recently, had its charter renewed. The Advisory Committee is composed of 12 members who represent a cross-section of distinguished leaders from all over the country and from many disciplines, including academia, economics, financial services, private industry, public affairs, and the public interest community. The Committee has

provided the agency with valuable insights on banking-related issues as well as on corporate management, operations, and structure.

The FDIC Advisory Committee was established under the Federal Advisory Committee Act (FACA), which, among other things, generally requires that meetings of advisory committees be open to the public. Under current law, the FDIC must follow FACA's procedures and requirements when establishing or using committees to provide advice or recommendations to the agency relating to its supervisory responsibilities.

As useful as the Advisory Committee has been to the FDIC, it (and any future advisory committees) would be even more useful if the FDIC had an exemption to FACA similar to the Federal Reserve System's exemption. The banking industry and the way banks deliver products and services are changing rapidly; the FDIC must be able to keep abreast of these changes and their effect on the ability of banks to respond to customer and community needs. Because the kind of information that the FDIC needs can be sensitive, public meeting requirements could prevent the FDIC from obtaining frank, open, and candid advice from industry and community representatives and the customers the banks serve.

To solve this problem, we requested an amendment last year to FACA as part of our suggested regulatory burden relief proposals that would provide the FDIC and the other federal banking agencies, which share similar concerns, with an exemption similar to that already provided by law to the Federal Reserve System. This amendment would enable the regulatory agencies to more effectively establish and use committees to provide advice and recommendations with respect to safety and soundness, product and service developments and delivery, consumer issues affecting supervised institutions, and

deposit insurance issues, without concerns that confidential information will be publicly disclosed.

Industry Challenges for the Future

There is a well known adage that generals are always well prepared to fight the last war. One of my chief goals as Chairman of the FDIC has been to ensure that the FDIC is ready to fight the next one. In that regard, I asked the FDIC to undertake a study of the *Future of Banking in America* in order to chart likely trends in the next 5 to 10 years, and to anticipate the issues that will confront the industry and the regulatory community. The FDIC is nearing the end of this study and I would like to share with you some of its findings and also discuss some of the initiatives the FDIC is taking to address these and other issues.

The view of banking presented in our study is of a strong, competitive industry that continues to serve vital economic purposes. Within the banking industry, the FDIC has concluded that each of the three main sectors—community banks, regional and other mid-size banks, and the largest banking organizations—has favorable prospects for the years immediately ahead.

In presenting this view, however, the FDIC is mindful of the ever-changing nature of the financial market. One of the primary ongoing changes highlighted by the *Future of Banking* study is banking industry consolidation into fewer, larger organizations. Since the mid-1980s, consolidation has reduced the number of federally-insured banks and thrifts from just over 18,000 to just under 9,200. During the 1980s and early 1990s, much of that consolidation occurred as a result of bank and thrift failures. But during the

1990s, consolidation proceeded apace through voluntary mergers and charter consolidation within holding companies.

From 1984 to June 2003, the share of industry assets held by the ten largest insured banking organizations rose from approximately 19 percent to just over 44 percent. Similar trends are evident in the concentration of industry deposits and revenues, where the share of the top ten organizations now stand at 40 percent and 44 percent, respectively. Currently, the combined assets of the 18 largest insured banking organizations are greater than the combined assets of the more than 7,800 other banking companies.

Large Institutions

The greater size and complexity of some of our largest institutions pose significant challenges for management, supervisors, and the deposit insurance funds. The FDIC works closely with its fellow regulators to monitor the performance of large banks. Toward that end, the FDIC has placed dedicated examiners in the eight largest insured institutions. In addition, FDIC examiners continually analyze and review all institutions with assets greater than $25 billion, either by assigning full-time examiners to those banks for which the FDIC is the primary federal regulator or by communicating closely with the institution's primary federal regulator.

Bank supervisors continue to adapt to the consolidation trend and have encouraged the use of cutting-edge risk management methods that require both sophisticated analysis and sound judgment. The Basel II Accord, which, as you know, is an international initiative to improve the system of evaluating capital adequacy at the

largest banks, is an example of supervisors' attempts to encourage the use of advanced risk-management techniques.

Basel II. As I have testified before, the outcome of the current deliberations on Basel II is of crucial importance. There are significant issues relating to the adequacy of the capital requirements coming out of the Accord that must be addressed, in the FDIC's view, before the Basel document should be endorsed as the basis for national rulemaking processes. If these issues can be resolved—and the will to do so clearly exists—the result will be an international agreement that will serve our financial system well.

If Basel II were implemented without change to the capital formulas now being contemplated, the result most likely would be, over time and on average, a substantial decline in risk-based capital requirements. While some reduction in risk-based capital requirements may be appropriate, any reduction in capital requirements must be justified by the underlying risk, and must not simply result from unrealistic modeling assumptions.

At present, the Basel II formulas contain certain assumptions, made in the name of simplicity, that can in some situations substantially underestimate the true economic capital requirement. To offset this possible bias, supervisors have assumed that they will be able to require banks to provide appropriately conservative risk assessments in the formulas. Banks' comment letters, and the FDIC's own experience, suggest that determining these appropriately conservative assessments will be easier said than done. The FDIC is working closely with the other U.S. agencies and the Basel Committee to address the banks' legitimate concerns, the interests of bank supervisors, and the FDIC's interests as deposit insurer.

The FDIC's other fundamental concern with the Accord, as now drafted, is that its Pillar 1 minimum capital requirements are inconsistent with current U.S. regulatory

practice. The draft Accord explicitly provides that the current amount of capital required for a bank cannot decrease by more than 20 percent during the first two years of implementation. Thereafter, there is no lower boundary on the amount of capital that is necessary to meet regulatory capital requirements. Absent a regulatory minimum capital requirement, bank capital would be governed solely by the Basel formulas, supplemented by the exercise of supervisory judgment.

The statistical estimation of a bank's future loan losses and operational losses is subject to great uncertainty. The capital formulas in Basel II's advanced approaches reflect specific modeling choices, important simplifying assumptions, calibration based on historical data and a degree of political compromise. Moreover, the Basel formulas neither measure, nor provide capital against, other important risks that banks face, such as interest rate risk on loans outside the trading account and liquidity risk. The smaller the economic capital required by these formulas, the greater the likelihood that the requirements are driven by the assumptions and limitations of the formulas, rather than by underlying risk. For these reasons, the FDIC believes that clear minimum capital standards, such as those we have in our country's Prompt Corrective Action (PCA) requirements, are needed to complement the output of any risk based capital framework.

The FDIC does not intend to try to export our country's PCA framework to the rest of the world. Nevertheless, we believe it is important that the Accord not appear to explicitly repudiate a cornerstone of U.S. legislative and regulatory policy toward the federal safety net underlying insured depository institutions. There is no disagreement among the U.S. regulators on this issue that I am aware of, and we believe it is an issue that can be resolved to the satisfaction all Basel committee members.

Looking to the future, we expect that at the appropriate time there will be a robust debate in the U.S. about the appropriate levels of the leverage ratio requirements imbedded in the PCA regulations. We believe the result of that debate will be a capital regulatory structure that integrates Basel II with the PCA framework in a way that strengthens the U.S. financial system.

Community Banking

The consolidation trend also has led to concerns about the long-term viability of community banking. The challenge from non-bank competitors, such as credit unions, brokerage firms and insurance companies, and the effects of deregulation have—along with technology—created a world that, in general, favors fewer and larger institutions.

Much of this concern has come from the exodus of many small banks from rural communities where demographic shifts have taken the most significant toll. However, there is reason to believe that community banking is not disappearing. The data show that the location of community banking is shifting from rural areas to faster-growing suburbs with population growth and economic vibrancy. Nonetheless, the number of community banks overall has shrunk from about 14,000 in 1985 to about 7,400 today, a drop of approximately 47 percent. Many expect this trend to continue, but we believe the picture is more complex.

Many rural areas in America are suffering from a depopulation trend and are often dependent upon declining industries. These areas are likely to lose more community banks going forward. However, densely populated areas with strong economic growth are likely to see new bank formation. Some 1,100 new banks have been chartered in the past ten years, primarily in fast-growing suburban areas.

The large number of new bank charters reflect healthy competition. There are low barriers to entering the U.S. banking system, which is an important structural feature that helps to ensure a vibrant industry. Consolidation would be a much greater concern in a stagnant industry.

In the FDIC's view, the community-banking business model is viable and the FDIC expects that small banks will continue to play a vital role in their communities. The challenge for regulators is to guard against placing disproportionate burdens on smaller banks.

One concern the FDIC hears from community bankers pertains to the cumulative weight of regulatory burden and the fact that this may unduly impair their chances for success. From my own personal experience as a banker, I know all too well how heavy this burden can be. Larger banks are able to spread the fixed costs of regulatory compliance across a larger volume of business. I believe we have a special obligation to eliminate all unnecessary regulatory burdens. I will discuss more about this later in the testimony.

FDIC Risk Management

As the banking industry has become more sophisticated, the FDIC has developed cutting edge risk-management techniques to identify, measure and manage risk to the insurance funds. The FDIC employs a robust, integrated risk analysis process that was strengthened by several initiatives in 2003. The focal point of the FDIC's integrated risk management infrastructure is its National Risk Committee (NRC). Created in early 2003, this executive committee oversees and coordinates the risk analysis activities of the FDIC

and provides strategic direction and appropriate policy responses to emerging risk issues. The NRC receives regular input from other risk oversight groups throughout FDIC.

One of these other oversight groups is the FDIC's Risk Analysis Center (RAC), which was established in March 2003 to better coordinate risk monitoring and action plans among the various business units in the FDIC. The RAC, located here in Washington, D.C., is a best practice that brings together economists, examiners, financial analysts, and others involved in assessing risk to the banking industry and the deposit insurance funds. Individuals from these disciplines work together to monitor and analyze economic, financial, regulatory, and supervisory trends and determine the implications for banks and the deposit insurance funds. Comprehensive solutions are developed to address risks that are identified during this process. We anticipate that this process will enable the FDIC to respond to emerging risks quickly and effectively. One of the lessons learned from the last banking and thrift crisis is the need to constantly coordinate efforts to monitor and analyze current and future risks in the industry.

The principle of a coordinated approach to analyzing and addressing risks also extends to the regions. In each of the FDIC's six regional offices individuals from various disciplines, both from within and outside the FDIC, meet to analyze and address unique risks facing the region.

In 2003, the FDIC hired an independent, outside consultant to review the FDIC's financial risk management practices, in particular, the methodology and processes used to develop the quarterly value of the FDIC's contingent liability for anticipated failures. The final report, *Strengthening Financial Risk Management at the FDIC*, validates our methods and procedures and includes meaningful suggestions—which we have implemented—to enhance the overall accuracy, robustness, and transparency of the

FDIC's reserving process. Finally, the report endorses and enhances a road map to use in developing the next-generation tools and organizational practices for managing risk at the FDIC. One of these next-generation tools is the Loss Distribution Model, which employs many of the same advanced techniques used by large financial companies to measure and manage risk. A prototype version of this model was developed in 2003 and represents a significant step toward developing a fully integrated approach to quantifying risks to the insurance funds that includes factors such as investment returns, premium income, insured deposit growth, and failure-related losses.

Regulatory Burden Relief

With the rapid pace of change in the financial services industry, it is important that regulators ensure that their actions and regulations—while continuing to maintain safety and soundness and ensure consumer protection—do not unnecessarily stifle innovation or impair banks' ability to compete. As I mentioned earlier, this is particularly important for community banks.

EGRPRA. The FDIC is leading an interagency effort to identify unnecessary burden, duplication, and outmoded restrictions on both large and small financial institutions. Under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), Congress required the federal banking agencies and the National Credit Union Administration to review all regulations every ten years for areas that are outdated, unnecessary or unduly burdensome. FDIC Vice Chairman John Reich is leading this interagency review.

The agencies have jointly published the first two of a series of notices soliciting comment on regulations in a number of areas, and have been conducting outreach

sessions with bankers and consumer/community groups. Armed with input from these efforts, the agencies will conduct a comprehensive review of banking regulations and will report to Congress on their findings and the actions they have taken, or plan to take, to reduce the level of burden. The agencies also anticipate sending this Committee a list of legislative areas for consideration.

Community Reinvestment Act. On February 6, 2004, the FDIC, along with the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Office of Thrift Supervision, published a joint interagency notice of proposed rulemaking (NPR) regarding the Community Reinvestment Act (CRA). This NPR fulfilled the commitment the agencies made in 1995, when the current CRA regulations were adopted, to review the regulations to determine whether they were producing objective, performance-based CRA evaluations that did not impose undue burden on institutions. The NPR reflects the agencies' analysis of about four hundred comments on an Advance Notice of Proposed Rulemaking published in 2001 on the same subject.

The proposed rulemaking underscores the agencies' conclusion that the CRA regulations are essentially sound, but need to be updated to keep pace with changes in the financial services industry. The NPR proposes two fundamental changes, one of which should help substantially reduce unwarranted burden. First, for purposes of the streamlined small bank CRA test, the agencies propose to amend the definition of "small institution" to mean an institution with total assets of less than $500 million, without regard to holding company assets. The gap in assets between the largest and smallest institutions has grown substantially since the 1995 CRA regulations were implemented. The number of institutions considered small has declined by more than 2000 since 1995.

This proposal would expand the number of institutions eligible for evaluation under the streamlined small bank test, while only slightly reducing the portion of industry assets subject to the large retail institution test.

Second, the NPR expands and clarifies the adverse effect on the CRA rating of an institution engaging in discriminatory, illegal or abusive credit practices. The bank regulatory agencies are seeking comment on this proposal until April 6 and we encourage interested parties to provide input.

MERIT Program. The FDIC has continued to refine its risk-focused examination processes in several stages. The latest refinement was implemented in January 2004, when the FDIC expanded the use of a streamlined examination program called MERIT - for ***M***aximum ***E***fficiency, ***R***isk-Focused, ***I***nstitution ***T***argeted Examinations. The MERIT program, originally implemented in April 2002, was applicable to banks that met basic eligibility criteria, such as total assets of $250 million or less and satisfactory regulatory ratings. The MERIT program now applies to well-capitalized insured depository institutions with total assets of $1 billion or less that meet basic eligibility criteria, including component and composite safety and soundness ratings of "1" or "2," stable management and effective loan-grading systems.

During a MERIT examination, examiners devote significant attention to the overall assessment of the institution's risk-management processes, and spend less time engaged in transaction testing. Examiners review an institution's lower-risk activities primarily through discussions with management and by monitoring the activities through various off-site analytical programs.

Revised Compliance Examination Process. In July 2003, the FDIC also implemented a risk-focused approach to consumer compliance examinations. This

approach begins by evaluating an institution's compliance management system, which consists of its management, internal controls, and compliance audits. The intensity and extent of further testing is then based upon the institution's risk profile. The FDIC believes that this approach will maintain examination quality while allowing the FDIC, over time, to spend less time examining institutions with good compliance management systems and more time examining institutions with weak systems.

In addition to the revised compliance examination approach and the MERIT program, the FDIC recently established a special task force to reevaluate the FDIC's examination process and supervisory practices for any excesses or inefficiencies that impose undue costs on insured institutions. The FDIC's examination processes will continue to evolve to ensure that the Corporation's resources are focused on the greatest areas of risk, while preserving the integrity of the examination process.

Call Report Modernization

The FDIC and other banking regulators are employing the latest technology to collect and release more timely information. Under the sponsorship of the Federal Financial Institutions Examination Council, the FDIC, along with the OCC and the Federal Reserve, initiated an effort last year to modernize the process for collecting and publishing Reports of Condition and Income (Call Reports) from banks. The new process will use modern technology so that banks can identify and correct errors in their data before they submit their Call Reports, thereby enabling the banking regulators to collect and release more timely information in a format that can readily be shared among all those who use Call Reports in their business. Currently, the FDIC and the other agencies are working to develop a central data repository that will be shared by the FDIC,

OCC and Federal Reserve. Banks and other users will be instructed on the new process well in advance of implementation. While banks may have to begin preparation of their Call Reports slightly earlier, the new process should not increase the overall burden of preparing the reports. In fact, the new process will give banks greater confidence that they have submitted reports that are in compliance with federal requirements. The agencies anticipate implementing the new process for the third quarter 2004 report, after it has been tested by regulators and the industry. Once the process has been put in place for Call Reports, the agencies anticipate that it will be used for other types of financial information.

Consumer Protection

Financial Education and Money Smart. While much of the world has become increasingly technologically and financially sophisticated, the FDIC has long recognized that a large portion of American families do not have bank accounts and lack an understanding of basic financial concepts. The FDIC is committed to continuing its efforts to open up opportunities for people to enter the financial mainstream. A little over two years ago, the FDIC rolled out *Money Smart*, an award-winning financial education curriculum designed specifically to meet the needs of low- and moderate-income adults, who are often unbanked (*i.e.*, they have no bank accounts or other financial relationships with a bank).

Unbanked households represent a category of customers that can be potentially profitable to depository institutions. Many banks have recognized this and are taking steps to expand their banks' presence, activities, and customer base in underserved emerging markets. The FDIC, for its part, is committed to furthering these efforts

through *Money Smart.* Since the rollout of *Money Smart*, FDIC has distributed more than 111,000 copies of the curriculum and trained over 5,000 instructors. *Money Smart* is currently available in English, Spanish, Chinese, Korean and Vietnamese.

The FDIC has taken the lead in establishing financial education partnerships with communities and bankers. The FDIC has entered into over 600 local Money Smart Alliances across the country, including national partnerships with the U.S. Department of Labor, the U.S. Department of Housing and Urban Development, the Association of Military Banks of America, Goodwill Industries International, the National Coalition for Asian Pacific American Community and the Internal Revenue Service. Last year, for example, the FDIC's work during the 2002 tax season with the "Back of the Yards" voluntary income tax assistance site in Chicago helped over 600 families file tax returns and receive $1.1 million in earned income tax credit refunds. Many of these families also opened their first bank accounts through this initiative.

Later this year, the FDIC will broaden its outreach efforts by releasing an interactive version of *Money Smart* in English and in Spanish that can be accessed directly through a CD-ROM or on the FDIC's website either at home or at public libraries. The FDIC also is working closely with its faith- and community-based organization partners to integrate the interactive versions into their programs. In addition, the FDIC will play an important role as a member of the Financial Literacy and Education Commission established by section 513 of the Fair and Accurate Credit Transactions Act of 2003. We will lead one of the two stated projects outlined in the bill creating the commission—the establishment of a single government toll-free number for financial education matters.

Expanded Fair Lending Examination Specialist Program. Building on improvements made in recent years to the FDIC's fair lending program, in January, the FDIC expanded the program by appointing fair lending examination specialists in each of its six regions. These specialists will provide expert guidance and assistance to compliance examiners during complex fair lending examinations to help focus examinations and identify discrimination.

The Bank Secrecy Act and the USA Patriot Act

The FDIC is responsible for ensuring that state nonmember banks comply with the Bank Secrecy Act (BSA). At each safety and soundness examination, the adequacy of an institution's BSA compliance program and procedures is assessed, and a review for compliance with the BSA is conducted. Over the past three years, the FDIC has conducted more than 7,500 BSA compliance examinations.

The FDIC employs a variety of supervisory methods to ensure that financial institutions correct BSA-related infractions. The majority of BSA violations are corrected while the examiners are still in the institution or shortly after their departure. Occasionally, some institutions fail to correct violations or implement adequate compliance programs at subsequent examinations. The FDIC visits these institutions between the regularly scheduled examinations and takes supervisory action if appropriate. Over the past three years, the FDIC has imposed 23 formal actions and entered into 32 informal agreements with institutions that demonstrated significant BSA compliance weaknesses.

The FDIC also has taken many measures to implement the USA Patriot Act and to combat money laundering and terrorist financing. Since the enactment of the USA

Patriot Act, we have participated in numerous interagency working groups led by the Department of Treasury to draft revisions to the Bank Secrecy Act as required by the USA Patriot Act and to develop interpretive guidance for the financial services community.

For years, the FDIC has worked with the Department of Treasury, the Financial Crimes Enforcement Network and the other banking agencies to develop policies, best practices and international standards to combat money laundering and more recently, terrorist funding. We have also worked with the other federal banking agencies and the Conference of State Bank Supervisors to issue risk-focused examination procedures designed to evaluate a financial institution's anti-money laundering program and compliance with the Bank Secrecy Act and the final rules implementing the USA Patriot Act. Last fall, we revised our Bank Secrecy Act examination procedures for reviewing compliance with the new provisions of the USA Patriot Act and released them to examiners.

The FDIC believes that strong supervision of foreign banks contributes to the stability of foreign economies, enhances trade opportunities for U.S. companies, and reduces opportunities for money laundering. Therefore, we actively participate in working groups and technical assistance missions sponsored by the Departments of State and Treasury to assess vulnerabilities to terrorist financing activity worldwide and to develop and implement plans to assist foreign governments. We have assembled a team of experts ready to assist with foreign missions under the auspices of the Department of State's Financial Systems Assessment Team. Since 2002, we have assisted in the evaluation of eight countries and have provided training and technical assistance to over thirty-eight countries.

Resolutions and Receiverships

During the 1980s and early 1990s, nearly 2,950 banks and thrifts failed with almost $950 billion in assets. By 1991, these failures had left the FDIC and RTC with an inventory of over $170 billion in assets to sell, which would have made the combined agency one of the largest banks in the United States. Since that time, the FDIC has resolved virtually all of these assets and receiverships, and today there are only $800 million assets and 90 receiverships remaining to be resolved. Fortunately, the pace of bank and thrift failures has declined dramatically since 1991, but the failures that do occur today tend to involve more complex assets and operations.

Banking industry consolidation, globalization, technology and increased use of such nontraditional banking business lines as internet banking, securitization, expanded credit card banking, and subprime lending pose new challenges for the FDIC in resolving failed banks and thrifts. The FDIC has developed innovative approaches and tools in response to these challenges.

First, the FDIC has taken advantage of new technologies. To assess the marketability of an institution and its assets before failure, the FDIC uses statistical models and sampling techniques. In its marketing efforts, the FDIC uses a secure web site—called Intralinks—that allows prospective acquirers of failing banks or their assets to obtain asset information quickly and conduct due diligence largely off-site. This results in less interference with a failing bank's efforts to conduct day-to-day business and market itself or attract new capital to help it survive. Intralinks also allows the FDIC to conduct bid meetings over the Internet (or by regional video-conference). This innovation has greatly increased bidder participation (over 6,500 banks and thrifts are now participating) and has served to reduce due diligence expenses for the FDIC and for

prospective investors. The FDIC also uses another website, FDICSales.com, to notify potential bidders of sales, distribute information, and hold asset sales and auctions. In late 2003, the President's Quality Award Program recognized the FDIC's leadership in "Expanded Electronic Government" with an award for its efforts to apply technology to bank and thrift resolutions.

Second, the FDIC relies on sound business principles to resolve banks. The FDIC has developed business plans to guide pre-resolution planning and to manage customer service and asset sales. The FDIC has developed plans for responding to insolvencies involving credit card banks, large complex banks, internet banks, subprime assets, securitized assets, and other new banking issues. As a result, the FDIC successfully protected depositors in the sudden failure of Superior Bank, F.S.B., which had an extensive subprime mortgage securitization program, and in the failure of NextBank, which was the first Internet-only bank to fail. The FDIC also continues to work with other regulators to enhance contingency strategies to ensure that the regulators can properly respond if one of the largest banks ever threatens to fail.

Third, the FDIC has focused on maximizing the flexibility of employees and enhancing their skills. The FDIC cross-trains employees in different closing functions and has a systemized training program that now offers over 30 comprehensive courses in the critical resolutions and receivership functions. As a result, the FDIC sells the more complex assets of failed banks and thrifts much more quickly than ever before, all while giving insured depositors access to their funds virtually overnight.

Conclusion

Over the past 20 years, the banking industry has changed greatly. Consolidation has created large, complex institutions and technology is adding to the complexity. Community banks have had to develop new business strategies in response to the changing financial environment. Banks and thrifts have come through the most recent economic cycle well, which attests to their success in responding to change. As a result, the industry and the deposit insurance system are strong and well-positioned for the future.

United States General Accounting Office
Washington, DC 20548

April 20, 2004

The Honorable Sue W. Kelly
Chairwoman
Subcommittee on Oversight and Investigations
Committee on Financial Services
House of Representatives

Subject: *Posthearing Questions Related to the Federal Deposit Insurance Corporation's 2003 and 2002 Financial Audits*

Dear Madam Chairwoman:

On March 4, 2004, I testified before your subcommittee at a hearing on oversight of the Federal Deposit Insurance Corporation (FDIC)[1] and discussed the results of our 2003 and 2002 audits of FDIC's financial statements.[2] This letter responds to subsequent questions that you asked me to answer for the record. The questions and my responses follow.

1. **The FDIC has made significant progress in correcting the computer security weaknesses identified in GAO's 2002 report. Do you feel that the FDIC is on the right path to correct the 22 new information security weaknesses identified through your oversight in 2003? How will GAO monitor the agency in the coming months to ensure that these weaknesses are addressed?**

FDIC has been responsive to addressing information security weaknesses we have previously reported. For example, during the past year, FDIC corrected 28 of 29 weaknesses that were still open from our 2002 calendar year financial audit. Similarly, prior to the completion of our audit, the corporation developed a comprehensive corrective action plan to address each of the 22 new information security weaknesses identified in our calendar year 2003 financial audit. If fully

[1]U.S. General Accounting Office, *Federal Deposit Insurance Corporation: Results of 2003 and 2002 Financial Audits*, GAO-04-522T (Washington, D.C.: Mar. 4, 2004).
[2] U.S. General Accounting Office, *Financial Audit: Federal Deposit Insurance Corporation Funds' 2003 and 2002 Financial Statements*, GAO-04-429 (Washington, D.C.: Feb. 13, 2004).

and effectively implemented, FDIC's corrective actions should address each of the security deficiencies identified.

In addition to these 22 weaknesses, as we included in our testimony, a key reason for FDIC's continuing weaknesses in information system security controls is that it has not yet fully implemented all elements of a comprehensive security management program. Such a program is critical to resolving existing computer security problems and continuously managing information security risks, and includes a testing and evaluation program to ensure that systems are in compliance with policies and procedures and to identify and correct weaknesses that may occur. While FDIC has done much to establish a complete security management program, its review, testing, and evaluation program does not yet address all key areas. FDIC management currently has a plan in place to establish a comprehensive security management program that includes a complete review, testing, and evaluation program. Implementing such a program should allow FDIC to better identify and correct security problems, such as those identified in our 2003 audit.

We will continue to monitor FDIC's progress in addressing the 22 information security weaknesses and in implementing its comprehensive security management program. During the course of the next several months, we plan to meet periodically with FDIC's Chief Information Officer and his staff to discuss their progress in implementing their corrective action plans. Further, in connection with our calendar year 2004 financial audit, we will follow-up on the status of these weaknesses and perform tests, as appropriate, to determine whether adequate actions were taken to remediate the information security weaknesses.

2. **In your testimony, you state that since the banking and financial services environment is constantly changing, the FDIC must continually monitor its business environment and related risks, and adapt its internal operations as well as its monitoring functions to manage risk and maximize its overall mission. What steps is GAO taking to uphold its high audit standards in this constantly changing financial services environment?**

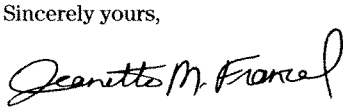
GAO has a two-pronged approach for keeping pace with the constantly changing environment in which we conduct our audits. First, we update our own audit methodology, the *Financial Audit Manual* (FAM), to reflect current issues and updated auditing standards. For example, soon we will be requesting comments on an exposure draft that will update the FAM, primarily to incorporate the provisions of Statement on Auditing Standards 99, *Consideration of Fraud in a Financial Statement Audit*. Second, during the audit process we monitor and review FDIC's actions to adapt and improve its operations to a changing environment. FDIC is currently in the process of changing the methodology it uses

to estimate potential failure and loss rates of insured financial institutions and of developing new financial systems to enhance its ability to meet financial management and information needs. As part of our audit, we will analyze FDIC's new and revised methodologies and programs to determine if they follow a reasonable approach and include the proper internal controls over the accuracy and completeness of the data being captured and the results.

We are sending copies of this letter to the Ranking Minority Member and Vice Chairman of your subcommittee. This letter is also available on GAO's Web site at www.gao.gov.

If you or your staff have questions about the responses to your questions, please contact me at (202) 512-9471 for financial issues or Robert Dacey at (202) 512-3317 for information technology issues. We can also be reached by e-mail at franzelj@gao.gov or daceyr@gao.gov.

Sincerely yours,



Jeanette M. Franzel
Director
Financial Management and Assurance

(194393)

Oversight of the Federal Deposit Insurance Corporation Hearing
Wednesday, March 4, 2004

Questions submitted by Rep. Sue Kelly to the Honorable Gaston L. Gianni, FDIC Inspector General

1) Safety and Soundness

a) In your most recent semi-annual report to Congress, you noted that two of the ten most recent material loss reviews that your office has performed on failed institutions have involved so-called industrial loan companies, which have been the subject of much discussion recently in this Committee. Your report references an upcoming Inspector General audit specifically focusing on the potential risks that may result from the lack of Bank Holding Company Act supervision of the parent companies of ILCs. Can you tell the Committee more about the scope and objectives of this audit? Has the work your office has conducted thus far on ILCs yielded any preliminary conclusions on whether these entities' exemption from Bank Holding Company Act supervision poses any unique risks to the deposit insurance funds?

We are undertaking a review to focus specifically on the potential risks that may result from the lack of Bank Holding Company Act (BHCA) supervision of the parent companies of Industrial Loan Companies (ILC). This evaluation will begin in April 2004. In conducting our work, we will review:

- the manner in which the Corporation's Division of Supervision and Consumer Protection (DSC) identifies and assesses the relationship between an ILC and its parent company during the safety and soundness examination process;
- the guidelines used by DSC examiners to determine when it is deemed necessary to perform an onsite visitation of the parent holding company;
- the examination procedures used by DSC examiners for the onsite visitation of the parent company; and
- the controls imposed on the ILC to ensure sufficient autonomy and insulation of the ILC from its parent company.

In the following two reviews that we have conducted in the past related to financial institution failures, the issue of ILCs has surfaced:

Material Loss Review of the Failure of Pacific Thrift and Loan (PTL): This institution failed in November 1999 and caused a loss to the insurance funds of $42.05 million. Because PTL was an ILC, its parent holding company was not subject to the BHCA and thus not regulated by federal banking authorities. PTL used the holding company as a source for increasing its asset portfolio through loans that PTL itself was precluded by state banking authorities from obtaining. The holding company accumulated monumental debt and engaged in numerous transactions with PTL that were not in conformance with accounting principles and that contributed to PTL's failure.

Material Loss Review of the Failure of Southern Pacific Bank (SPB): SPB was another ILC that failed in February 2003, causing losses to the insurance funds of $93.04 million. SPB's holding company, Imperial Credit Industries, Inc. (ICII), had financial troubles that hindered its ability to provide assistance to SPB. Prior to when SPB failed, examiners concluded that SPB's holding company was not a source of strength for the bank. Had ICII been subject to periodic federal review, some efforts to address ICII's financial troubles could have assisted SPB in resolving its problems.

Although the above instances raise some concerns related to ILCs, we encountered such issues in 2 of 10 material loss reviews that we conducted during the period 1993-2003 and are not in a position at this time to conclude definitively on the unique risks that ILCs may pose. We expect that our work described above will provide additional insights on ILCs. We plan to complete the evaluation by September 2004 and would be happy to provide copies of our report to the Subcommittee upon completion of our work.

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2) Downsizing and Human Capital

a) Since the end of the banking and thrift crises of the 1980s and early 1990s, the FDIC's workforce has been downsized from approximately 23,000 to its current level of approximately 5,000. What kind of grade would you give the FDIC on its implementation of this significant reduction in its workforce? In your view, does the Corporation retain sufficient human capital resources to carry out its mission?

The Corporation has done its best to conduct a fair and equitable downsizing program and along the way has sought to minimize the negative impact of such downsizing on its employees. It undertook a comprehensive program of solicitations of interest, reassignments, retraining, and outplacement assistance. It has offered employees on several occasions a very generous buyout program—in our view, probably one of the best in government.

Corporate downsizing must be done with an eye toward ensuring that sufficient resources are available to carry out the mission of the FDIC. In that regard, examiners perform one of the core functions of the Corporation. At the peak staffing level for safety and soundness and compliance examination functions in 1992, combined Division of Consumer Affairs and Division of Supervision staffing totaled 3,997. By year-end 2003, the Division of Supervision and Consumer Protection's (DSC) total staffing had decreased by 30 percent to 2,797.[1]

Turning now to another of the FDIC's core functions--employees in the Corporation's Division of Resolutions and Receiverships (DRR) are responsible for resolving financial institution failures. The number of employees in DRR declined from a high of 5,989 in 1993 to 405 at the end of 2003, a 93-percent decline. This decline corresponds to the significant decrease in assets in receiverships. While both the number of institution failures and DRR staffing have decreased,

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[1] From 1978 through 1993, the Division of Supervision (DOS) and Division of Consumer Affairs (DCA) formed one organizational unit with DOS conducting safety and soundness examinations and DCA conducting compliance examinations. In August 1994, the two divisions were split. They were combined once again in 2002 as DSC.

some recent failures have presented unique or difficult circumstances requiring substantial contractor resources to address.

In 1999, DRR began to prepare its Corporate Readiness Plan (CRP) to develop organizational structures and staffing levels needed to handle the resolution and closing of institutions in the future. This plan was completed in September 2002. We completed a review of the plan in November 2002, and concluded that the CRP is reasonable and provides sufficient flexibility for the FDIC to handle a relatively wide range of institution failures without causing significant disruption to other aspects of the Corporation's mission.

While preparing the CRP, DRR analyzed the staffing requirements and identified a "staffing gap" that would be filled with non-DRR resources in certain scenarios. Specifically, DRR performed an analysis of its closing functional areas and non-DRR position descriptions to identify comparable skills within other FDIC Divisions and Offices. This analysis determined that most of the positions with compatible skills were in DSC and the Division of Administration (DOA). Therefore, for DRR to successfully handle the entire range of institution failures, it needs to continuously work with DSC and DOA to ensure that those divisions are on-board with providing employees if the need arises.

In addition to the efforts at the corporate level, the FDIC's Division of Information Resources Management (DIRM) initiated a priority project called the Comprehensive Information Technology (IT) Program Review. One aspect of this effort is an assessment of human capital needs and a plan to identify and address any shortfalls in staff resources or skills mix for the IT security program. DIRM has proposed developing and implementing a human capital resource strategy that will include a skills inventory, a training/career development strategy, and a strategic staffing plan. We will be addressing the progress of this effort as part of our upcoming work under the Federal Information Security Management Act of 2002.

b) Some have expressed a concern that the downsizing that has occurred over the past decade - combined with the increased use of contractors and the ability to outsource - has diminished the capabilities of the FDIC. In fact, in your testimony, you state that you have a series of reviews planned to address the FDIC's Human Capital Development program. What are your concerns about the FDIC recruiting and retaining qualified personnel?

With respect to the Corporation's use of contractors, we would suggest that contracting itself is often an efficient and cost-effective means for procuring goods and services for the Corporation. However, some of our past work has identified a number of concerns in the Corporation's oversight and monitoring of its contractors. More recently, the FDIC has engaged in several multi-million dollar projects involving contractors, such as the New Financial Environment, Central Data Repository, and Virginia Square Phase II Construction. Our work assessing these efforts has shown certain lapses in project management—that is—defining, planning, scheduling, and controlling the tasks that must be completed to reach a goal and the allocation of resources to perform those tasks. Without effective project management, the FDIC runs the risk that corporate requirements and user needs may not be met in a timely, cost-effective manner. The Corporation has taken or planned a number of steps to address our

concerns, such as revised policies and procedures, oversight training, establishment of a project management framework, implementation of a business review process to ensure sound acquisition strategies, and creation of an Enterprise Program Management Office.

Having reduced the number of FDIC's permanent staff, the Corporation must now look closely at the skill mix of its remaining workforce. As the Corporation adjusts to a smaller workforce, it must continue to ensure the readiness of its staff to carry out the corporate mission. To do this, the Corporation must fill key vacancies in a timely manner, engage in careful succession planning, and continue to conserve and replenish the institutional knowledge and expertise that has guided the organization over the past years.

We recently completed a high-level assessment of the FDIC's overall human capital framework. We concluded that the FDIC's strategic human capital framework addressed the underlying human capital concepts that the General Accounting Office, Office of Personnel Management, and Office of Management and Budget consider vital to the success of human capital management. Nevertheless, we pointed out that there were steps the FDIC can take to strengthen its human capital program, and we recommended that the Corporation institutionalize the Human Resources Committee (comprised of the Chief Human Capital Officer and executives from major units of the FDIC) and develop a human capital blueprint. Taking these actions will sustain the FDIC's long-term commitment and focus on strategic human capital management, including recruiting and retaining qualified personnel, and will maintain transparency in the development, implementation, and monitoring of human capital initiatives. The Corporation agreed to take recommended actions.

In March 2004, we also initiated a second project to evaluate the FDIC's strategic workforce planning effort. This evaluation will determine whether the FDIC has established a comprehensive workforce planning strategy, linked to the FDIC's strategic and program planning efforts, to identify its current and future human capital needs. This will include looking at the FDIC's process for determining the size of its workforce, deployment across the organization, and the competencies needed for the Corporation to fulfill its mission.

The FDIC has undertaken a significant effort to address skill levels and preserve institutional knowledge by creating the FDIC Corporate University (CU). The goal of CU, as the training and employee development arm of the FDIC, is to support the Corporation's mission and business objectives through high-quality, cost-effective continuous learning and development. CU provides opportunities for employees to enhance their sense of corporate identity while learning more about the FDIC's major program areas of supervision, compliance, resolutions, and insurance.

We plan to begin a review in October 2004 to evaluate the success of the FDIC's Corporate University initiative. Specifically, we will assess (1) whether the FDIC has made appropriate investments in education, training, and other developmental opportunities for its employees; (2) specific measures for evaluating the impact of CU programs relative to the cost of the program; and (3) the FDIC's evaluation of its investment in training and development activities.

We would be happy to share the results of our human capital-related work with the Subcommittee when our reviews are completed.

c) The Office of Inspector General has done a significant amount of work addressing the effectiveness of prompt corrective action in reducing losses to the deposit insurance funds. In light of the several bank and thrift failures we have seen in recent years where the losses to the insurance funds relative to the asset size of the failed institution were high, are you concerned that the prompt corrective action regime is not working as originally intended? Based upon your extensive audit work in this area, is the FDIC utilizing its supervisory tools under prompt corrective action effectively?

Based on our work to determine the effectiveness and implementation of the Prompt Corrective Action (PCA) provisions, we concluded that the FDIC generally used PCA directives as part of the supervisory process, in conjunction with other supervisory actions, once institutions' capital levels reached designated thresholds. Further, we concluded that because of PCA directives, insurance fund losses were prevented in two of eight institutions when other institutions acquired them. In four other institutions, insurance fund losses were reduced when institutions were closed before they became insolvent.

The enactment of sections 38 and 39 was intended to increase the likelihood that regulators would respond promptly and forcefully to prevent or minimize losses to the deposit insurance funds. While we noted that the FDIC used section 38 of the FDI Act, we identified a number of factors that delay the use of that section and impact the effectiveness of its capital-related provisions. Specifically:

- PCA's focus is on capital and capital can be a lagging indicator of an institution's financial health.
- Capital ratios reported by institutions in their Call Reports did not always reflect actual financial conditions.
- Institutions increased their capital before or after the issuance of PCA directives and thus avoided implementation of PCA directives or closure.
- The current method of computing capital does not take into account risks related to subprime loans.
- The FDIC seldom used the non-capital provisions of PCA because they do not provide objective or measurable criteria for implementation and, in some instances, their use is restricted.

We identified the following **six options** intended to improve the effectiveness of PCA provisions:

(1) Regulatory changes making the higher capital expectations specified in the Expanded Guidance on Subprime Loans part of the Call Report instructions, or through some other method, to ensure that the reported capital ratios of institutions with subprime loans reflect the risk related to those loans.

(2) Legislative and regulatory changes to add the CAMELS rating or some other objective criteria as the trigger for implementing section 38(g).

(3) Legislative or regulatory changes to remove or lessen the due process provisions imposed by section 38(g).

(4) Legislative and regulatory changes needed to allow implementation of section 38(f)(2) when institutions become "undercapitalized."

(5) Regulatory changes to add objective or quantifiable criteria, such as CAMELS ratings, to section 39 provisions to trigger actions.

(6) Regulatory changes to make it mandatory to take corrective actions when institutions do not meet section 39 safety and soundness standards.

These options were presented in our report to the Corporation, and we transmitted copies of that report to the Chairmen and Ranking Minority Members of the House Financial Services Committee and the Senate Banking, Housing, and Urban Affairs Committee.

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3) Information Security

a) One of the new provisions found in the Federal Information Security Management Act of 2002, not previously included in the Government Information Security Reform Act, calls for agency information security programs to include annual testing of the management, operational, and technical controls for every information system contained in the agency's inventory. What types of testing does the FDIC conduct, and have these various tests revealed any further weaknesses that need to be addressed?

The FDIC conducts a variety of ongoing and periodic tests of its information systems. These tests include:

- An information security review conducted every three years of the FDIC's general support systems and major applications. These reviews focus on the management controls defined in the system or application's security plan;
- An annual assessment of the FDIC's general support systems and major applications in accordance with the National Institute of Standards and Technology (NIST) Special Publication 800-26, *Security Self-Assessment Guide for Information Technology Systems*;
- Ongoing self-assessments of the management, operational, and technical controls of the FDIC's general support systems and major applications. (The FDIC is working to fully develop and implement these ongoing self-assessments);
- Periodic internal control reviews of selected corporate programs and processes, such as security awareness and training, virus detection and prevention, and disaster recovery; and
- Periodic program reviews as determined by management, such as a vulnerability assessment completed by the National Security Agency of the FDIC's network operations in January 2004.

The FDIC is also working to address new and emerging requirements established by the Federal Information Security Management Act (FISMA) of 2002. Of particular significance, the FDIC is developing a formal certification and accreditation program to strengthen the security posture of its most critical information systems and applications. In addition, the FDIC is working to fully develop a corporate inventory of its information systems as required by the FISMA. In February 2004, the FDIC developed a corporate definition of the term "application" to better determine which software components should be considered applications and included in its official inventory.

Tests conducted by the FDIC of its information systems, as well as audits and evaluations performed by our office and the U.S. General Accounting Office, identify information security weaknesses that the FDIC must correct. Testing is an ongoing process that is an important management tool for identifying potential weaknesses that warrant prompt attention. Generally, we have not made the results of our or the Corporation's information security-related reviews publicly available because the specific weaknesses discussed in the reports, if disclosed, could jeopardize the security of the FDIC's information systems. However, we are available to brief the members of the Subcommittee on the issues contained in these reports should they be interested.

b) The FDIC, together with the other federal regulators of banks, thrifts and credit unions, has issued guidance on managing the risk exposure an institution faces when it uses outside firms for technology. The guidance is intended to assist financial institutions that are increasingly relying on outside firms for technology-related products and services to support an array of banking functions. Institutions of all sizes are using these products and services, as technology grows more complex and dynamic, creating a greater impetus to outsource. What is the Office of Inspector General's view on the FDIC policy regarding outsourcing, and would the FDIC allow its information technology contractors to outsource sensitive personal data offshore for analysis or processing?

Security of information outsourced by institutions to outside technology firms is covered as part of the FDIC's Information Technology (IT) examinations. Specifically, FDIC IT examiners review vendor management and contractor security-related questions when assessing the IT security programs in FDIC-supervised institutions. In addition, the FDIC has provided guidance to financial institutions in the form a Financial Institution Letter, FIL-50-2001, dated June 1, 2001 entitled "Bank Technology Bulletin on Oursourcing." This FIL contained practical ideas for banks to consider when they engage in technology outsourcing. Our office has not assessed in-depth the coverage afforded to this area by the FDIC IT examiners, and accordingly, our office is not in a position to offer judgment at this time as to whether the bank's contractors are adequately securing the bank's customer data when analyzing or processing it. We currently have an ongoing audit of the FDIC's IT Examination Program. The objective of this review is to determine whether DSC's examinations provide reasonable assurance that IT risks are being addressed by the risk management programs of FDIC-supervised financial institutions. We can provide the Subcommittee members with copies of our report upon completion.

With regard to the FDIC's policy and practices regarding outsourcing, we conducted a review on information security management of FDIC contractors and issued our report in September 2002. We noted during our review that in general, the FDIC relied on contractors to provide the Corporation with a substantial portion of its needed information services. We concluded that the

FDIC's implementation of security requirements in acquisition planning, incorporation of information security requirements in its contracts, and oversight of contractor security practices were not adequate. The FDIC contractors generally failed to implement sufficient security measures. These control weaknesses exposed the FDIC's information resources to the risk of unauthorized disclosure, destruction, and modification of sensitive and critical data, and disruption of system operations. As a result, we made eight recommendations to improve information security at FDIC contractors.

A year later, in September 2003, we conducted a follow-up audit to determine whether the FDIC had made adequate progress in addressing our earlier recommendations. The FDIC conducted a training session for oversight managers and began reviews of off-site contractors. The FDIC issued corporate-wide policies and procedures that address incorporation of security into all phases of the information technology acquisition process, IT security requirements for third-party providers, and security policy and procedures that contractors must follow to do business with the FDIC. Also, a memorandum was issued in August 2003 that states all new contracts over $100,000 must include security requirements. However, adequate security procedures were not implemented at contractor sites we visited. Therefore, we concluded that even though the FDIC's information security management of contractors had improved, more needed to be done.

In a related vein, in February 2003, we issued a report on the control and use and protection of Social Security Numbers (SSN) by the FDIC. In conducting this audit, we focused on SSN information of non-employees such as depositors, debtors, and loan guarantors that was obtained from failing financial institutions insured by the FDIC. We determined that the FDIC's control over the use and protection of this type of SSN information was not fully adequate. Specifically, there was no FDIC policy governing the protection of the information. In addition, SSN and other personal information was made readily available on several Web sites used in marketing and selling the remaining assets from the failed institutions to parties external to the FDIC that were not subject to a pre-approval process or access control. The Corporation took action to address the concerns we identified in this report.

Finally, several years ago we conducted an audit to determine whether the FDIC was conducting background investigations on contractor employees. (This review was conducted in February 2001 and covered contractors performing services for the FDIC in the United States and did not include contractors working offshore.) Specifically, the background investigation process is initiated when service contracts are awarded and the contracting officer obtains background questionnaires that include certifications from key personnel designated in the contract regarding disqualifying conditions. In this review, we determined that the contractor investigation policies did not consistently cover all contractor personnel. As a result of this review, we made several recommendations to improve security over contractor personnel, which the Corporation agreed to implement. We will address these corrective actions as part of our Federal Information Security Management Act review for 2004.

1. What research have you done into the practice of outsourcing? Are financial institutions always aware when a third party vendor outsources certain functions? Specifically, is there a safety and soundness risk when banks outsource certain functions, such as their call centers, credit card processing, etc., to another country. Have you checked into the security of outsourcing? Are there backup systems in place that would limit the impact of political unrest or diplomatic tensions between the United States and another country where these tasks are performed? What steps are financial institutions taking to ensure the privacy and security of customer data when it is accessible in another country?

During the testimony on March 4, a number of questions were raised relating to outsourcing. Subcommittee Chairman Kelly asked the FDIC to study these issues and report back to the Subcommittee. The FDIC has begun work on the study, which will address the questions you raise. We anticipate meeting with the industry, outsourcing companies, and industry consultants to answer these questions and will report back on our findings when the study is complete.

2. In response to a range of safety and soundness risks and violations of consumer protection laws, the OTS, OCC and the Federal Reserve have taken strong enforcement and policy actions to prevent the financial institutions under their jurisdiction from renting their charters to payday lenders.

a) Do you disagree with any of the specific concerns about payday lending raised by these regulators?

The FDIC shares the specific concerns raised in policy statements on payday lending issued by the OTS and OCC. Institutions face increased legal and reputational risks when they enter into arrangements with third parties to offer payday loans with fees, interest rates, or terms that could not be offered by the third party directly. Because of our concerns about these and other risks, we issued Guidelines for Payday Lending in July 2003 (Guidelines). A copy of these guidelines is enclosed.

The Guidelines describe the FDIC's expectations for prudent risk-management practices for payday lending activities, particularly with regard to concentrations, capital, allowance for loan and lease losses, classifications, and protection of consumers. The Guidelines also address managing third-party relationships. The Guidelines state that payday lenders will be subject to special examination procedures, particularly relating to partnering with third parties and compliance with applicable consumer protection laws and regulations. The Guidelines expressly address Community Reinvestment Act (CRA) issues, explaining that: (1) discriminatory or other illegal credit practices will adversely affect the evaluation of an institution's performance; and (2) certain payday lending practices, while not expressly prohibited by law, may be inconsistent with helping to meet the convenience and needs of an institution's community. Practices of either type would be fully described in the public CRA performance evaluation of an FDIC-supervised bank. The Guidelines also remind state nonmember banks that payday lending

arrangements are subject to rules and guidelines intended to ensure the privacy, security, confidentiality, and integrity of consumer financial information.

Finally, the FDIC Guidelines emphasize that state nonmember banks will be held responsible if they engage in unfair or deceptive payday lending practices in violation of section 5 of the Federal Trade Commission Act (FTC Act). In this context, the Guidelines instruct examiners to pay particular attention to marketing programs for payday loans and collection practices that may be abusive. To help state-chartered institutions avoid engaging in these and other forms of unfair or deceptive conduct, the FDIC and Federal Reserve provided detailed guidance to the banks under their supervision on March 11, 2004. A copy of this guidance is also enclosed.

The Guidelines are being enforced through an examination program that includes on-site reviews at third-party locations. To date, FDIC-supervised institutions involved in payday lending have been in substantial compliance with the principles set forth in the Guidelines. Banks that fail to meet the rigorous standards outlined in the Guidelines could be subject to enforcement actions requiring corrective action, which could include instructions to exit the business. In the past two years, two FDIC-supervised institutions have exited the payday lending business as a result of the FDIC concluding that enforcement action was necessary in light of examination findings.

b) Have you considered that banks are using unfair and deceptive practices when they rent their exportation privileges to third-party entities who are the actual lenders?

During my testimony, you raised the issue of "charter renting," the term often used to describe arrangements by which a bank originates and funds payday loans through a third party. The FDIC pays careful attention to the institutions it supervises that are involved in payday lending, with particular emphasis on the review of arrangements between these institutions and third parties. Our examiners scrutinize such relationships and recommend corrective action when warranted.

Federal law authorizes federal and state-chartered insured depository institutions making loans to out-of-state borrowers to "export" favorable interest rates provided under the laws of the state where the bank is located. The authority of national banks to export favorable interest rates on loans to borrowers residing in another state was recognized by the U.S. Supreme Court in Marquette National Bank v. First Omaha Service Corp., 439 U.S. 299 (1978), in the context of section 85 of the National Bank Act. To ensure a level competitive playing field, Congress extended that authority to other insured depository institutions through the Depository Institutions Deregulation and Monetary Control Act of 1980. State laws that attempt to set usury limits on out-of-state institutions are preempted by these "competitive equality" statutes.

With respect to unfair and deceptive practices, the FDIC has concluded that the exportation of interest rates is not inherently unfair or deceptive. As discussed above, the exportation of interest rates is specifically permitted by federal law. We are not aware that any of the other federal banking agencies contend otherwise. Our efforts to ensure that state

nonmember banks do not engage in unfair or deceptive conduct are based on the Federal Trade Commission Act and the approach long taken by the FTC in this area.

To be "unfair" under this framework, conduct must cause or be likely to cause substantial harm that consumers cannot reasonably avoid that is not outweighed by countervailing benefits to consumers or to competition. See 15 U.S.C. §45(n) (FTC Act standards for unfairness) and FTC Policy Statement on Unfairness issued on December 17, 1980 (copy enclosed). To be "deceptive," a material misrepresentation or omission must mislead or be likely to mislead a reasonable consumer. See FTC Policy Statement on Deception issued October 14, 1983 (copy enclosed).

If the FDIC determines that an institution under its supervision has violated the FTC Act, we will require appropriate corrective action. The facts and circumstances of the case will determine whether it is necessary to initiate formal enforcement proceedings to obtain such a correction.

3. Why did the FDIC fail to promptly examine the state chartered FDIC banks and their payday loan partners after the Guidelines were issued? It has been nine months since the FDIC guidelines were issued and no examination results have been made public. Three more banks have entered the rent-a-bank payday loan business while the FDIC has failed to act. The FDIC payday loan guidelines fail to actually impose any limits on loan terms and do not substitute for state usury, small loan, or even state payday loan laws. The guidelines are viewed by the industry as a road map for evading state laws.

Since the Guidelines were issued (July 2003), the FDIC has examined all but three of the state-nonmember banks engaged in payday lending; the remaining examinations are underway or are scheduled in the very near term. The FDIC conducted visitations at several of the banks after issuing the Guidelines.

As you know, with the exception of CRA evaluations, examination reports are not made public. We can tell you that in many cases the examination cycle has been accelerated to provide for more frequent evaluations of each institution's payday lending program and its conformance with the Guidelines. Examinations of banks involved in payday lending have often included on-site visits to vendor store-front offices to verify their practices and conformity with applicable laws.

4. Currently ten state-chartered FDIC banks rent their charters to pawn shops, payday loan outlets, and check cashers so that these storefronts can make loans that would be illegal under state usury and small loan laws if made directly by the banks' partners. Do you consider this safe and sound banking? Should any banks be in the business of encouraging consumers to write checks without money in the bank?

The FDIC recognizes payday lending as a legal lending activity that, because it is among the highest-risk forms of subprime lending, demands close regulatory supervision. The federal

banking agencies have established guidelines that clearly identify the inherent risks of subprime lending; however, subprime lending can nonetheless be a safe and sound banking activity if bank management properly manages and controls those risks, and if the bank has adequate capital to absorb the additional risks. The FDIC's Guidelines on Payday Lending build on the existing interagency guidelines for subprime lending by establishing rigorous capital and operational standards for banks engaged in this business. For FDIC-supervised banks that have not met these standards, the FDIC has taken, and will continue to take, appropriate enforcement action. As mentioned earlier, two FDIC-supervised banks have exited the payday lending business due to the FDIC initiating enforcement actions.

5. Would you permit banks entering the remittance business to engage in the same kind of third-party charter rental for money transmitters who charge outrageous rates and fail to make proper disclosures of hidden charges to consumers?

The FDIC's authority in this area, similar to payday lending or any other permissible banking activity, is one of ongoing supervision rather than the granting of permission to initially undertake specific activities. In addition, because the remittance business does not involve the extension of credit and the payment of interest, the laws applicable to remittances are different than those applicable to third-party business relationships that involve payday lending.

Our authority over a state nonmember bank's relationship with a third-party money transmitter would depend on the specific features of that relationship and the potential impact on the bank. Under certain circumstances, the FDIC could take action to address business practices that are unfair or deceptive under the Federal Trade Commission Act. For example, the enforcement jurisdiction of the FDIC extends to depository institutions for which we are the appropriate Federal banking agency as well as to "institution-affiliated parties" of such institutions in certain circumstances. An institution-affiliated party is defined by Section 3(u) of the Federal Deposit Insurance Act to include directors, officers, employees, controlling stockholders (other than bank holding companies), other persons who participate in the conduct of the affairs of an insured depository institution, and independent contractors under limited circumstances.

As you know, in cases where the FDIC does not have jurisdiction, a number of other agencies would have authority to combat unfair or deceptive acts or practices. In particular, the FTC has broad authority to enforce the requirements of the FTC Act against many nonbank entities. In addition, the various state authorities have primary responsibility for enforcing state statutes that prohibit unfair or deceptive acts or practices.

If the FDIC becomes aware of apparent violations in entities subject to the primary jurisdiction of another agency, an appropriate referral is made. There also are situations where jurisdiction is concurrent, allowing corrective action by both the FDIC and another agency.

6. Payday loans are originated with little or no underwriting or consideration of ability to repay the loans. The practice of loaning money without regard for ability to repay is a

hallmark of predatory lending. Since the FDIC is the lead agency on protecting the safety and soundness of federally insured banks, why hasn't the FDIC clearly required banks to make safe and sound small loans under terms that borrowers can successfully repay? Why aren't banks required to do analysis of debt to income ratios? Find out other obligations borrowers have? Consider the impact of high finance charges for loans due in full on the next payday on consumers' ability to repay?

Payday loans are made utilizing limited underwriting and documentation, typically involving little more than verifying a borrower's income and the existence of a checking account. Limited underwriting and documentation is not uncommon for very small loans. Likewise, finance charges are typically higher for this type of unsecured credit because there is very little recourse for the lender if a borrower chooses not to repay. Again, the FDIC views payday lending as among the highest-risk forms of subprime lending, but the FDIC also recognizes that payday lending can nonetheless be undertaken in a safe and sound manner, provided bank management properly manages and controls all the associated risks, and provided the bank has adequate capital to absorb the additional risks.

In developing the Guidelines, the FDIC looked closely at industry practices for "rollovers" and "consecutive advances" in order to address potentially poor practices in these areas. The Guidelines mitigate concerns in these areas by requiring institutions to establish an appropriate cooling-off period between the time a payday loan is repaid and another application is made, establish an appropriate limit for the number of loans per customer allowed within a designated time period, and limit the number of payday loans at any one time to any one borrower to only one loan. The Guidelines also direct institutions to charge-off credits that do not have an appropriate cooling-off period and require that institutions not make additional advances on such credits to finance unpaid interest and fees. Where FDIC-supervised banks engaged in this activity do not meet the rigorous capital and operational standards embodied in the Guidelines, the FDIC has taken, and will continue to take, appropriate enforcement actions.

7. We believe you currently have the authority to expand upon the service test in the joint regulations to give CRA credit to banks that are providing low cost remittances services to low and moderate income customers. Is this correct? Would there be any technical difficulty in establishing a standard for defining lower cost services relative to service charges by nonbank providers in the same service areas? Since the service test applies only to large institutions (and there would be about 1100 fewer "large" institutions under the pending CRA proposal) is there a way to provide credit to smaller banks who provide these services?

Remittances by wire transfer or an automated clearing house (ACH) are a retail service, and therefore, are relevant under the CRA regulations. To the extent that offering remittances increases access to financial services for low- or moderate-income individuals, this service also could receive favorable consideration as a community development service.

As you note, Community Reinvestment Act (CRA) examinations of large financial institutions (generally those with assets over $250 million or belonging to a holding company

with assets over $1 billion) include a service test to assess a bank's record of providing retail and community development services. The availability and effectiveness of a bank's retail services and the extent to which those services are tailored to community needs are reviewed under the service test. Services that are designed to increase access to financial services for low- or moderate-income individuals, such as services offered at a low cost, receive favorable consideration as community development services. (See Interagency Questions and Answers on Community Reinvestment, 66 Fed. Reg. 36619, 36621, 36628 (July 12, 2001).)

Under the CRA regulation, small institutions are subject to a streamlined examination that focuses on five broad performance indicators – loan to deposit ratio, assessment area lending ratio, loan distribution by size and geography, and whether the institution has had any complaints about its CRA performance. At a small institution's option, examiners will consider its record of providing services, such as remittances, to determine whether an outstanding rating should be assigned when it has received a satisfactory rating on these five assessment factors. In fact, the FDIC recently gave favorable CRA consideration to a small community bank based in Milwaukee, Wisconsin, for offering a remittance product.

In evaluating any product or service, regardless of the bank's size or performance methods, examiners evaluate it within the bank's performance context. This context includes the demographics of the community, the bank's business strategy and institutional capacity and constraints, and the performance of other similarly situated institutions, including, in the case of a specialized service like remittances, both bank and non-bank providers. In light of the increasing participation of insured institutions in this arena, it may be premature to establish any single standard or comparison for determining whether a particular service is lower cost. Considerations such as security, availability of transfer services to both transferors and recipients, and the restrictions imposed or ease of transactions must be weighed as well as the price.

In May 2003, the FDIC and the Consulate General of Mexico launched the New Alliance Task Force (NATF), a broad-based coalition of 30 banks and 25 community-based organizations, whose mission is to provide immigrants, both established and recently arrived, with the necessary financial education and support services to improve their access to the U.S. banking system. We are pleased to be part of this significant undertaking.

The NATF is comprised of four major working groups, including the Bank Products & Services working group. The main responsibility of this group is to develop products to bank the "unbanked" and to encourage financial institutions to develop financial service products with remittance features as a way to reach the "unbanked" immigrant community.

Data collected from more than 30 banks that operate in the Midwest indicate that in the last 18 months, more than 50,000 accounts have been opened by formerly "unbanked" customers, with an average balance of $2,000. Many of these accounts were opened through remittance products offered by banks.

Nearly 20 banks in the Midwest offer bank products with remittance features that allow immigrants to open bank accounts, avoid high-cost wire services, and lower remittance costs for

immigrants sending money back home. Many banks now offer wire transfer services and/or products with remittance features (for example, issuing two ATM cards -- one for use in the U.S. and one to be sent to the home country) as a vehicle to reach this market.

8. A 2000 FDIC Office of Inspector General report found that: "DCA's (Division of Compliance and Consumer Affairs) examination procedures do not provide specific guidance in some critical areas of the evaluation process in which we believe consistency is vital. Consequently, CRA examination procedures are not consistently applied by examiners within and among regional offices. We also found that the CRA Performance Evaluation reports (PE reports) do not comprehensively identify the credit needs of the communities in which the banks are operating.

"Additionally, the PE reports do not consistently include the types of comparative and analytical data in the analyses of the banks' small business lending performance that would enable the reader to understand the basis for the examiners' conclusions. As a result of the lack of information related to the credit needs of the community and small business lending data, it is difficult to determine if the resulting ratings provide an accurate measure of the banks' performance. In addition, we determined that internal control procedures over the CRA examination review process and workpaper maintenance need to be enhanced to ensure consistent presentations of CRA data and complete analyses to support the examiners' conclusions.

What have you done to reform your examination procedures to meet these concerns? Have you improved the quality standards of the PE reports over the last three years? What steps have you taken to enhance internal control procedures over the exam process?

The CRA audit issued by the FDIC's Office of the Inspector General (OIG) covered 57 CRA public evaluations from 1998, including 25 large bank and 32 small bank public evaluations. Those evaluations were the first group conducted by the FDIC under the revised CRA regulations, which became effective for small banks in January 1996 and the large banks in January 1997.

All of the evaluations reviewed were prepared prior to the issuance of comprehensive large bank examination guidance by the FDIC in December 1998 that addressed many of the issues cited in the OIG report. That guidance provided specific criteria and instruction, not only to ensure consistency in the presentation of data from large bank examinations through the use of standardized tables, but also to support conclusions in the evaluations. They also precede, by approximately two years, further steps taken by the FDIC to improve the FDIC's CRA examination process through the agency's own review in April 2000 of 250 CRA public evaluations – small and large – which led to improvements in regional examination oversight, quality assurance, training, and examiner guidance.

Following both the OIG and the FDIC's own analysis of public evaluations in 2000, the FDIC adopted new consolidated guidance for CRA Examinations and Performance Evaluations

that comprehensively addresses the recommendations made by the OIG and issues identified by the FDIC's national public evaluation review.

This guidance, issued in July 2001 and updated in January 2003, provides specific guidance to examiners in several areas, including:

- Presenting information and analyses in public evaluations
- Selecting loan product lines, sampling, and analyzing loan data
- Evaluating loans, investments, and services
- Differentiating among CRA ratings
- Conducting community contact interviews

A full-day, detailed review of this guidance was incorporated into the advanced training for compliance examiners and remains a core topic at introductory and advanced compliance examiner schools conducted by the FDIC.

The guidance also required the FDIC to strengthen examination oversight and quality assurance procedures. The implementation of these efforts is evaluated as part of periodic internal quality assurance reviews.

Among the changes in the CRA implementing regulations adopted in 1995 was the elimination of a so-called "needs assessment," particularly for small banks – which comprise the vast majority of banks supervised by the FDIC. This requirement was replaced by the concept of "performance context," which requires examiners to evaluate a bank's performance within the context of a number of factors, including demographic and lending data, information regarding lending, investment and service opportunities maintained by the bank or obtained from community organizations or government agencies, the bank's business strategy, and institutional capacity and constraints.

To emphasize the importance of analyzing community credit needs, guidance issued by the FDIC in July 2001 specifically states that community credit needs must be discussed in every public evaluation, as must community contact information. The FDIC took a leading role in creating a community contact data base to enable the four federal banking agencies to share the information obtained from community contacts.

The FDIC also issued software in March 1999, prior to the audit, that facilitates the use and analysis of standardized data tables on examiner laptop computers. This software is used for both small and large bank examinations, and is updated annually to incorporate new releases of Home Mortgage Disclosure Act (HMDA), Dunn & Bradstreet, census and other data.

The standardized tables adopted by the FDIC in 1998 as part of its large bank examination guidance have been superseded by a set of large bank core tables created by the four federal banking agencies for use in all large bank CRA public evaluations. These tables, which went into effect in April 2002, were adopted in response to criticisms that public evaluations were inconsistent from one regulatory agency to another. The use of the core tables created

greater consistency among the public evaluations and better utilizes data required to be collected and reported by financial institutions without imposing any additional burden on them.

Other interagency efforts that have substantially improved the quality and consistency of CRA public evaluations include the publication of the Interagency Questions and Answers on CRA, which have greatly assisted examiners, bankers and the public with respect to interpretative issues regarding CRA.

9. The FDIC is reported to have given Venture Bank of Washington State a 'satisfactory' CRA rating, even though the bank engages in 'rent-a-charter' activities with an out-of-state payday lender.

a) Did the FDIC consider the bank's relationship with the payday lender in performing the CRA evaluation?

The FDIC considered Venture Bank's relationship with a payday lender as part of a recent CRA performance evaluation. The evaluation found that the payday lending relationship did not adversely affect the bank's CRA performance in its local communities and did not limit the bank's ability to meet community credit needs in its assessment area. As indicated in the evaluation, the examiners did not identify any evidence of discriminatory or other illegal credit practices when they considered the payday lending operation.

b) Is the payday lender with which Venture Bank has a relationship the same one which People's National Bank of Paris, Texas, had a relationship, which resulted in the OCC brought an enforcement action that culminated in the bank paying $175,000 in civil money penalties and agreed to terminate its relationship with the payday lender, among other provisions of a consent order? Is the payday lender the same payday lender that also entered into an agreement last year with the OCC in which it agreed it would not enter into any contract to become either an agent or bank service provider for a national bank without first applying to the OCC?

As of the date of the CRA evaluation, Venture Bank had a relationship with Advance America Cash Advance Centers, Inc. (Advance America), which is the same entity with which People's National Bank of Paris, Texas, had a relationship. Both People's National Bank and Advance America, the bank's agent, entered into consent orders with the OCC as a result of the OCC's findings that they violated federal consumer protection laws and regulations in their payday lending operations.

While involving the same entity, the specific facts and circumstances of Venture Bank's relationship are materially different than those existing at the time of the OCC's findings in regard to People's National Bank. The nature of the relationship, as well as both entities' governing policies and controls relating to the relationship, alleviate the central concerns that led to the OCC's consent orders. As indicated above, FDIC examiners did not identify evidence of discriminatory or other illegal credit practices when they reviewed Venture Bank's payday loan operations conducted through Advance America as marketer and servicer.

c) Does a relationship with an out-of-state payday lender help a bank meet "the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safety and sound operation" of the bank, as specified in section 804 of CRA?

The standards for assessing bank CRA performance focus on activities within an institution's self-defined assessment area. Assessment areas may not extend substantially beyond state boundaries unless the bank operates in a multi-state metropolitan statistical area. The standards for both large and small banks focus on lending performance, and give particular weight to making loans to persons or on property within the assessment area. If an out-of-state payday loan agent is not operating within the bank's assessment area, then such a relationship would not help a bank meet the credit needs of its community. As with Venture Bank, such a relationship may not affect the bank's CRA performance, so long as it is carefully controlled and does not constitute an undue percentage of the bank's loan portfolio.

As indicated in the FDIC's Guidelines for Payday Lending, a payday lending program within a bank's assessment area might be inconsistent with meeting the community's convenience and needs. Loans made "to individuals who do not have the ability to repay, or that may result in repeated renewals or extensions and fee payments over a relatively short span of weeks, do not help to meet credit needs in a responsive manner."

10. Do you believe the recent OCC preemption rules will affect the normal patterns of bank chartering and charter conversions, particularly state bank movement to national bank charters? Have you noticed any unusual charter movement regarding the banks you regulate?

To date, the FDIC has seen no evidence that OCC preemption rules have affected bank charter choices in the banking industry.

Guidelines For Payday Lending

Purpose

This guidance provides information about payday lending, a particular type of subprime lending, and supplements previously issued guidance about such programs.[1] It describes safety and soundness and compliance considerations for examining and supervising state nonmember institutions that have payday lending programs.

This guidance is necessitated by the high risk nature of payday lending and the substantial growth of this product. It describes the FDIC's expectations for prudent risk-management practices for payday lending activities, particularly with regard to concentrations, capital, allowance for loan and lease losses, classifications, and protection of consumers. The guidelines also address recovery practices, income recognition, and managing risks associated with third-party relationships.

When examiners determine that management of safety and soundness or compliance risks is deficient, they should criticize management and initiate corrective action. Such actions may include formal or informal enforcement action. When serious deficiencies exist, enforcement actions may instruct institutions to discontinue payday lending.

Background

In recent years a number of lenders have extended their risk selection standards to attract subprime loans. Among the various types of subprime loans, "payday loans" are now offered by an increasing number of insured depository institutions.

Payday loans (also known as deferred deposit advances) are small-dollar, short-term, unsecured loans that borrowers promise to repay out of their next paycheck or regular income payment (such as a social security check). Payday loans are usually priced at a fixed dollar fee, which represents the finance charge to the borrower. Because these loans have such short terms to maturity, the cost of borrowing, expressed as an annual percentage rate (APR), is very high.[2]

In return for the loan, the borrower usually provides the lender with a check or debit authorization for the amount of the loan plus the fee. The check is either post-dated to the borrower's next payday or the lender agrees to defer presenting the check for payment until a future date, usually two weeks or less. When the loan is due, the lender expects to collect the loan by depositing the check or debiting the borrower's account or by having the borrower redeem the check with a cash payment. If the borrower informs the lender that he or she does not have the funds to repay the loan, the loan is often refinanced [3] through payment of an additional fee. If the borrower does not redeem the check in cash and the loan is not refinanced, the lender normally puts the check or debit authorization through the payment system. If the borrower's deposit account has insufficient funds, the borrower typically incurs a NSF charge on this account. If the check or the debit is returned to the lender unpaid, the lender also may impose a returned item fee plus collection charges on the loan.

Significant Risks

Borrowers who obtain payday loans generally have cash flow difficulties, and few, if any, lower-cost borrowing alternatives. In addition, some payday lenders perform minimal analysis of the borrower's ability to repay either at the loan's inception or upon refinancing; they may merely require a current pay stub or proof of a regular income source and evidence that the customer has a checking account. Other payday lenders use scoring models and consult nationwide databases that track bounced checks and persons with outstanding payday loans. However, payday lenders typically do not obtain or

analyze information regarding the borrower's total level of indebtedness or information from the major national credit bureaus (Equifax, Experian, TransUnion). In addition, payday lenders generally do not conduct a substantive review of the borrower's credit history. The combination of the borrower's limited financial capacity, the unsecured nature of the credit, and the limited underwriting analysis of the borrower's ability to repay pose substantial credit risk for insured depository institutions.

Insured depository institutions may have payday lending programs that they administer directly, using their own employees, or they may enter into arrangements with third parties. In the latter arrangements, the institution typically enters into an agreement in which the institution funds payday loans originated through the third party. These arrangements also may involve the sale to the third party of the loans or servicing rights to the loans.[4] Institutions also may rely on the third party to provide additional services that the bank would normally provide, including collections, advertising and soliciting applications. The existence of third party arrangements may, when not properly managed, significantly increase institutions' transaction, legal, and reputation risks.

Federal law authorizes federal and state-chartered insured depository institutions making loans to out of state borrowers to "export" favorable interest rates provided under the laws of the state where the bank is located. That is, a state-chartered bank is allowed to charge interest on loans to out of state borrowers at rates authorized by the state where the bank is located, regardless of usury limitations imposed by the state laws of the borrower's residence.[5] Nevertheless, institutions face increased reputation risks when they enter into certain arrangements with payday lenders, including arrangements to originate loans on terms that could not be offered directly by the payday lender.

Payday loans are a form of specialized lending not typically found in state nonmember institutions, and are most frequently originated by specialized nonbank firms subject to state regulation. Payday loans can be subject to high levels of transaction risk given the large volume of loans, the handling of documents, and the movement of loan funds between the institution and any third party originators. Because payday loans may be underwritten off-site, there also is the risk that agents or employees may misrepresent information about the loans or increase credit risk by failing to adhere to established underwriting guidelines.

Procedures

General

Examiners should apply this guidance to banks with payday lending programs that the bank administers directly or that are administered by a third party contractor. This guidance does ***not*** apply to situations where a bank makes occasional low-denomination, short-term loans to its customers.

As described in the *2001 Subprime Guidance*, a program involves the regular origination of loans, using tailored marketing, underwriting standards and risk selection. The *2001 Subprime Guidance* applies specifically to institutions with programs where the aggregate credit exposure is equal to or greater than 25% or more of tier 1 capital. However, because of the significant credit, operational, legal, and reputation risks inherent in payday lending, this guidance applies regardless of whether a payday loan program meets that credit exposure threshold.

All examiners should use the procedures outlined in the *Subprime Lending Examination Procedures*, as well as those described here. While focused on safety and soundness issues, segments of the *Subprime Lending Examination Procedures* also are applicable to compliance examinations. They will need to be supplemented with existing procedures relating to specific consumer protection laws and regulations.

Due to the heightened safety and soundness and compliance risks posed by payday lending, concurrent risk management and consumer protection examinations should be conducted absent overriding resource or scheduling problems. In all cases, a review of each discipline's examinations and workpapers should be part of the pre-examination planning process. Relevant state examinations also should be reviewed.

Examiners may conduct targeted examinations of the third party where appropriate. Authority to conduct examinations of third parties may be established under several circumstances, including through the bank's written agreement with the third party, section 7 of the Bank Service Company Act, or through powers granted under section 10 of the Federal Deposit Insurance Act. Third party examination activities would typically include, but not be limited to, a review of compensation and staffing practices; marketing and pricing policies; management information systems; and compliance with bank policy, outstanding law, and regulations. Third party reviews should also include testing of individual loans for compliance with underwriting and loan administration guidelines, appropriate treatment of loans under delinquency, and re-aging and cure programs.

Third-Party Relationships and Agreements

The use of third parties in no way diminishes the responsibility of the board of directors and management to ensure that the third-party activity is conducted in a safe and sound manner and in compliance with policies and applicable laws. Appropriate corrective actions, including enforcement actions, may be pursued for deficiencies related to a third-party relationship that pose concerns about either safety and soundness or the adequacy of protection afforded to consumers.

The FDIC's principal concern relating to third parties is that effective risk controls are implemented. Examiners should assess the institution's risk management program for third-party payday lending relationships. An assessment of third-party relationships should include an evaluation of the bank's risk assessment and strategic planning, as well as the bank's due diligence process for selecting a competent and qualified third party provider. (Refer to the *Subprime Lending Examination Procedures* for additional detail on strategic planning and due diligence.)

Examiners also should ensure that arrangements with third parties are guided by written contract and approved by the institution's board. At a minimum, the arrangement should:

- Describe the duties and responsibilities of each party, including the scope of the arrangement, performance measures or benchmarks, and responsibilities for providing and receiving information;
- Specify that the third party will comply with all applicable laws and regulations;
- Specify which party will provide consumer compliance related disclosures;
- Authorize the institution to monitor the third party and periodically review and verify that the third party and its representatives are complying with its agreement with the institution;
- Authorize the institution and the appropriate banking agency to have access to such records of the third party and conduct onsite transaction testing and operational reviews at third party locations as necessary or appropriate to evaluate such compliance;
- Require the third party to indemnify the institution for potential liability resulting from action of the third party with regard to the payday lending program; and
- Address customer complaints, including any responsibility for third-party forwarding and responding to such complaints.

Examiners also should ensure that management sufficiently monitors the third party with respect to its activities and performance. Management should dedicate sufficient staff with the necessary expertise to oversee the third party. The bank's oversight program should monitor the third party's financial condition, its controls, and the quality of its service and support, including its resolution of consumer complaints if handled by the third party. Oversight programs should be documented sufficiently to facilitate the monitoring and management of the risks associated with third-party relationships.

Safety and Soundness Issues

Concentrations

Given the risks inherent in payday lending, concentrations of credit in this line of business pose a significant safety and soundness concern. In the context of these guidelines, a concentration would be

defined as a volume of payday loans totaling 25 percent or more of a bank's Tier 1 capital. Where concentrations of payday lending are noted, bank management should be criticized for a failure to diversify risks. Examiners will work with institutions on a case-by-case basis to determine appropriate supervisory actions necessary to address concentrations. Such action may include directing the institution to reduce its loans to an appropriate level, raise additional capital, or submit a plan to achieve compliance.

Capital Adequacy

The FDIC's minimum capital requirements generally apply to portfolios that exhibit substantially lower risk profiles and that are subject to more stringent underwriting procedures than exist in payday lending programs. Therefore, minimum capital requirements are not sufficient to offset the risks associated with payday lending.

As noted in the *2001 Subprime Guidance*, examiners should reasonably expect, as a starting point, that an institution would hold capital against subprime portfolios in an amount that is one and a half to three times greater than what is appropriate for non-subprime assets of a similar type. However, payday lending is among the highest risk subsets of subprime lending, and significantly higher levels of capital than the starting point should be required.

The *2001 Subprime Guidance* indicates that institutions that underwrite higher risk subprime pools, such as payday loans, need significantly higher levels of capital, perhaps as high as 100% of the loans outstanding (dollar-for-dollar capital), depending on the level and volatility of risk. Risks to consider when determining capital requirements include the unsecured nature of the credit, the relative levels of risk of default, loss in the event of default, and the level of classified assets. Examiners should also consider the degree of legal or reputational risk associated with the payday business line, especially as it relates to third-party agreements.

Because of the higher inherent risk levels and the increased impact that payday lending portfolios may have on an institution's overall capital, examiners should document and reference each institution's capital evaluation in their comments and conclusions regarding capital adequacy. (Refer to the *2001 Subprime Guidance* for further information on capital expectations.)

Allowance for Loan and Lease Losses (ALLL) Adequacy

As with other segments of an institution's loan portfolio, examiners should ensure that institutions maintain an ALLL that is adequate to absorb estimated credit losses within the payday loan portfolio. Consistent with the *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Associations (Interagency Policy Statement on ALLL)*,[6] the term "estimated credit losses" means an estimate of the current amount of loans that is not likely to be collected; that is, net charge-offs that are likely to be realized in a segment of the loan portfolio given the facts and circumstances as of the evaluation date. Although the contractual term of each payday loan may be short, institutions' methodologies for estimating credit losses on these loans should take into account the fact that many payday loans remain continuously outstanding for longer periods because of renewals and rollovers. In addition, institutions should evaluate the collectibility of accrued fees and finance charges on payday loans and employ appropriate methods to ensure that income is accurately measured.

Examiners should ensure that institutions engaged in payday lending have methodologies and analyses in place that demonstrate and document that the level of the ALLL for payday loans is appropriate. The application of historical loss rates to the payday loan portfolio, adjusted for the current environmental factors, is one way to determine the ALLL needed for these loans. Environmental factors include levels of and trends in delinquencies and charge-offs, trends in loan volume, effects of changes in risk selection and underwriting standards and in account management practices, and current economic conditions. For institutions that do not have loss experience of their own, it may be appropriate to reference the payday loan loss experience of other institutions with payday loan portfolios with similar attributes. Other methods, such as loss estimation models, are acceptable if they estimate losses in accordance with generally accepted accounting principles. Examiners should review

documentation to ensure that institutions loss estimates and allowance methodologies are consistent with the *Interagency Policy Statement on ALLL*.

Classification Guidelines

The *Uniform Retail Credit Classification and Account Management Policy (Retail Classification Policy)*[7] establishes general classification thresholds for consumer loans based on delinquency, but also grants examiners the discretion to classify individual retail loans that exhibit signs of credit weakness regardless of delinquency status. An examiner also may classify retail portfolios, or segments thereof, *where underwriting standards are weak and present unreasonable credit risk*, and may criticize account management practices that are deficient.

Most payday loans have well-defined weaknesses that jeopardize the liquidation of the debt. Weaknesses include limited or no analysis of repayment capacity and the unsecured nature of the credit. In addition, payday loan portfolios are characterized by a marked proportion of obligors whose paying capacity is questionable. As a result of these weaknesses, payday loan portfolios should be classified Substandard.

Furthermore, payday loans that have been outstanding for extended periods of time evidence a high risk of loss. While such loans may have some recovery value, it is not practical or desirable to defer writing off these essentially worthless assets. Payday loans that are outstanding for greater than 60 days from origination generally meet the definition of Loss. In certain circumstances, earlier charge off may be appropriate (i.e., the bank does not renew beyond the first payday and the borrower is unable to pay, the bank closes an account, etc.). The institution's policies regarding consecutive advances also should be considered when determining Loss classifications. Where the economic substance of consecutive advances is substantially similar to "rollovers" - without appropriate intervening "cooling off" or waiting periods - examiners should treat these loans as continuous advances and classify accordingly.

When classifying payday loans, examiners should reference the *Retail Classification Policy* as the source document. Examiners would normally not classify loans for which the institution has documented adequate paying capacity of the obligors and/or sufficient collateral protection or credit enhancement.

Renewals/Rewrites

The *Retail Classification Policy* establishes guidelines for extensions, deferrals, renewals, or rewrites of closed-end accounts. Despite the short-term nature of payday loans, borrowers that request an extension, deferral, renewal, or rewrite should exhibit a renewed willingness and ability to repay the loan. Examiners should ensure that institutions adopt and adhere to the *Retail Classification Policy* standards that control the use of extensions, deferrals, renewals, or rewrites of payday loans. Under the *Retail Classification Policy*, institutions' standards should:

- Limit the number and frequency of extensions, deferrals, renewals, and rewrites;
- Prohibit additional advances to finance unpaid interest and fees and simultaneous loans to the same customer; and
- Ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained.

In addition to the above items, institutions should also:

- Establish appropriate "cooling off" or waiting periods between the time a payday loan is repaid and another application is made;
- Establish the maximum number of loans per customer that are allowed within one calendar year or other designated time period; and
- Provide that no more than one payday loan is outstanding with the bank at a time to any one

borrower.

Accrued Fees and Finance Charges[8]

Examiners should ensure that institutions evaluate the collectibility of accrued fees and finance charges on payday loans because a portion of accrued interest and fees is generally not collectible. Although regulatory reporting instructions do not require payday loans to be placed on nonaccrual based on delinquency status, institutions should employ appropriate methods to ensure that income is accurately measured. Such methods may include providing loss allowances for uncollectible fees and finance charges or placing delinquent and impaired receivables on nonaccrual status. After a loan is placed on nonaccrual status, subsequent fees and finance charges imposed on the borrower would not be recognized in income and accrued, but unpaid fees and finance charges normally would be reversed from income.

Recovery Practices

After a loan is charged off, institutions must properly report any subsequent collections on the loan.[9] Typically, some or all of such collections are reported as recoveries to the ALLL. In some instances, the total amount credited to the ALLL as recoveries on an individual loan (which may have included principal, finance charges, and fees) may exceed the amount previously charged off against the ALLL on that loan (which may have been limited to principal). Such a practice understates an institution's net charge-off experience, which is an important indicator of the credit quality and performance of an institution's portfolio.

Consistent with regulatory reporting instructions and prevalent industry practice, recoveries represent collections on amounts that were previously charged off against the ALLL. Accordingly, institutions must ensure that the total amount credited to the ALLL as recoveries on a loan (which may include amounts representing principal, finance charges, and fees) is limited to the amount previously charged off against the ALLL on that loan. Any amounts collected in excess of this limit should be recognized as income.

Compliance Issues

Payday lending raises many consumer protection issues and attracts a great deal of attention from consumer advocates and other regulatory organizations, increasing the potential for litigation. Regardless of whether state law characterizes these transactions as loans, they are considered extensions of credit for purposes of federal consumer protection law. Laws and regulations to be closely scrutinized when reviewing payday lending during consumer compliance examinations include:

Community Reinvestment Act (CRA)/ Part 345

Under interagency CRA regulations and interpretive guidance, a payday lending program may adversely affect CRA performance. For example, evidence of discriminatory or other illegal credit practices are inconsistent with helping to meet community credit needs and adversely affect an evaluation of a financial institution's performance. Examples of illegal credit practices include, but are not limited to violations of: the Equal Credit Opportunity Act, concerning discouraging or discriminating against consumers on a prohibited basis; the Truth in Lending Act, regarding disclosures and certain loan restrictions; and the Federal Trade Commission Act, concerning unfair and deceptive acts or practices. Under longstanding interagency regulatory guidance, only illegal credit practices adversely affect CRA performance and may result in a lower CRA rating. As in all other aspects of the CRA evaluation, FDIC examiners will continue to follow the CRA regulations and guidance issued jointly by the federal banking agencies (FDIC, Federal Reserve, OTS and OCC) and in effect at the time of an examination.

However, other questionable payday lending practices, while not specifically prohibited by law, may be inconsistent with helping to meet the convenience and needs of the community. For example, payday loans to individuals who do not have the ability to repay, or that may result in repeated renewals or

extensions and fee payments over a relatively short span of weeks, do not help to meet credit needs in a responsive manner. A full description of the payday lending program and such practices should be included in the section of the CRA Public Performance Evaluation that describes the institution. This section provides a description of the institution's profile, business strategy, and product offerings inside and outside the assessment area(s). As with any public comment, public comments regarding payday lending practices should be discussed appropriately in a financial institution's CRA Public Performance Evaluation, and included in the institution's CRA Public File.

Truth in Lending Act/ Regulation Z

TILA and Regulation Z[10] require banks engaged in consumer lending to ensure that accurate disclosures are provided to customers. A bank that fails to disclose finance charges and APRs accurately for payday loans - considering the small dollar tolerance for inaccuracies - risks having to pay restitution to consumers, which in some instances could be substantial. This risk remains even if the bank provides loans through a third-party agreement.

TILA and Regulation Z also require banks to advertise their loan products in accordance with their provisions. For example, advertisements that state specific credit terms may state only those terms that actually are or will be arranged or offered by the creditor. If an advertisement states a rate of finance charge, it must state the rate as an APR, using that term. If the APR may be increased after the initial origination date, the advertisement must so state. Additional disclosures also may be required in the advertisements.

Equal Credit Opportunity Act/ Regulation B

Illegal discrimination may occur when a bank has both payday and other short-term lending programs that feature substantially different interest rate or pricing structures. Examiners should determine to whom the products are marketed, and how the rates or fees for each program are set, and whether there is evidence of potential discrimination. Payday lending, like other forms of lending, is also susceptible to discriminatory practices such as discouraging applications, requesting information or evaluating applications on a prohibited basis. If the lender requires that a borrower have income from a job, and does not consider income from other sources such as social security or veterans benefits, then it is illegally discriminating against applicants whose income derives from public assistance.

ECOA and Regulation B limit the type of information that may be requested of applicants during an application for credit. A creditor may not refuse to grant an individual account to a creditworthy applicant on the basis of sex, marital status or any other prohibited basis. A state nonmember bank must ensure that its payday lending program complies with these limitations.

ECOA and Regulation B require creditors to notify applicants of adverse actions taken in connection with an application for credit. Notices of adverse action taken must be provided within specified time frames and in specified forms. State nonmember banks involved in payday lending must ensure that such notices are given in an accurate and timely manner.

Fair Credit Reporting Act

A bank engaged directly or indirectly in payday lending is responsible for complying with requirements to provide notice to a consumer when it declines an application for credit or takes other adverse action based on certain information. If adverse action is taken based on information received from a consumer reporting agency, the consumer must be notified and provided the name and address of the consumer reporting agency. It is important to note that information in "bad check lists" or databases that track outstanding payday loans are considered to be consumer reports, and therefore the companies that provide such a tracking service (such as Teletrack) are consumer reporting agencies. If adverse action is taken based on information received from a third party that is not a consumer reporting agency, the adverse action notice must direct the consumer to the bank, and not any third party, for details regarding the character of the information (even where the payday loan applications are received by the bank through a third party such as a payday lender).

Electronic Fund Transfer Act (EFTA)/ Regulation E and Truth in Savings Act (TISA)

Payday lending arrangements that involve the opening of a deposit account or the establishment of "electronic fund transfers" must meet the disclosure and other requirements of both the EFTA and TISA. Examples include providing a device to access funds from a deposit account, or depositing a payday loan directly in a borrower's account and debiting the subsequent payment.

Fair Debt Collection Practices Act (FDCPA)

If a bank engages in payday lending through an arrangement with a third party, and the third party collects defaulted debts on behalf of the bank, the third party may become subject to the provisions of the FDCPA. Although the bank itself may not be subject to the FDCPA, it may face reputational risk if the third party violates the FDCPA in collecting the bank's loans. A compliance program should provide for monitoring of collection activities, including collection calls, of any third party on behalf of the bank.

Federal Trade Commission Act (FTC Act)

The Federal Trade Commission Act (FTC Act) declares that unfair or deceptive trade practices are illegal. (See 15 USC § 45(a)). State nonmember banks and their institution-affiliated parties will be cited for violations of section 5 of the FTC Act and the FDIC will take appropriate action pursuant to its authority under section 8 of the Federal Deposit Insurance Act when unfair or deceptive trade practices are discovered. Examiners should focus attention on marketing programs for payday loans, and also be alert for potentially abusive collection practices. Of particular concern is the practice of threatening, and in some cases pursuing, criminal bad check charges, despite the payment of offsetting fees by the consumer and the lender's knowledge at the time the check was accepted that there were insufficient funds to pay it. If evidence of unfair or deceptive trade practices is found, examiners should consult with the regional office and the region should consult with Washington.

Where entities other than banks engage in unfair or deceptive trade practices, the FDIC will coordinate its response with the Federal Trade Commission. (Refer to FIL-57-2002, dated May 30, 2002, for further information.)

Privacy of Consumer Financial Information/Part 332

Payday lending arrangements are subject to the same information sharing restrictions and requirements as any other type of financial service or product provided by FDIC-supervised institutions to consumers. The bank should ensure consumers are appropriately provided with a copy of the bank's initial, revised, and annual notices, as applicable. In addition, the bank should ensure that a consumer's nonpublic personal information is used and disclosed only as permitted and described in the privacy notice.

Safeguarding Customer Information

The *Interagency Guidelines Establishing Standards for Safeguarding Customer Information,* Appendix B to Part 364, require banks to implement a written information security program to protect the security, confidentiality, and integrity of customer information. The guidelines require banks to assess reasonably foreseeable internal and external threats that could result in unauthorized uses or destruction of customer information systems, and to design a security program to control those risks. A bank's board of directors should approve the written program and oversee its implementation.

Examiners should ensure the bank has appropriately addressed the security risks in payday lending arrangements to safeguard customer information, whether in paper, electronic, or other form, maintained by or on behalf of the bank.

FOOTNOTES:

[1] See January 31, 2001, Interagency *Expanded Guidance for Subprime Lending Programs* (FIL 9-2001) (2001 Subprime Guidance); January 24, 2000, *Subprime Lending Examination Procedures* (RD Memo No. 00-004); March 4, 1999, *Interagency Guidelines on Subprime Lending* (FIL-20-99); and May 2, 1997, *Risks Associated with Subprime Lending* (FIL-44-97).

[2] The typical charge is $15 to $20 per $100 advanced for a two-week period, resulting in an APR of nearly 400%.

[3] Payday lenders generally use the term "rollover." Other terms used may include extension, deferral, renewal or rewrite.

[4] Insured depository institutions also may fund payday lenders through a lending relationship. This guidance does not address such situations.

[5] *See* section 27 of the Federal Deposit Insurance Act, 12 U.S.C. § 1831d (enacted as section 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 [the "DIDMCA"]). The authority of national banks to export favorable interest rates on loans to borrowers residing in other states was recognized by the U.S. Supreme Court in **Marquette National Bank of Minneapolis v. First Omaha Service Corp.**, 439 U.S. 299 (1978), in the context of section 85 of the National Bank Act. That authority was subsequently extended to credit unions, savings associations, state nonmember banks and insured foreign branches in the DIDMCA to provide competitive lending equality with national banks.

[6] *See* July 25, 2001, *Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Associations* (FIL 63-2001).

[7] *See* June 29, 2000, *Uniform Retail Credit Classification and Account Management Policy* (FIL -40-2000).

[8] AICPA Statement of Position 01-6 *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others*, provides guidance for accounting for delinquency fees.

[9] AICPA Statement of Position 01-6 provides recognition guidance for recoveries of previously charged-off loans.

[10] Federal Reserve Board staff considered payday loans in the context of Regulation Z, and found that they are a form of credit under the Truth in Lending Act. 12 CFR Part 226, Supplement I, Subpart A, Section 226.2(a)(14), note 2. If the fees are finance charges, as they usually will be, see 12 CFR Part 226.4, they must be disclosed as an APR, regardless of how the fee is characterized under state law.

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation

Unfair or Deceptive Acts or Practices by State-Chartered Banks

March 11, 2004

Purpose

The Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation (the "Board" and the "FDIC," or collectively, the "Agencies") are issuing this statement to outline the standards that will be considered by the Agencies as they carry out their responsibility to enforce the prohibitions against unfair or deceptive trade practices found in section 5 of the Federal Trade Commission Act ("FTC Act")[1] as they apply to acts and practices of state-chartered banks. The Agencies will apply these standards when weighing the need to take supervisory and enforcement actions and when seeking to ensure that unfair or deceptive practices do not recur.

This statement also contains a section on managing risks relating to unfair or deceptive acts or practices, which includes best practices as well as general guidance on measures that state-chartered banks can take to avoid engaging in such acts or practices.

Although the majority of insured banks adhere to a high level of professional conduct, banks must remain vigilant against possible unfair or deceptive acts or practices both to protect consumers and to minimize their own risks.

Coordination of Enforcement Efforts

Section 5(a) of the FTC Act prohibits "unfair or deceptive acts or practices in or affecting commerce,"[2] and applies to all persons engaged in commerce, including banks. The Agencies each have affirmed their authority under section 8 of the Federal Deposit Insurance Act to take appropriate action when unfair or deceptive acts or practices are discovered.[3]

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[1] 15 U.S.C. § 45.

[2] 15 U.S.C. § 45(a).

[3] 12 U.S.C. § 1818(b)(1), (e)(1), and (i)(2). See letter from Chairman Greenspan to the Hon. John J. LaFalce (May 30, 2002); and "Unfair or Deceptive Acts or Practices: Applicability of the Federal Trade Commission Act," FIL 57-2002 (May 30, 2002).

A number of agencies have authority to combat unfair or deceptive acts or practices. For example, the FTC has broad authority to enforce the requirements of section 5 of the FTC Act against many non-bank entities.[4] In addition, state authorities have primary responsibility for enforcing state statutes against unfair or deceptive acts or practices. The Agencies intend to work with these other regulators as appropriate in investigating and responding to allegations of unfair or deceptive acts or practices that involve state banks and other entities supervised by the Agencies.

Standards for Determining What is Unfair or Deceptive

The FTC Act prohibits unfair or deceptive acts or practices. Congress drafted this provision broadly in order to provide sufficient flexibility in the law to address changes in the market and unfair or deceptive practices that may emerge.[5]

An act or practice may be found to be *unfair* where it "causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition."[6] A representation, omission, or practice is *deceptive* if it is likely to mislead a consumer acting reasonably under the circumstances and is likely to affect a consumer's conduct or decision regarding a product or service.

The standards for unfairness and deception are independent of each other. While a specific act or practice may be both unfair and deceptive, an act or practice is prohibited by the FTC Act if it is *either* unfair *or* deceptive. Whether an act or practice is unfair or deceptive will in each instance depend upon a careful analysis of the facts and circumstances. In analyzing a particular act or practice, the Agencies will be guided by the body of law and official interpretations for defining unfair or deceptive acts or practices developed by the courts and the FTC. The Agencies will also consider factually similar cases brought by the FTC and other agencies to ensure that these standards are applied consistently.

Unfair Acts or Practices

Assessing whether an act or practice is unfair

An act or practice is unfair where it (1) causes or is likely to cause substantial injury to consumers, (2) cannot be reasonably avoided by consumers, and (3) is not outweighed by countervailing benefits to consumers or to competition. Public policy may also be considered in the analysis of whether a particular act or practice is unfair. Each of these elements is discussed further below.

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[4] 15 U.S.C. § 45(a)(2) and Gramm-Leach-Bliley Act § 133, published in notes to 15 U.S.C. § 41.

[5] See FTC Policy Statement on Unfairness (December 17, 1980); and FTC Policy Statement on Deception (October 14, 1983).

[6] This standard was first issued as a policy by the FTC and later codified into the FTC Act as 15 U.S.C. § 45(n).

- *The act or practice must cause or be likely to cause substantial injury to consumers.*

To be unfair, an act or practice must cause or be likely to cause substantial injury to consumers. Substantial injury usually involves monetary harm. An act or practice that causes a small amount of harm to a large number of people may be deemed to cause substantial injury. An injury may be substantial if it raises a significant risk of concrete harm. Trivial or merely speculative harms are typically insufficient for a finding of substantial injury. Emotional impact and other more subjective types of harm will not ordinarily make a practice unfair.

- *Consumers must not reasonably be able to avoid the injury.*

A practice is not considered unfair if consumers may reasonably avoid injury. Consumers cannot reasonably avoid injury from an act or practice if it interferes with their ability to effectively make decisions. Withholding material price information until after the consumer has committed to purchase the product or service would be an example of preventing a consumer from making an informed decision. A practice may also be unfair where consumers are subject to undue influence or are coerced into purchasing unwanted products or services.

The Agencies will not second-guess the wisdom of particular consumer decisions. Instead, the Agencies will consider whether a bank's behavior unreasonably creates or takes advantage of an obstacle to the free exercise of consumer decision-making.

- *The injury must not be outweighed by countervailing benefits to consumers or to competition.*

To be unfair, the act or practice must be injurious in its net effects —that is, the injury must not be outweighed by any offsetting consumer or competitive benefits that are also produced by the act or practice. Offsetting benefits may include lower prices or a wider availability of products and services.

Costs that would be incurred for remedies or measures to prevent the injury are also taken into account in determining whether an act or practice is unfair. These costs may include the costs to the bank in taking preventive measures and the costs to society as a whole of any increased burden and similar matters.

- *Public policy may be considered.*

Public policy, as established by statute, regulation, or judicial decisions may be considered with all other evidence in determining whether an act or practice is unfair. For example, the fact that a particular lending practice violates a state law or a banking regulation may be considered as evidence in determining whether the act or practice is unfair. Conversely, the fact that a particular practice is affirmatively allowed by statute

may be considered as evidence that the practice is not unfair. Public policy considerations by themselves, however, will not serve as the primary basis for determining that an act or practice is unfair.

Deceptive Acts and Practices

Assessing whether an act or practice is deceptive

A three-part test is used to determine whether a representation, omission, or practice is "deceptive." First, the representation, omission, or practice must mislead or be likely to mislead the consumer. Second, the consumer's interpretation of the representation, omission, or practice must be reasonable under the circumstances. Lastly, the misleading representation, omission, or practice must be material. Each of these elements is discussed below in greater detail.

- *There must be a representation, omission, or practice that misleads or is likely to mislead the consumer.*

An act or practice may be found to be deceptive if there is a representation, omission, or practice that misleads or is likely to mislead the consumer. Deception is not limited to situations in which a consumer has already been misled. Instead, an act or practice may be found to be deceptive if it is likely to mislead consumers. A representation may be in the form of express or implied claims or promises and may be written or oral. Omission of information may be deceptive if disclosure of the omitted information is necessary to prevent a consumer from being misled.

In determining whether an individual statement, representation, or omission is misleading, the statement, representation, or omission will not be evaluated in isolation. The Agencies will evaluate it in the context of the entire advertisement, transaction, or course of dealing to determine whether it constitutes deception. Acts or practices that have the potential to be deceptive include: making misleading cost or price claims; using bait-and-switch techniques; offering to provide a product or service that is not in fact available; omitting material limitations or conditions from an offer; selling a product unfit for the purposes for which it is sold; and failing to provide promised services.

- *The act or practice must be considered from the perspective of the reasonable consumer.*

In determining whether an act or practice is misleading, the consumer's interpretation of or reaction to the representation, omission, or practice must be reasonable under the circumstances. The test is whether the consumer's expectations or interpretation are reasonable in light of the claims made. When representations or marketing practices are targeted to a specific audience, such as the elderly or the financially unsophisticated, the standard is based upon the effects of the act or practice on a reasonable member of that group.

If a representation conveys two or more meanings to reasonable consumers and one meaning is misleading, the representation may be deceptive. Moreover, a consumer's interpretation or reaction may indicate that an act or practice is deceptive under the circumstances, even if the consumer's interpretation is not shared by a majority of the consumers in the relevant class, so long as a significant minority of such consumers is misled.

In evaluating whether a representation, omission or practice is deceptive, the Agencies will look at the entire advertisement, transaction, or course of dealing to determine how a reasonable consumer would respond. Written disclosures may be insufficient to correct a misleading statement or representation, particularly where the consumer is directed away from qualifying limitations in the text or is counseled that reading the disclosures is unnecessary. Likewise, oral disclosures or fine print may be insufficient to cure a misleading headline or prominent written representation.

- *The representation, omission, or practice must be material.*

A representation, omission, or practice is material if it is likely to affect a consumer's decision regarding a product or service. In general, information about costs, benefits, or restrictions on the use or availability of a product or service is material. When express claims are made with respect to a financial product or service, the claims will be presumed to be material. Similarly, the materiality of an implied claim will be presumed when it is demonstrated that the institution intended that the consumer draw certain conclusions based upon the claim.

Claims made with the knowledge that they are false will also be presumed to be material. Omissions will be presumed to be material when the financial institution knew or should have known that the consumer needed the omitted information to evaluate the product or service.

Relationship to Other Laws

Acts or practices that are unfair or deceptive within the meaning of section 5 of the FTC Act may also violate other federal or state statutes. On the other hand, there may be circumstances in which an act or practice violates section 5 of the FTC Act even though the institution is in technical compliance with other applicable laws, such as consumer protection and fair lending laws. Banks should be mindful of both possibilities. The following laws warrant particular attention in this regard:

Truth in Lending and Truth in Savings Acts

Pursuant to the Truth in Lending Act (TILA), creditors must "clearly and conspicuously" disclose the costs and terms of credit.[7] The Truth in Savings Act (TISA) requires depository institutions to provide interest and fee disclosures for deposit accounts so that

[7] 15 U.S.C. § 1632(a).

consumers may compare deposit products.[8] TISA also provides that advertisements shall not be misleading or inaccurate, and cannot misrepresent an institution's deposit contract. An act or practice that does not comply with these provisions of TILA or TISA may also violate the FTC Act. On the other hand, a transaction that is in technical compliance with TILA or TISA may nevertheless violate the FTC Act. For example, consumers could be misled by advertisements of "guaranteed" or "lifetime" interest rates when the creditor or depository institution intends to change the rates, whether or not the disclosures satisfy the technical requirements of TILA or TISA.

Equal Credit Opportunity and Fair Housing Acts

The Equal Credit Opportunity Act (ECOA) prohibits discrimination in any aspect of a credit transaction against persons on the basis of race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to contract), the fact that an applicant's income derives from any public assistance program, and the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act. Similarly, the Fair Housing Act (FHA) prohibits creditors involved in residential real estate transactions from discriminating against any person on the basis of race, color, religion, sex, handicap, familial status, or national origin. Unfair or deceptive practices that target or have a disparate impact on consumers who are members of these protected classes may violate the ECOA or the FHA, as well as the FTC Act.

Fair Debt Collection Practices Act

The Fair Debt Collection Practices Act prohibits unfair, deceptive, and abusive practices related to the collection of consumer debts. Although this statute does not by its terms apply to banks that collect their own debts, failure to adhere to the standards set by this Act may support a claim of unfair or deceptive practices in violation of the FTC Act. Moreover, banks that either affirmatively or through lack of oversight, permit a third-party debt collector acting on their behalf to engage in deception, harassment, or threats in the collection of monies due may be exposed to liability for approving or assisting in an unfair or deceptive act or practice.

Managing Risks Related to Unfair or Deceptive Acts or Practices

Since the release of the FDIC's statement and the Board's letter on unfair and deceptive practices in May 2002, bankers have asked for guidance on strategies for managing risk in this area. This section outlines guidance on best practices to address some areas with the greatest potential for unfair or deceptive acts and practices, including: advertising and solicitation; servicing and collections; and the management and monitoring of employees and third-party service providers. Banks also should monitor compliance with their own policies in these areas, and should have procedures for receiving and addressing consumer complaints and monitoring activities performed by third parties on behalf of the bank.

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[8] 12 U.S.C. § 4301 *et seq.*

To avoid engaging in unfair or deceptive activity, the Agencies encourage use of the following practices, which have already been adopted by many institutions:

Review all promotional materials, marketing scripts, and customer agreements and disclosures to ensure that they fairly and adequately describe the terms, benefits, and material limitations of the product or service being offered, including any related or optional products or services, and that they do not misrepresent such terms either affirmatively or by omission. Ensure that these materials do not use fine print, separate statements or inconspicuous disclosures to correct potentially misleading headlines, and ensure that there is a reasonable factual basis for all representations made.

Draw the attention of customers to key terms, including limitations and conditions, that are important in enabling the customer to make an informed decision regarding whether the product or service meets the customer's needs.

Clearly disclose all material limitations or conditions on the terms or availability of products or services, such as a limitation that applies a special interest rate only to balance transfers; the expiration date for terms that apply only during an introductory period; material prerequisites for obtaining particular products, services or terms (e.g., minimum transaction amounts, introductory or other fees, or other qualifications); or conditions for canceling a service without charge when the service is offered on a free trial basis.

Inform consumers in a clear and timely manner about any fees, penalties, or other charges (including charges for any force-placed products) that have been imposed, and the reasons for their imposition.

Clearly inform customers of contract provisions that permit a change in the terms and conditions of an agreement.

When using terms such as "pre-approved" or "guaranteed," clearly disclose any limitations, conditions, or restrictions on the offer.

Clearly inform consumers when the account terms approved by the bank for the consumer are less favorable than the advertised terms or terms previously disclosed.

Tailor advertisements, promotional materials, disclosures and scripts to take account of the sophistication and experience of the target audience. Do not make claims, representations or statements that mislead members of the target audience about the cost, value, availability, cost savings, benefits, or terms of the product or service.

Avoid advertising that a particular service will be provided in connection with an account if the bank does not intend or is not able to provide the service to accountholders.

Clearly disclose when optional products and services — such as insurance, travel services, credit protection, and consumer report update services that are offered simultaneously with credit — are not required to obtain credit or considered in decisions to grant credit.

Ensure that costs and benefits of optional or related products and services are not misrepresented or presented in an incomplete manner.

When making claims about amounts of credit available to consumers, accurately and completely represent the amount of potential, approved, or useable credit that the consumer will receive.

Avoid advertising terms that are not available to most customers and using unrepresentative examples in advertising, marketing, and promotional materials.

Avoid making representations to consumers that they may pay less than the minimum amount due required by the account terms without adequately disclosing any late fees, overlimit fees, or other account fees that will result from the consumer paying such reduced amount.

Clearly disclose a telephone number or mailing address (and, as an addition, an email or website address if available) that consumers may use to contact the bank or its third-party servicers regarding any complaints they may have, and maintain appropriate procedures for resolving complaints. Consumer complaints should also be reviewed by banks to identify practices that have the potential to be misleading to customers.

Implement and maintain effective risk and supervisory controls to select and manage third-party servicers.

Ensure that employees and third parties who market or promote bank products, or service loans, are adequately trained to avoid making statements or taking actions that might be unfair or deceptive.

Review compensation arrangements for bank employees as well as third-party vendors and servicers to ensure that they do not create unintended incentives to engage in unfair or deceptive practices.

Ensure that the institution and its third party servicers have and follow procedures to credit consumer payments in a timely manner. Consumers should be clearly told when and if monthly payments are applied to fees, penalties, or other charges before being applied to regular principal and interest.

The need for clear and accurate disclosures that are sensitive to the sophistication of the target audience is heightened for products and services that have been associated with abusive practices. Accordingly, banks should take particular care in marketing credit and other products and services to the elderly, the financially vulnerable, and customers who

are not financially sophisticated. In addition, creditors should pay particular attention to ensure that disclosures are clear and accurate with respect to: the points and other charges that will be financed as part of home-secured loans; the terms and conditions related to insurance offered in connection with loans; loans covered by the Home Ownership and Equity Protection Act; reverse mortgages; credit cards designed to rehabilitate the credit position of the cardholder; and loans with pre-payment penalties, temporary introductory terms, or terms that are not available as advertised to all consumers.

Conclusion

The development and implementation of policies and procedures in these areas and the other steps outlined above will help banks assure that products and services are provided in a manner that is fair, allows informed customer choice, and is consistent with the FTC Act.

FTC POLICY STATEMENT ON UNFAIRNESS

FEDERAL TRADE COMMISSION
WASHINGTON, D. C. 20580

December 17, 1980

The Honorable Wendell H. Ford
Chairman, Consumer Subcommittee
Committee on Commerce, Science, and Transportation
Room 130 Russell Office Building
Washington, D.C. 20510

The Honorable John C. Danforth
Ranking Minority Member, Consumer Subcommittee
Committee on Commerce, Science, and Transportation
Room 130 Russell Office Building
Washington, D.C. 20510

Dear Senators Ford and Danforth:

This is in response to your letter of June 13, 1980, concerning one aspect of this agency's jurisdiction over "unfair or deceptive acts or practices." You informed us that the Subcommittee was planning to hold oversight hearings on the concept of "unfairness" as it has been applied to consumer transactions. You further informed us that the views of other interested parties were solicited and compiled in a Committee Print earlier this year.[1] Your letter specifically requested the Commission's views on cases under Section 5 "not involving the content of advertising," and its views as to "whether the Commission's authority should be limited to regulating false or deceptive commercial advertising." Our response addresses these and other questions related to the concept of consumer unfairness.

We are pleased to have this opportunity to discuss the future work of the agency. The subject that you have selected appears to be particularly timely. We recognize that the concept of consumer unfairness is one whose precise meaning is not immediately obvious, and also recognize that this uncertainty has been honestly troublesome for some businesses and some members of the legal profession. This result is understandable in light of the general nature of the statutory standard. At the same time, though, we believe we can respond to legitimate concerns of business and the Bar by attempting to delineate in this letter a concrete framework for future application of the Commission's unfairness authority. We are aided in this process by the cumulative decisions of this agency and the federal courts, which, in our opinion, have brought added clarity to the law. Although the administrative and judicial evolution of the consumer unfairness concept has still left some necessary flexibility in the statute, it is possible to provide a reasonable working sense of the conduct that is covered.

In response to your inquiry we have therefore undertaken a review of the decided cases and rules and have synthesized from them the most important principles of general applicability. Rather than merely reciting the law, we have attempted to provide the Committee with a concrete indication of the manner in which the Commission has

enforced, and will continue to enforce, its unfairness mandate. In so doing we intend to address the concerns that have been raised about the meaning of consumer unfairness, and thereby attempt to provide a greater sense of certainty about what the Commission would regard as an unfair act or practice under Section 5.

This letter thus delineates the Commission's views of the boundaries of its consumer unfairness jurisdiction and is subscribed to by each Commissioner. In addition, we are enclosing a companion Commission statement that discusses the ways in which this body of law differs from, and supplements, the prohibition against consumer deception, and then considers and evaluates some specific criticisms that have been made of our enforcement of the law.[2] Since you have indicated a particular interest in the possible application of First Amendment principles to commercial advertising, the companion statement will include discussions relevant to that question. The companion statement is designed to respond to the key questions raised about the unfairness doctrine. However, individual Commissioners may not necessarily endorse particular arguments or particular examples of the Commission's exercise of its unfairness authority contained in the companion statement.

Commission Statement of Policy on the Scope of the
Consumer Unfairness Jurisdiction

Section 5 of the FTC Act prohibits, in part, "unfair ... acts or practices in or affecting commerce."[3] This is commonly referred to as the Commission's consumer unfairness jurisdiction. The Commission's jurisdiction over "unfair methods of competition" is not discussed in this letter.[4] Although we cannot give an exhaustive treatment of the law of consumer unfairness in this short statement, some relatively concrete conclusions ran nonetheless be drawn.

The present understanding of the unfairness standard is the result of an evolutionary process. The statute was deliberately framed in general terms since Congress recognized the impossibility of drafting a complete list of unfair trade practices that would not quickly become outdated or leave loopholes for easy evasion.[5] The task of identifying unfair trade practices was therefore assigned to the Commission, subject to judicial review,[6] in the expectation that the underlying criteria would evolve and develop over time. As the Supreme Court observed as early as 1931, the ban on unfairness "belongs to that class of phrases which do not admit of precise definition, but the meaning and application of which must be arrived at by what this court elsewhere has called 'the gradual process of judicial inclusion and exclusion.'"[7]

By 1964 enough cases had been decided to enable the Commission to identify three factors that it considered when applying the prohibition against consumer unfairness. These were: (1) whether the practice injures consumers; (2) whether it violates established public policy; (3) whether it is unethical or unscrupulous.[8] These factors were later quoted with apparent approval by the Supreme Court in the 1972 case of *Sperry & Hutchinson*.[9] Since then the Commission has continued to refine the standard of unfairness in its cases and rules, and it has now reached a more detailed sense of both the definition and the limits of these criteria.[10]

Consumer injury

Unjustified consumer injury is the primary focus of the FTC Act, and the most important of the three *S&H* criteria. By itself it can be sufficient to warrant a finding of unfairness. The Commission's ability to rely on an independent criterion of consumer injury is consistent with the intent of the statute, which was to "[make] the consumer who may be injured by an unfair trade practice of equal concern before the law with the merchant injured by the unfair methods of a dishonest competitor."[11]

The independent nature of the consumer injury criterion does not mean that every consumer injury is legally "unfair," however. To justify a finding of unfairness the injury must satisfy three tests. It must be substantial; it must not be outweighed by any countervailing benefits to consumers or competition that the practice produces; and it must be an injury that consumers themselves could not reasonably have avoided.

First of all, the injury must be substantial. The Commission is not concerned with trivial or merely speculative harms.[12] In most cases a substantial injury involves monetary harm, as when sellers coerce consumers into purchasing unwanted goods or services[13] or when consumers buy defective goods or services on credit but are unable to assert against the creditor claims or defenses arising from the transaction. [14] Unwarranted health and safety risks may also support a finding of unfairness.[15] Emotional impact and other more subjective types of harm, on the other hand, will not ordinarily make a practice unfair. Thus, for example, the Commission will not seek to ban an advertisement merely because it offends the tastes or social beliefs of some viewers, as has been suggested in some of the comments.[16]

Second, the injury must not be outweighed by any offsetting consumer or competitive benefits that the sales practice also produces. Most business practices entail a mixture of economic and other costs and benefits for purchasers. A seller's failure to present complex technical data on his product may lessen a consumer's ability to choose, for example, but may also reduce the initial price he must pay for the article. The Commission is aware of these tradeoffs and will not find that a practice unfairly injures consumers unless it is injurious in its net effects.[17] The Commission also takes account of the various costs that a remedy would entail. These include not only the costs to the parties directly before the agency, but also the burdens on society in general in the form of increased paperwork, increased regulatory burdens on the flow of information, reduced incentives to innovation and capital formation, and similar matters.[18] Finally, the injury must be one which consumers could not reasonably have avoided.[19] Normally we expect the marketplace to be self-correcting, and we rely on consumer choice--the ability of individual consumers to make their own private purchasing decisions without regulatory intervention--to govern the market. We anticipate that consumers will survey the available alternatives, choose those that are most desirable, and avoid those that are inadequate or unsatisfactory. However, it has long been recognized that certain types of sales techniques may prevent consumers from effectively making their own decisions, and that corrective action may then become necessary. Most of the Commission's unfairness matters are brought under these circumstances. They are brought, not to second-guess the wisdom of particular consumer decisions, but rather to halt some form of seller behavior that unreasonably creates or takes advantage of an obstacle to the free

exercise of consumer decisionmaking.[20]

Sellers may adopt a number of practices that unjustifiably hinder such free market decisions. Some may withhold or fail to generate critical price or performance data, for example, leaving buyers with insufficient information for informed comparisons.[21] Some may engage in overt coercion, as by dismantling a home appliance for "inspection" and refusing to reassemble it until a service contract is signed.[22] And some may exercise undue influence over highly susceptible classes of purchasers, as by promoting fraudulent "cures" to seriously ill cancer patients.[23] Each of these practices undermines an essential precondition to a free and informed consumer transaction, and, in turn, to a well-functioning market. Each of them is therefore properly banned as an unfair practice under the FTC Act.[24]

Violation of public policy

The second *S&H* standard asks whether the conduct violates public policy as it has been established by statute, common law, industry practice, or otherwise. This criterion may be applied in two different ways. It may be used to test the validity and strength of the evidence of consumer injury, or, less often, it may be cited for a dispositive legislative or judicial determination that such injury is present.

Although public policy was listed by the *S&H* Court as a separate consideration, it is used most frequently by the Commission as a means of providing additional evidence on the degree of consumer injury caused by specific practices. To be sure, most Commission actions are brought to redress relatively clear-cut injuries, and those determinations are based, in large part, on objective economic analysis. As we have indicated before, the Commission believes that considerable attention should be devoted to the analysis of whether substantial net harm has occurred, not only because that is part of the unfairness test, but also because the focus on injury is the best way to ensure that the Commission acts responsibly and uses its resources wisely. Nonetheless, the Commission wishes to emphasize the importance of examining outside statutory policies and established judicial principles for assistance in helping the agency ascertain whether a particular form of conduct does in fact tend to harm consumers. Thus the agency has referred to First Amendment decisions upholding consumers' rights to receive information, for example, to confirm that restrictions on advertising tend unfairly to hinder the informed exercise of consumer choice.[25]

Conversely, statutes or other sources of public policy may affirmatively allow for a practice that the Commission tentatively views as unfair. The existence of such policies will then give the agency reason to reconsider its assessment of whether the practice is actually injurious in its net effects.[26] In other situations there may be no clearly established public policies, or the policies may even be in conflict. While that does not necessarily preclude the Commission from taking action if there is strong evidence of net consumer injury, it does underscore the desirability of carefully examining public policies in all instances.[27] In any event, whenever objective evidence of consumer injury is difficult to obtain, the need to identify and assess all relevant public policies assumes increased importance.

Sometimes public policy will independently support a Commission action. This occurs when the policy is so clear that it will entirely determine the question of consumer injury, so there is little need for separate analysis by the Commission. In these cases the legislature or court, in announcing the policy, has already determined that such injury does exist and thus it need not be expressly proved in each instance. An example of this approach arose in a case involving a mail-order firm.[28] There the Commission was persuaded by an analogy to the due-process clause that it was unfair for the firm to bring collection suits in a forum that was unreasonably difficult for the defendants to reach. In a similar case the Commission applied the statutory policies of the Uniform Commercial Code to require that various automobile manufacturers and their distributors refund to their customers any surplus money that was realized after they repossessed and resold their customer's cars.[29] The Commission acts on such a basis only where the public policy is suitable for administrative enforcement by this agency, however. Thus it turned down a petition for a rule to require fuller disclosure of aerosol propellants, reasoning that the subject of fluorocarbon safety was currently under study by other scientific and legislative bodies with more appropriate expertise or jurisdiction over the subject.[30]

To the extent that the Commission relies heavily on public policy to support a finding of unfairness, the policy should be clear and well-established. In other words, the policy should be declared or embodied in formal sources such as statutes, judicial decisions, or the Constitution as interpreted by the courts, rather than being ascertained from the general sense of the national values. The policy should likewise be one that is widely shared, and not the isolated decision of a single state or a single court. If these two tests are not met the policy cannot be considered as an "established" public policy for purposes of the S&H criterion. The Commission would then act only on the basis of convincing independent evidence that the practice was distorting the operation of the market and thereby causing unjustified consumer injury.

Unethical or unscrupulous conduct

Finally, the third *S&H* standard asks whether the conduct was immoral, unethical, oppressive, or unscrupulous. This test was presumably included in order to be sure of reaching all the purposes of the underlying statute, which forbids "unfair" acts or practices. It would therefore allow the Commission to reach conduct that violates generally recognized standards of business ethics. The test has proven, however, to be largely duplicative. Conduct that is truly unethical or unscrupulous will almost always injure consumers or violate public policy as well. The Commission has therefore never relied on the third element of *S&H* as an independent basis for a finding of unfairness, and it will act in the future only on the basis of the first two.

We hope this letter has given you the information that you require. Please do not hesitate to call if we can be of any further assistance. With best regards,

/s/Michael Pertschuk Chairman

/s/Paul Rand Dixon Commissioner

/s/David A. Clanton Commissioner

/s/Robert Pitofsky Commissioner

/s/Patricia P. Bailey Commissioner

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[1]Unfairness: Views on Unfair Acts and Practices in Violation of the Federal Trade Commission Act (1980) (hereinafter referred to as "Committee Print").

[2]Neither this letter nor the companion statement addresses ongoing proceedings, but the Commission is prepared to discuss those matters separately at an appropriate time.

[3]The operative sentence of Section 5 reads in full as follows: "Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are declared unlawful." 15 U.S.C. 45(a)(1).

[4]In fulfilling its competition or antitrust mission the Commission looks to the purposes, policies, and spirit of the other antitrust laws and the FTC Act to determine whether a practice affecting competition or competitors is unfair. *See, e.g., FTC v. Brown Shoe Co.*, 384 U.S. 316 (1966). In making this determination the Commission is guided by the extensive legislative histories of those statutes and a considerable body of antitrust case law. The agency's jurisdiction over "deceptive acts or practices" is likewise not discussed in this letter.

[5]*See* H.R. Conf. Rep. No. 1142, 63d Cong., 2d Sess., at 19 (1914) (If Congress "were to adopt the method of definition, it would undertake an endless task"). In 1914 the statute was phrased only in terms of "unfair methods of competition," and the reference to "unfair acts or practices" was not added until the Wheeler-Lee Amendment in 1938. The initial language was still understood as reaching most of the conduct now characterized as consumer unfairness, however, and so the original legislative history remains relevant to the construction of that part of the statute.

[6]The Supreme Court has stated on many occasions that the definition of "unfairness" is ultimately one for judicial determination. *See, e.g., FTC v. Sperry & Hutchinson Co.*, 405 U.S. 233, 249 (1972); *FTC v. R.F. Keppel & Bro.*, 291 U.S. 304, 314 (1934).

[7]*FTC v. Raladam Co.*, 283 U.S. 643, 648 (1931). *See also FTC v. R.F. Keppel & Bro.*, 291 U.S. 304, 310 (1934) ("Neither the language nor the history of the Act suggests that Congress intended to confine the forbidden methods to fixed and unyielding categories").

[8]The Commission's actual statement of the criteria was as follows:

> (1) whether the practice, without necessarily having been previously considered unlawful, offends public policy as it has been established by statutes, the common law, or otherwise-whether, in other words, it is within at least the penumbra of some common- law, statutory, or other established concept of unfairness; (2) whether it is immoral, unethical, oppressive, or unscrupulous; (3) whether it causes substantial injury to consumers (or competitors or other businessmen).

Statement of Basis and Purpose, Unfair or Deceptive Advertising and Labeling of Cigarettes in Relation to the Health Hazards of Smoking, 29 Fed. Reg. 8324, 8355 (1964).

[9]*FTC v. Sperry & Hutchinson C..*, 405 U.S. 223, 244-45 n.5 (1972). The Circuit Courts have concluded that this quotation reflected the Supreme Court's own views. *See Spiegel, Inc. v. FTC*, 540 F.2d 287, 293 n.8 (7th Cir. 1976); *Heater v. FTC*, 503 F.2d 321, 323 (9th Cir. 1974). The application of these factors to antitrust matters is beyond the scope of this letter.

[10]These standards for unfairness are generally applicable to both advertising and non-advertising cases.

[11]83 Cong. Rec. 3255 (1938) (remarks of Senator Wheeler).

[12]An injury may be sufficiently substantial, however, if it does a small harm to a large number of people, or if it raises a significant risk of concrete harm.

[13]*See, e.g., Holland Furnace Co. v. FTC*, 295 F.2d 302 (7th Cir. 1961) (seller's servicemen dismantled home furnaces and then refused to reassemble them until the consumers had agreed to buy services or replacement parts).

[14]Statement of Basis and Purpose, Preservation of Consumers' Claims and Defenses, 40 Fed. Reg. 53,506, 53522-23 (1975).

[15]For an example *see Philip Morris, Inc.*, 82 F.T.C. 16 (1973) (respondent had distributed free-sample razor blades in such a way that they could come into the hands of small children) (consent agreement). Of course, if matters involving health and safety are within the primary jurisdiction of some other agency, Commission action might not be appropriate.

[16]*See, e.g.*, comments of Association of National Advertisers, Committee Print at 120. In an extreme case, however, where tangible injury could be clearly demonstrated, emotional effects might possibly be considered as the basis for a finding of unfairness. *Cf.* 15 U.S.C. 1692 *et seq.* (Fair Debt Collection Practices Act) (banning, eg., harassing late-night telephone calls).

[17]*See Pfizer, Inc.*, 81 F.T.C. 23, 62-63 n. 13 (1972); Statement of Basis and Purpose, Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 43 Fed. Reg. 59614, 59636 n.95 (1978).

When making this determination the Commission may refer to existing public policies for help in ascertaining the existence of consumer injury and the relative weights that should be assigned to various costs and benefits. The role of public policy in unfairness determinations will be discussed more generally below.

[18]For example, when the Commission promulgated the Holder Rule it anticipated an overall lowering of economic costs to society because the rule gave creditors the incentive to police sellers, thus increasing the likelihood that those selling defective goods or services would either improve their practices or leave the marketplace when they could not obtain financing. These benefits, in the Commission's judgment, outweighed any costs to creditors and sellers occasioned by the rule. See Statement of Basis and Purpose, Preservation of Consumers' Claims and Defenses, 40 Fed. Reg. 53506, 53522-23 (1975).

[19]In some senses any injury can be avoided--for example, by hiring independent experts to test all products in advance, or by private legal actions for damages-but these courses may be too expensive to be practicable for individual consumers to pursue.

[20]This emphasis on informed consumer choice has commonly been adopted in other statutes as well. *See, e.g.*, Declaration of Policy, Fair Packaging and Labeling Act, 15 U.S.C. 1451 ("Informed consumers are essential to the fair and efficient functioning of a free market economy".)

[21]*See, e.g.*, Statement of Basis and Purpose, Labeling and Advertising of Home Insulation, 44 Fed. Reg. 50218, 50222-23 (1979); Statement of Basis and Purpose, Posting of Minimum Octane Numbers on Gasoline Dispensing Pumps, 36 Fed. Reg. 23871,23882 (1971). *See also Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council*, Inc., 425 U.S. 748 (1976).

[22]*See Holland Furnace Co. v. ETC*, 295 F.2d 302 (7th Cir. 1961); *cf Arthur Murray Studio, Inc. v.* EW, 458 F.2d 622 (5th Cir. 1972) (emotional high-pressure sales tactics, using teams of salesmen who refused

to let the customer leave the room until a contract was signed). *See also* Statement of Basis and Purpose, Cooling-Off Period for Door-to-Door Sales, 37 Fed. Reg. 22934, 22937-38 (1972).

[23]*See, e.g., Travel King,* Inc., 86 F.T.C. 715, 774 (1975). The practices in this rase primarily involved deception, but the Commission noted the special susceptibilities of such patients as one reason for banning the ads entirely rather than relying on the remedy of fuller disclosure. The Commission recognizes that "undue influence" in advertising and promotion is difficult to define, and therefore exercises its authority here only with respect to substantial coercive-like practices and significant consumer injury.

[24]These few examples are not exhaustive, but the general direction they illustrate is clear. As the Commission stated in promulgating its Eyeglasses Rule, the inquiry should begin, at least, by asking "whether the acts or practices at issue inhibit the functioning of the competitive market and whether consumers are harmed thereby." Statement of Basis and Purpose, Advertising of Ophthalmic Goods and Services, 43 Fed. Reg. 23992,24001 (1978).

[25]*See* Statement of Basis and Purpose, Advertising of ophthalmic Goods and Services, 43 Fed. Reg. 23992,24001 (1978), *citing Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council,* 425 U.S. 748 (1976).

[26]*Cf.* Statement of Basis and Purpose, Advertising of ophthalmic Goods and Services, *supra; see also n.17 supra.*

[27]The analysis of external public policies is extremely valuable but not always definitive. The legislative history of Section 5 recognizes that new forms of unfair business practices may arise which, at the time of the Commission's involvement, have not yet been generally proscribed. See page 4, *supra.* Thus a review of public policies established independently of Commission action may not be conclusive in determining whether the challenged practices should be prohibited or otherwise restricted. At the same time, however, we emphasize the importance of examining public policies, since a thorough analysis can serve as an important check on the overall reasonableness of the Commission's actions.

[28]*Spiegel, Inc. v. FTC,* 540 F.2d 287 (7th Cir. 1976). In this case the Commission did inquire into the extent of the resulting consumer injury, but under the rationale involved it presumably need not have done so. *See also FTC v. R.F. Keppel & Bro.,* 291 U.S. 304 (1934) (firm had gained a marketing advantage by selling goods through a lottery technique that violated state gambling policies); *cf. Simeon Management Corp.,* 87 F.T.C. 1184, 1231 (1976), *aff'd,* 579 F.2d 1137 (9th Cir. 1978) (firm advertised weight-loss program that used a drug which could not itself be advertised under FDA regulations) (alternative ground). Since these public-policy cases are based on legislative determinations, rather than on a judgment within the Commission's area of special economic expertise, it is appropriate that they can reach a relatively wider range of consumer injuries than just those associated with impaired consumer choice.

[29]A surplus occurs when a repossessed car is resold for more than the amount owed by the debtor plus the expenses of repossession and resale. The law of 49 states requires that creditors refund surpluses when they occur, but if creditors systematically refuse to honor this obligation, consumers have no practical way to discover that they have been deprived of money to which they are entitled. *See Ford Motor Co.,* 94 F.T.C. 564, 618 (1979) *appeal pending,* Nos. 79-7649 and 79-7654 (9th Cir.); *Ford Motor Co.,93* F.T.C. 402 (1979) (consent decree); *General Motors Corp.,* D. 9074 (Feb., 1980) (consent decree). By these latter two consent agreements the Commission, because of its unfairness jurisdiction, has been able to secure more than $2 million for consumers allegedly deprived of surpluses to which they were entitled.

[30]See Letter from John F. Dugan, Acting Secretary, to Action on Smoking and Health (January 13, 1977). *See* also letter from Charles A. Tobin, Secretary, to Prof. Page and Mr. Young (September 17,1973) (denying petition to exercise § 6(b) subpoena powers to obtain consumer complaint information from cosmetic fu-ms and then to transmit the data to FDA for that agency's enforcement purposes).

FTC POLICY STATEMENT ON DECEPTION

FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

October 14, 1983

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

This letter responds to the Committee's inquiry regarding the Commission's enforcement policy against deceptive acts or practices.[1] We also hope this letter will provide guidance to the public.

Section 5 of the FTC Act declares unfair or deceptive acts or practices unlawful. Section 12 specifically prohibits false ads likely to induce the purchase of food, drugs, devices or cosmetics. Section 15 defines a false ad for purposes of Section 12 as one which is "misleading in a material respect."[2] Numerous Commission and judicial decisions have defined and elaborated on the phrase "deceptive acts or practices" under both Sections 5 and 12. Nowhere, however, is there a single definitive statement of the Commission's view of its authority. The Commission believes that such a statement would be useful to the public, as well as the Committee in its continuing review of our jurisdiction.

We have therefore reviewed the decided cases to synthesize the most important principles of general applicability. We have attempted to provide a concrete indication of the manner in which the Commission will enforce its deception mandate. In so doing, we intend to address the concerns that have been raised about the meaning of deception, and thereby attempt to provide a greater sense of certainty as to how the concept will be applied.[3]

I. SUMMARY

Certain elements undergird all deception cases. First, there must be a representation, omission or practice that is likely to mislead the consumer.[4] Practices that have been found misleading or deceptive in specific cases include false oral or written representations, misleading price claims, sales of hazardous or systematically defective products or services without adequate disclosures, failure to disclose information regarding pyramid sales, use of bait and switch techniques, failure to perform promised services, and failure to meet warranty obligations.[5]

Second, we examine the practice from the perspective of a consumer acting reasonably in the circumstances. If the representation or practice affects or is directed primarily to a particular group, the Commission examines reasonableness from the perspective of that group.

Third, the representation, omission, or practice must be a "material" one. The basic question is whether the act or practice is likely to affect the consumer's conduct or decision with regard to a product or service. If so, the practice is material, and consumer injury is likely, because consumers are likely to have chosen differently but for the deception. In many instances, materiality, and hence injury, can be presumed from the nature of the practice. In other instances, evidence of materiality may be necessary.

Thus, the Commission will find deception if there is a representation, omission or practice that is likely to mislead the consumer acting reasonably in the circumstances, to the consumer's detriment. We discuss each of these elements below.

II. THERE MUST BE A REPRESENTATION, OMISSION, OR PRACTICE THAT IS LIKELY TO MISLEAD THE CONSUMER.

Most deception involves written or oral misrepresentations, or omissions of material information. Deception may also occur in other forms of conduct associated with a sales transaction. The entire advertisement, transaction or course of dealing will be considered. The issue is whether the act or practice is likely to mislead, rather than whether it causes actual deceptions.

Of course, the Commission must find that a representation, omission, or practice occurred in cases of express claims, the representation itself establishes the meaning. In cases of implied claims, the Commission will often be able to determine meaning through an examination of the representation itself, including an evaluation of such factors as the entire document, the juxtaposition of various phrases in the document, the nature of the claim, and the nature of the transactions.[7] In other situations, the Commission will require extrinsic evidence that reasonable consumers reach the implied claims.[8] In all instances, the Commission will carefully consider any extrinsic evidence that is introduced.

Some cases involve omission of material information, the disclosure of which is necessary to prevent the claim, practice, or sale from being misleading.[9] Information may be omitted from written[10] or oral[11] representations or from the commercial transaction.12

In some circumstances, the Commission can presume that consumers are likely to reach false beliefs about the product or service because of an omission. At other times, however, the Commission may require evidence on consumers' expectations.[13]

Marketing and point-of-sales practices that are likely to mislead consumers are also deceptive. For instance, in bait and switch cases, a violation occurs when the offer to sell the product is not a bona fide offer.[14] The Commission has also found deception where a sales representative misrepresented the purpose of the initial contact with customers.[15] When a product is sold, there is an implied representation that the product is fit for the purposes for which it is sold. When it is not, deception occurs.[16] There may be a concern about the way a product or service is marketed, such as where inaccurate or incomplete information is provided.[17] A failure to perform services promised under a warranty or by contract can also be deceptive.[18]

III. THE ACT OR PRACTICE MUST BE CONSIDERED FROM THE PERSPECTIVE OF THE REASONABLE CONSUMER

The Commission believes that to be deceptive the representation, omission or practice must be likely to mislead reasonable consumers under the circumstances.[19] The test is whether the consumer's interpretation or reaction is reasonable.[20] When representations or sales practices are targeted to a specific audience, the Commission determines the effect of the practice on a reasonable member of that group. In evaluating a particular practice, the Commission considers the totality of the practice in determining how reasonable consumers are likely to respond.

A company is not liable for every interpretation or action by a consumer. In an advertising context, this principle has been well-stated:

> An advertiser cannot be charged with liability with respect to every conceivable misconception, however outlandish, to which his representations might be subject among the foolish or feeble-minded. Some people, because of ignorance or incomprehension, may be misled by even a scrupulously honest claim. Perhaps a few misguided souls believe, for example, that all "Danish pastry" is made in Denmark. Is it therefore an actionable deception to advertise "Danish pastry" when it is made in this country.? Of course not, A representation does not become "false and deceptive" merely because it will be unreasonably misunderstood by an insignificant and unrepresentative segment of the class of persons to whom the representation is addressed. Heinz W. Kirchner, 63 F.T.C. 1282, 1290 (1963).

To be considered reasonable, the interpretation or reaction does not have to be the only one.[21] When a seller's representation conveys more than one meaning to reasonable consumers, one of which is false, the seller is liable for the misleading interpretation.[22] An interpretation will be presumed reasonable if it is the one the respondent intended to convey.

The Commission has used this standard in its past decisions. The test applied by the Commission is whether the interpretation is reasonable in light of the claim."[23] In the Listerine case, the Commission evaluated the claim from the perspective of the "average listener."[24] In a case involving the sale of encyclopedias, the Commission observed "[i]n determining the meaning of an advertisement, a piece of promotional material or a sales presentation, the important criterion is the net impression that it is likely to make on the general populace."[25] The decisions in American Home Products, Bristol Myers, and Sterling Drug are replete with references to reasonable consumer interpretations.[26] In a land sales case, the Commission evaluated the oral statements and written representations "in light of the sophistication and understanding of the persons to whom they were directed."[27] Omission cases are no different: the Commission examines the failure to disclose in light of expectations and understandings of the typical buyer[28] regarding the claims made.

When representations or sales practices are targeted to a specific audience, such as

children, the elderly, or the terminally ill, the Commission determines the effect of the practice on a reasonable member of that group.[29] For instance, if a company markets a cure to the terminally ill, the practice will be evaluated from the perspective of how it affects the ordinary member of that group. Thus, terminally ill consumers might be particularly susceptible to exaggerated cure claims. By the same token, a practice or representation directed to a well-educated group, such as a prescription drug advertisement to doctors, would be judged in light of the knowledge and sophistication of that group.[30]

As it has in the past, the Commission will evaluate the entire advertisement, transaction, or course of dealing in determining how reasonable consumers are likely to respond. Thus, in advertising the Commission will examine "the entire mosaic, rather than each tile separately."[31] As explained by a court of appeals in a recent case:

> The Commission's right to scrutinize the visual and aural imagery of advertisements follows from the principle that the Commission looks to the impression made by the advertisements as a whole. Without this mode of examination, the Commission would have limited recourse against crafty advertisers whose deceptive messages were conveyed by means other than, or in addition to, spoken words. American Home Products, 695 F.2d 681, 688 (3d Cir. Dec. 3, 1982).[32]

In a case involving a weight loss product, the Commission observed:

> It is obvious that dieting is the conventional method of losing weight. But it is equally obvious that many people who need or want to lose weight regard dieting as bitter medicine. To these corpulent consumers the promises of weight loss without dieting are the Siren's call, and advertising that heralds unrestrained consumption while muting the inevitable need for temperance, if not abstinence, simply does not pass muster. Porter & Dietsch, 90 F.T.C. 770, 864-865 (1977), 605 F.2d 294 (7th Cir. 1979), cert. denied, 445 U.S. 950 (1980).

Children have also been the specific target of ads or practices. In *Ideal Toy*, the Commission adopted the Hearing Examiner's conclusion that:

> False, misleading and deceptive advertising claims beamed at children tend to exploit unfairly a consumer group unqualified by age or experience to anticipate or appreciate the possibility that representations may be exaggerated or untrue. *Ideal Toy*, 64 F.T.C. 297, 310 (1964).

See also, *Avalon Industries Inc.*, 83 F.T.C. 1728, 1750 (1974).

In a subsequent case, the Commission explained that "[i]n evaluating advertising representations, we are required to look at the complete advertisement and formulate our opinions on them on the basis of the net general impression conveyed by them and not on isolated excerpts." *Standard Oil of Calif*, 84 F.T.C. 1401, 1471 (1974), *aff'd as modified*, 577 F.2d 653 (9th Cir. 1978), *reissued*, 96 F.T.C. 380 (1980).

The Third Circuit stated succinctly the Commission's standard. "The tendency of the advertising to deceive must be judged by viewing it as a whole, without emphasizing isolated words or phrases apart from their context." *Beneficial Corp. v. FTC*, 542 F.2d 611, 617 (3d Cir. 1976), *cert denied*, 430 U.S. 983 (1977).

Commission cases reveal specific guidelines. Depending on the circumstances, accurate information in the text may not remedy a false headline because reasonable consumers may glance only at the headline.[33] Written disclosures or fine print may be insufficient to correct a misleading representations.[34] Other practices of the company may direct consumers' attention away from the qualifying disclosures.[35] Oral statements, label disclosures or point-of-sale material will not necessarily correct a deceptive representation or omission.[36] Thus, when the first contact between a seller and a buyer occurs through a deceptive practice, the law may be violated even if the truth is subsequently made known to the purchaser.[37] Pro forma statements or disclaimers may not cure otherwise deceptive messages or practices.[38]

Qualifying disclosures must be legible and understandable. In evaluating such disclosures, the Commission recognizes that in many circumstances, reasonable consumers do not read the entirety of an ad or are directed away from the importance of the qualifying phrase by the acts or statements of the seller. Disclosures that conform to the Commission's Statement of Enforcement Policy regarding clear and conspicuous disclosures, which applies to television advertising, are generally adequate, CCH Trade Regulation Reporter, ¶ 7569.09 (Oct. 21, 1970). Less elaborate disclosures may also suffice.[39]

Certain practices, however, are unlikely to deceive consumers acting reasonably. Thus, the Commission generally will not bring advertising cases based on subjective claims (taste, feel, appearance, smell) or on correctly stated opinion claims if consumers understand the source and limitations of the opinion.[40] Claims phrased as opinions are actionable, however, if they are not honestly held, if they misrepresent the qualifications of the holder or the basis of his opinion or if the recipient reasonably interprets them as implied statements of fact.[41]

The Commission generally will not pursue cases involving obviously exaggerated or puffing representations, *i.e.*, those that the ordinary consumers do not take seriously.42 Some exaggerated claims, however, may be taken seriously by consumers and are actionable. For instance, in rejecting a respondent's argument that use of the words "electronic miracle" to describe a television antenna was puffery, the Commission stated:

Although not insensitive to respondent's concern that the term miracle is commonly used in situations short of changing water into wine, we must conclude that the use of "electronic miracle" in the context of respondent's grossly exaggerated claims would lead consumers to give added credence to the overall suggestion that this device is superior to other types of antennae. *Jay Norris*, 91 F.T.C. 751, 847 n.20 (1978), *aff'd*, 598 F.2d 1244 (2d Cir.), *cert. denied*, 444 U.S. 980 (1979).

Finally, as a matter of policy, when consumers can easily evaluate the product or service, it is inexpensive, and it is frequently purchased, the Commission will examine the

practice closely before issuing a complaint based on deception. There is little incentive for sellers to misrepresent (either by an explicit false statement or a deliberate false implied statement) in these circumstances since they normally would seek to encourage repeat purchases. Where, as here, market incentives place strong constraints on the likelihood of deception, the Commission will examine a practice closely before proceeding.

In sum, the Commission will consider many factors in determining the reaction of the ordinary consumer to a claim or practice. As would any trier of fact, the Commission will evaluate the totality of the ad or the practice and ask questions such as: how clear is the representation? how conspicuous is any qualifying information? how important is the omitted information? do other sources for the omitted information exist? how familiar is the public with the product or service?[43]

IV. THE REPRESENTATION, OMISSION OR PRACTICE MUST BE MATERIAL

The third element of deception is materiality. That is, a representation, omission or practice must be a material one for deception to occur.[44] A "material" misrepresentation or practice is one which is likely to affect a consumer's choice of or conduct regarding a product.[45] In other words, it is information that is important to consumers. If inaccurate or omitted information is material, injury is likely.[46]

The Commission considers certain categories of information presumptively material.[47] First, the Commission presumes that express claims are material.[48] As the Supreme Court stated recently, "[i]n the absence of factors that would distort the decision to advertise, we may assume that the willingness of a business to promote its products reflects a belief that consumers are interested in the advertising."[49] Where the seller knew, or should have known, that an ordinary consumer would need omitted information to evaluate the product or service, or that the claim was false, materiality will be presumed because the manufacturer intended the information or omission to have an effect.[50] Similarly, when evidence exists that a seller intended to make an implied claim, the Commission will infer materiality.[51]

The Commission also considers claims or omissions material if they significantly involve health, safety, or other areas with which the reasonable consumer would be concerned. Depending on the facts, information pertaining to the central characteristics of the product or service will be presumed material. Information has been found material where it concerns the purpose,[52] safety,[53] efficacy,[54] or cost,[55] of the product or service. Information is also likely to be material if it concerns durability, performance, warranties or quality. Information pertaining to a finding by another agency regarding the product may also be material.[56]

Where the Commission cannot find materiality based on the above analysis, the Commission may require evidence that the claim or omission is likely to be considered important by consumers. This evidence can be the fact that the product or service with the feature represented costs more than an otherwise comparable product without the feature, a reliable survey of consumers, or credible testimony.[57]

A finding of materiality is also a finding that injury is likely to exist because of the representation, omission, sales practice, or marketing technique. Injury to consumers can take many forms.[58] Injury exists if consumers would have chosen differently but for the deception. If different choices are likely, the claim is material, and injury is likely as well. Thus, injury and materiality are different names for the same concept.

V. CONCLUSION

The Commission will find an act or practice deceptive if there is a misrepresentation, omission, or other practice, that misleads the consumer acting reasonably in the circumstances, to the consumer's detriment. The Commission will not generally require extrinsic evidence concerning the representations understood by reasonable consumers or the materiality of a challenged claim, but in some instances extrinsic evidence will be necessary.

The Commission intends to enforce the FTC Act vigorously. We will investigate, and prosecute where appropriate, acts or practices that are deceptive. We hope this letter will help provide you and the public with a greater sense of certainty concerning how the Commission will exercise its jurisdiction over deception. Please do not hesitate to call if we can be of any further assistance.

By direction of the Commission, Commissioners Pertschuk and Bailey dissenting, with separate statements attached and with separate response to the Committee's request for a legal analysis to follow.

/s/James C. Miller III
Chairman

cc: Honorable James T. Broyhill
Honorable James J. Florio
Honorable Norman F. Lent

Endnotes:

[1]S. Rep. No. 97-451, 97th Cong., 2d Sess. 16; H.R. Rep. No. 98-156, Part I, 98th Cong., 1st Sess. 6 (1983). The Commission's enforcement policy against unfair acts or practices is set forth in a letter to Senators Ford and Danforth, dated December 17, 1980.

[2]In determining whether an ad is misleading, Section 15 requires that the Commission take into account "representations made or suggested" as well as "the extent to which the advertisement fails to reveal facts material in light of such representations or material with respect to consequences which may result from the use of the commodity to which the advertisement relates under the conditions prescribed in said advertisement, or under such conditions as are customary or usual." 15 U.S.C. 55. If an act or practice violates Section 12, it also violates Section 5. *Simeon Management Corp.*, 87 F.T.C. 1184, 1219 (1976), *aff'd*, 579 F.2d 1137 (9th Cir. 1978); *Porter & Dietsch*, 90 F.T.C. 770, 873-74 (1977), *aff'd*, 605 F.2d 294 (7th Cir. 1979), *cert. denied*, 445 U.S. 950 (1980).

[3]Chairman Miller has proposed that Section 5 be amended to define deceptive acts. Hearing Before the Subcommittee for Consumers of the Committee on Commerce, Science, and Transportation, United States Senate, 97th Cong., 2d Sess. *FTCs Authority Over Deceptive Advertising*, July 22,1982, Serial No. 97-134, p. 9. Three Commissioners believe a legislative definition is unnecessary. *Id.* at 45 (Commissioner

Clanton), at 51 (Commissioner Bailey) and at 76 (Commissioner Pertschuk). Commissioner Douglas supports a statutory definition of deception. Prepared statement by Commissioner George W. Douglas, Hearing Before the Subcommittee for Consumers of the Committee on Commerce, Science and Transportation, United States Senate, 98th Cong. lst Sess. (March 16, 1983) p. 2.

[4]A misrepresentation is an express or implied statement contrary to fact. A misleading omission occurs when qualifying information necessary to prevent a practice, claim, representation, or reasonable expectation or belief from being misleading is not disclosed. Not all omissions are deceptive, even if providing the information would benefit consumers. As the Commission noted in rejecting a proposed requirement for nutrition disclosures, "In the final analysis, the question whether an advertisement requires affirmative disclosure would depend on the nature and extent of the nutritional claim made in the advertisement.". ITT Continental Baking Co. Inc., 83 F.T.C. 865, 965 (1976). In determining whether an omission is deceptive, the Commission will examine the overall impression created by a practice, claim, or representation. For example, the practice of offering a product for sale creates an implied representation that it is fit for the purposes for which it is sold. Failure to disclose that the product is not fit constitutes a deceptive omission. [See discussion below at 5-6) Omissions may also be deceptive where the representations made are not literally misleading, if those representations create a reasonable expectation or belief among consumers which is misleading, absent the omitted disclosure.

Non-deceptive emissions may still violate Section 5 if they are unfair. For instance, the R-Value Rule, 16 C.F.R. 460.5 (1983), establishes a specific method for testing insulation ability, and requires disclosure of the figure in advertising. The Statement of Basis and Purpose, 44 FR 50,242 (1979), refers to a deception theory to support disclosure requirements when certain misleading claims are made, but the rule's general disclosure requirement is based on an unfairness theory. Consumers could not reasonably avoid injury in selecting insulation because no standard method of measurement existed.

[5]Advertising that lacks a reasonable basis is also deceptive. *Firestone*, 81 F.T.C. 398, 451-52 (1972), *aff'd*, 481 F.2d 246 (6th Cir.), *cert. denied*, 414 U.S. 1112 (1973). *National Dynamics*, 82 F.T.C. 488, 549-50 (1973); *aff'd and remanded on other grounds*, 492 F.2d 1333 (2d Cir.), *cert. denied*, 419 U.S. 993 (1974), *reissued*, 85 F.T.C. 391 (1976). *National Comm'n on Egg Nutrition*, 88 F.T.C. 89, 191 (1976), *aff'd*, 570 P.2d 157 (7th Cir.), *cert. denied*, 439 U.S. 821, *reissued*, 92 F.T.C. 848 (1978). The deception theory is based on the fact that most ads making objective claims imply, and many expressly state, that an advertiser has certain specific grounds for the claims. If the advertiser does not, the consumer is acting under a false impression. The consumer might have perceived the advertising differently had he or she known the advertiser had no basis for the claim. This letter does not address the nuances of the reasonable basis doctrine, which the Commission is currently reviewing. 48 FR 10,471 (March 11, 1983)

[6]In *Beneficial Corp. v. FTC*, 542 F.2d 611, 617 (3d Cir. 1976), the court noted "the likelihood or propensity of deception is the criterion by which advertising is measured."

[7]On evaluation of the entire document:

> The Commission finds that many of the challenged Anacin advertisements, when viewed in their entirety, did convey the message that the superiority of this product has been proven [footnote omitted]. It is immaterial that the word "established", which was used in the complaint, generally did not appear in the ads; the important consideration is the net impression conveyed to the public. *American Home Products*, 98 F.T.C. 136, 374 (1981), *aff'd*, 695 F.2d (3d Cir. 1982).

On the juxtaposition of phrases:

> On this label, the statement "Kills Germs By Millions On Contact" immediately precedes the assertion "For General Oral Hygiene Bad Breath, Colds and Resultant Sore Throats" [footnote omitted]. By placing these two statements in close proximity, respondent has conveyed the message that since Listerine can kill millions of germs, it can cure, prevent and ameliorate colds and sore throats [footnote omitted]. *Warner Lambert*, 86F.T.C. 1398, 1489-90 (1975), *aff'd*, 562 F.2d 749 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 950

(1978) (emphasis in original).

On the nature of the claim, *Firestone* is relevant. There the Commission noted that the alleged misrepresentation concerned the safety of respondent's product, "an issue of great significance to consumers. On this issue, the Commission has required scrupulous accuracy in advertising claims, for obvious reasons." 81 F.T.C. 398,456 (1972), *aff'd*, 481 F.2d 246 (6th Cir.), *cert. denied*, 414 U.S. IU2 (1973).

In each of these cases, other factors, including in some instances surveys, were in evidence on the meaning of the ad.

[8]The evidence can consist of expert opinion, consumer testimony (particularly in cases involving oral representations), copy tests, surveys, or any other reliable evidence of consumer interpretation.

[9]As the Commission noted in the Cigarette rule, "The nature, appearance, or intended use of a product may create the impression on the mind of the consumer . . . and if the impression is false, and if the seller does not take adequate steps to correct it, he is responsible for an unlawful deception." Cigarette Rule Statement of Basis and Purpose, 29 FR 8324, 8352 (July 2, 1964).

[10]*Porter & Dietsch*, 90 F.T.C. 770, 873-74 (1977), *aff'd*. 605 F.2d 294 (7th Cir. 1979), *cert. denied*, 445 U.S. 950 (1980); *Simeon Management Corp.*, 87 F.T.C. 1184, 1230 (1976), *aff'd*, 579 F.2d 1137 (9th Cir. 1978).

[11]*See, e.g., Grolier*, 91 F.T.C. 315,480 (1978), *remanded on other grounds*, 615 F.2d 1215 (9th Cir. 1980), *modified on other grounds*, 98 FM 882 (1981), *reissued*, 99 F.T.C. 379 (1982).

[12]In *Peacock Buick*, 86 F.T.C. 1532 (1975), *aff'd*, 553 F.2d 97 (4th Cir. 1977), the Commission held that absent a clear and early disclosure of the prior use of a late model car, deception can result from the setting in which a sale is made and the expectations of the buyer ... *Id* at 1555.

Even in the absence of affirmative misrepresentations, it is misleading for the seller of late model used cars to fail to reveal the particularized uses to which they have been put... When a later model used car is sold at close to list price ... the assumption likely to be made by some purchasers is that, absent disclosure to the contrary, such car has not previously been used in a way that might substantially impair its value. In such circumstances, failure to disclose a disfavored prior use may tend to mislead. *Id* at 1557-58.

[13]In *Leonard Porter*, the Commission dismissed a complaint alleging that respondents' sale of unmarked products in Alaska led consumers to believe erroneously that they were handmade in Alaska by natives. Complaint counsel had failed to show that consumers of Alaskan craft assumed respondents' products were handmade by Alaskans in Alaska. The Commission was unwilling, absent evidence, to infer from a viewing of the items that the products would tend to mislead consumers.

By requiring such evidence, we do not imply that elaborate proof of consumer beliefs or behavior is necessary, even in a case such as this, to establish the requisite capacity to deceive. However, where visual inspection is inadequate, some extrinsic testimony evidence must be added. 88 F.T.C. 546, 626, n.5 (1976).

[14]*Bait and Switch Policy Protocol*, December 10, 1975; Guides Against Bait Advertising, 16 C.F.R. 238.0 (1967). 32 PR 15,540.

[15]*Encyclopedia Britannica* 87 F.T.C. 421, 497 (1976), *aff'd*, 605 F.2d 964 (7th Cir. 1979), *cert. denied*, 445 U.S. 934 (1980), *modified*, 100 F.T.C. 500 (1982).

[16]See the complaints in *BayleySuit*, C-3117 (consent agreement) (September 30,1983) [102 F.T.C. 1285];

Figgie International, Inc., D. 9166 (May 17, 1983).

[17]The Commission's complaints in *Chrysler Corporation*, 99 F.T.C. 347 (1982), and *Volkswagen of America*, 99 F.T.C. 446 (1982), alleged the failure to disclose accurate use and care instructions for replacing oil filters was deceptive. The complaint in *Ford Motor Co.*, D. 9154, 96 F.T.C. 362 (1980), charged Ford with failing to disclose a "piston scuffing" defect to purchasers and owners which was allegedly widespread and costly to repair. *See also General Motors*, D. 9145 (provisionally accepted consent agreement, April 26, 1983). [102 F.T.C. 1741]

[18]*See Jay Norris Corp.*, 91 F.T.C. 751 (1978), *aff'd with modified language in order*, 598 P.2d 1244 (2d Cir. 1979), *cert. denied*, 444 U.S. 980 (1979) (failure to consistently meet guarantee claims of"immediate and prompt" delivery as well as money back guarantees); *Southern States Distributing Co.*, 83 F.T.C. 1126 (1973) (failure to honor oral and written product maintenance guarantees, as represented); *Skylark Originals, Inc.*, 80 F.T.C. 337 (1972), *aff'd*, 475 F.2d 1396 (3d Cir. 1973) (failure to promptly honor moneyback guarantee as represented in advertisements and catalogs); *Capitol Manufacturing Corp.*, 73 F.T.C. 872 (1968) (failure to fully, satisfactorily and promptly meet all obligations and requirements under terms of service guarantee certificate).

[19]The evidence necessary to determine how reasonable consumers understand a representation is discussed in Section II of this letter.

[20]An interpretation may be reasonable even though it is not shared by a majority of consumers in the relevant class, or by particularly sophisticated consumers. A material practice that misleads a significant minority of reasonable consumers is deceptive. *See Heinz W. Kirchner*, 63 F.T.C. 1282 (1963).

[21]A secondary message understood by reasonable consumers is actionable if deceptive even though the primary message is accurate. *Sears, Roebuck & Co.*, 95 F.T.C. 406, 511 (1980), *aff'd* 676 F.2d 385, (9th Cir. 1982); *Chrysler*, 87 F.T.C. 749 (1976), *aff'd*, 561 F.2d 357 (D.C. Cir.), *reissued* 90 F.T.C. 606 (1977); *Rhodes Pharmacal Co.*, 208 F.2d 382, 387 (7th Cir. 1953), *aff'd*, 348 U.S. 940 (1955).

[22]*National Comm'n on Egg Nutrition*, 88 F.T.C. 89, 185 (1976), *enforced in part*, 570 F.2d 157 (7th Cir. 1977); *Jay Norris Corp.*, 91 F.T.C. 751, 836 (1978), *aff'd*, 598 F.2d 1244 (2d Cir. 1979).

[23]*National Dynamics*, 82 F.T.C. 488, 524, 548 (1973), *aff'd*, 492 P.2d 1333 (2d Cir.), *cert. denied*, 419 U.S. 993 (1974), *reissued* 85 F.T.C. 39-1 (1976).

[24]*Warner-Lambert*, 86 F.T.C. 1398, 1415 n.4 (1975), *aff'd*, 562 F.2d 749 (D.C. Cir. 1977), *cert denied*, 435 U.S. 950 (1978).

[25]*Grolier*, 91 F.T.C. 315, 430 (1978), *remanded on other grounds*, 615 F.2d 1215 (9th Cir. 1980), *modified on other grounds*, 98 F.T.C. 882 (1981), *reissued*, 99 F.T.C. 379 (1982).

[26]*American Home Products*, 98 F.T.C. 136 (1981), *aff'd* 695 F.2d 681 (3d Cir. 1982). consumers may be led to expect, quite reasonably..." (at 386); "... consumers may reasonably believe..." (*Id.* n.52); "... would reasonably have been understood by consumers...." (at 371); "the record shows that consumers could reasonably have understood this language . . ." (at 372). See also, pp. 373, 374, 375. *Bristol-Myers*, D. 8917 (July 5, 1983), appeal docketed, No. 83-4167 (2nd Cir. Sept. 12,1983)..... ads must be judged by the impression they make on reasonable members of the public . . . " (Slip Op. at 4); ". . . consumers could reasonably have understood . . ." (Slip Op. at 7); ". . . consumers could reasonably infer . . ." (Slip Op. at 11) [102 F.T.C. 21 (1983)]. *Sterling Drug, Inc.*, D. 8919 (July 5,1983), appeal docketed, No. 83-7700 (9th Cir. Sept. 14,1983)..... consumers could reasonably assume . . ." (Slip Op. at 9); ". . . consumers could reasonably interpret the ads . . ." (Slip Op. at 33). [102 F.T.C. 395 (1983)]

[27] *Horizon Corp.*, 97 F.T.C. 464, 810 n.13 (1981).

[28] *Simeon Management*, 87 F.T.C. 1184, 1230 (1976).

[29] The listed categories are merely examples. Whether children, terminally ill patients, or any other subgroup of the population will be considered a special audience depends on the specific factual context of the claim or the practice.

The Supreme Court has affirmed this approach. "The determination whether an advertisement is misleading requires consideration of the legal sophistication of its audience." *Bates v. Arizona*, 433 U.S. 350, 383 n.37 (1977).

[30] In one case, the Commission's complaint focused on seriously ill persons. The ALJ summarized: According to the complaint, the frustrations and hopes of the seriously ill and their families were exploited, and the representation had the tendency and capacity to induce the seriously ill to forego conventional medical treatment worsening their condition and in some cases hastening death, or to cause them to spend large amounts of money and to undergo the inconvenience of traveling for a non-existent "operation." *Travel King*, 86 F.T.C. 715, 719 (1975).

[31] *FTC v. Sterling Drug*, 317 F.2d 669, 674 (2d Cir. 1963).

[32] Numerous cases exemplify this point. For instance, in *Pfizer*, the Commission ruled that "the net impression of the advertisement, evaluated from the perspective of the audience to whom the advertisement is directed, is controlling." 81 F.T.C. 23, 58 (1972).

[33] In *Litton Industries*, the Commission held that fine print disclosures that the surveys included only "Litton authorized" agencies were inadequate to remedy the deceptive characterization of the survey population in the headline. 97 F.T.C. 1, 71, n.6 (1981), *aff'd as modified*, 676 F.2d 364 (9th Cir. 1982). Compare the Commission's note in the same case that the fine print disclosure "Litton and one other brand" was reasonable to quote the claim that independent service technicians had been surveyed, "[F]ine print was a reasonable medium for disclosing a qualification of only limited relevance." 97 F.T.C. 1, 70, n.5 (1981).

In another case, the Commission held that the body of the ad corrected the possibly misleading headline because in order to enter the contest, the consumer had to read the text, and the text would eliminate any false impression stemming from the headline. *D.L. Blair*, 82 F.T.C. 234, 255,256 (1973).

In one case respondent's expert witness testified that the headline (and accompanying picture) of an ad would be the focal point of the first glance. He also told the administrative law judge that a consumer would spend [t]ypically a few seconds at most" on the ads at issue. *Crown Central*, 84 F.T.C. 1493, 1543 nn. 14-15 (1974),

[34] In *Giant Food*, the Commission agreed with the examiner that the fine-print disclaimer was inadequate to correct a deceptive impression. The Commission quoted from the examiner's finding that "very few if any of the persons who would read Giant's advertisements would take the trouble to, or did, read the fine print disclaimer." 61 F.T.C. 326, 348 (1962).

Cf. Beneficial Corp. v. FTC, 542 P.2d 611, 618 (3d Cir. 1976), where the court reversed the Commission's opinion that no qualifying language could eliminate the deception stemming from use of the slogan "Instant Tax Refund."

[35] "Respondents argue that the contracts which consumers signed indicated that credit life insurance was not required for financing, and that this disclosure obviated the possibility of deception. We disagree. It Is

clear from consumer testimony that oral deception was employed in some instances to cause consumers to ignore the warning in their sales agreement. . ." *Peacock Buick*, 86 F.T.C. 1532, 1558-59 (1974).

[36]*Exposition Press*, 295 F.2d $69, 873 (2d Cir. 1961); *Gimbel Bros.*, 61 F.T.C. 1051, 1066 (1962); *Carter Products*, 186 F.2d 821, 824 (1951).

By the same token, money-back guarantees do not eliminate deception. In *Sears*, the Commission observed:

> A money-back guarantee is no defense to a charge of deceptive advertising.... A money-back guarantee does not compensate the consumer for the often considerable time and expense incident to returning a major-ticket item and obtaining a replacement.

Sears, Roebuck and Co., 95 F.T.C. 406, 518 (1980), *aff'd*, 676 F.2d 385 (9th Cir. 1982). However, the existence of a guarantee, if honored, has a bearing on whether the Commission should exercise its discretion to prosecute. *See* Deceptive and Unsubstantiated Claims Policy Protocol, 1975.

[37]*See American Home Products*, 98 F.T.C. 136, 370 (1981), *aff'd*, 695 F.2d 681, 688 (3d Cir. Dec. 3, 1982), Whether a disclosure on the label cures deception in advertising depends on the circumstances:

> ... it is well settled that dishonest advertising is not cured or excused by honest labeling [footnote emitted). Whether the ill-effects of deceptive nondisclosure can be cured by a disclosure requirement limited to labeling, or whether a further requirement of disclosure in advertising should be imposed, is essentially a question of remedy. As such it is a matter within the sound discretion of the Commission [footnote omitted]. The question of whether in a particular case to require disclosure in advertising cannot be answered by application of any hard-and-fast principle. The test is simple and pragmatic: Is it likely that, unless such disclosure is made, a substantial body of consumers will be misled to their detriment? *Statement of Basis and Purpose for the Cigarette Advertising and Labeling Trade Regulation Rule*, 1965, pp. 89-90. 29 FR 8325 (1964).

Misleading "door openers" have also been found deceptive (Encyclopedia Britannica, 87 F.T.C. 421 (1976), *aff'd*, 605 P.2d 964 (7th Cir. 1979), *cert. denied*, 445 U.S. 934 (1980), *as modified*, 100 F.T.C. 500 (1982)), as have offers to sell that are not bona fide offers (*Seekonk Freezer Meats, Inc.*, 82 F.T.C. 1025 (1973)). In each of these instances, the truth is made known prior to purchase.

[38]In the Listerine case, the Commission held that pro forma statements of no absolute prevention followed by promises of fewer colds did not cure or correct the false message that Listerine will prevent colds. *Warner Lambert* 86 F.T.C. 1398, 1414 (1975), *aff'd*, 562 F.2d 749 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 950 (1978).

[39]*Chicago Metropolitan Pontiac Dealers' Ass'n*, C. 3110 (June 9,1983). [101 F.T.C. 854 (1983)]

[40]An opinion is a representation that expresses only the behalf of the maker, without certainty, as to the existence of a fact, or his judgement as to quality, value, authenticity, or other matters of judgement. American Law Institute, Restatement on Torts, Second ¶ 538 A.

[41]*Id.* ¶ 539. At common law, a consumer can generally rely on an expert opinion. *Id.*, ¶ 542(a). For this reason, representations of expert opinion will generally be regarded as representations of fact.

[42]"[T]here is a category of advertising themes, in the nature of puffing or other hyperbole, which do not amount to the type of affirmative product claims for which either the Commission or the consumer would expect documentation." *Pfizer, Inc*, 81 F.T.C. 23, 64 (1972).

The term "Puffing" refers generally to an expression of opinion not made as a representation of fact. A seller has some latitude in puffing his goods, but he is not authorized to misrepresent them or to assign to them benefits they do not possess [cite omitted]. Statements made for the purpose of deceiving prospective purchasers cannot properly be characterized as mere puffing. *Wilmington Chemical*, 69 F.T.C. 828, 865 (1966).

[43]In *Avalon Industries*, the ALJ observed that the "'ordinary person with a common degree of familiarity with industrial civilization' would expect a reasonable relationship between the size of package and the size of quantity of the contents. He would have no reason to anticipate slack filling." 83 F.T.C. 1728, 1750 (1974) (I.D.).

[44]"A misleading claim or omission in advertising will violate Section 5 or Section 12, however, only if the omitted information would be a material factor in the consumer's decision to purchase the product." *American Home Products Corp.*, 98 F.T.C. 136,368 (1981), *aff'd*, 695 F.2d 681 (3d Cir. 1982). A claim is material if it is likely to affect consumer behavior. "Is it likely to affect the average consumer in deciding whether to purchase the advertised product-is there a material deception, in other words?" Statement of Basis and Purpose, *Cigarette Advertising and Labeling Rule*, 1965, pp. 86-87. 29 FR 8325 (1964).

[45]Material information may affect conduct other than the decision to purchase a product. The Commission's complaint in *Volkswagen of America*, 99 F.T.C. 446 (1982), for example, was based on provision of inaccurate instructions for oil filter installation. In its *Restatement on Torts, Second*, the American Law Institute defines a material misrepresentation or omission as one which the reasonable person would regard as important in deciding how to act, or one which the maker knows that the recipient, because of his or her own peculiarities, is likely to consider important. Section 538(2). The Restatement explains that a material fact does not necessarily have to affect the finances of a transaction. "There are many more-or-less sentimental considerations that the ordinary man regards as important." Comment on Clause 2(a)(d).

[46]In evaluating materiality, the Commission takes consumer preferences as given. Thus, if consumers prefer one product to another, the Commission need not determine whether that preference is objectively justified. *See Algoma Lumber*, 291 U.S. 54, 78 (1933). Similarly, objective differences among products are not material if the difference is not likely to affect consumer choices.

[47]The Commission will always consider relevant and competent evidence offered to rebut presumptions of materiality.

[48]Because this presumption is absent for some implied claims, the Commission will take special caution to ensure materiality exists in such cases.

[49]*Central Hudson Gas & Electric Co. v. PSC*, 447 U.S. 557, 567 (1980).

[50]*Cf. Restatement on Contracts, Second* ¶ 162(1).

[51]In *American Home Products*, the evidence was that the company intended to differentiate its products from aspirin. The very fact that AHP sought to distinguish its products from aspirin strongly implies that knowledge of the true ingredients of those products would be material to purchasers." *American Home Products*, 98 F.T.C. 136, 368 (1981), *aff'd*, 695 F.2d 681 (3d. Cir. 1982).

[52]In *Fedders*, the ads represented that only Fedders gave the assurance of cooling on extra hot, humid days. "Such a representation is the raison d'etre for an air conditioning unit-it is an extremely material representation." 85 F.T.C. 38, 61 (1975) (I.D.), *petition dismissed*, 529 F.2d 1398 (2d Cir.), *cert. denied*, 429 U.S. 818 (1976).

[53]"We note at the outset that both alleged misrepresentations go to the issue of the safety of respondent's product, an issue of great significance to consumers." *Firestone*, 81 F.T.C. 398, 456 (1972), *aff'd*, 481 P.2d 246 (6th Cir.), *cert. denied*, 414 U.S. 1112 (1973).

[54]The Commission found that information that a product was effective in only the small minority of cases where tiredness symptoms are due to an iron deficiency, and that it was of no benefit in all other cases, was material. *J.B. Williams Co.*, 68 F.T.C. 481, 546 (1965), *aff'd*, 381 F.2d 884 (6th Cir. 1967).

[55]As the Commission noted in *MacMillan, Inc.*:

> In marketing their courses, respondents failed to adequately disclose the number of lesson assignments to be submitted in a course. These were material facts necessary for the student to calculate his tuition obligation, which was based on the number of lesson assignments he submitted for grading. The nondisclosure of these material facts combined with the confusion arising from LaSalle's inconsistent use of terminology had the capacity to mislead students about the nature and extent of their tuition obligation. *MacMillan, Inc.*, 96 F.T.C. 208, 303-304 (1980).

See also, Peacock Buick, 86 F.T.C. 1532, 1562 (1975), *aff'd*, 553 F.2d 97 (4th Cir. 1977).

[56]*Simeon Management Corp.*, 87 F.T.C. 1184 (1976), *aff'd*, 579 P.2d 1137, 1168, n.10 (9th Cir. 1978).

[57]In *American Home Products*, the Commission approved the ALJ's finding of materiality from an economic perspective:

> If the record contained evidence of a significant disparity between the prices of Anacin and plain aspirin, it would form a further basis for a finding of materiality. That is, there is a reason to believe consumers are willing to pay a premium for a product believed to contain a special analgesic ingredient but not for a product whose analgesic is ordinary aspirin. *American Home Products*, 98 F.T.C. 136, 369 (1981), *aff'd*, 695 F.2d 681 (3d Cir. 1982).

[58]The prohibitions of Section 5 are intended to prevent injury to competitors as well as to consumers. The Commission regards injury to competitors as identical to injury to consumers. Advertising and legitimate marketing techniques are intended to "lure" competitors by directing business to the advertiser. In fact, vigorous competitive advertising can actually benefit consumers by lowering prices, encouraging product innovation, and increasing the specificity and amount of information available to consumers. Deceptive practices injure both competitors and consumers because consumers who preferred the competitor's product are wrongly diverted.

1. Payday loans are an important source of credit to many consumers. Given the consumer demand for short-term, low-denomination credit, would not many consumers find it difficult, or even impossible, to obtain such credit without payday lending?

A study conducted by Georgetown University's Credit Research Center published in April 2001, sheds some light on the question. According to the study, typical payday loan customers have real constraints on their ability to borrow (lower income than adults in general, higher debt-to-income ratios, more bankruptcies, high utilization of credit limits on open-end bank credit cards). On the other hand, many payday loan customers do not appear to understand the concept of annual percentage rate, and may therefore not be making economically rational choices about loan sources (fewer payday loan customers have open-end bank credit cards than adults in general). The study further observed that some consumers may have more options than they believe., Others may choose the option of payday loans because of its convenience, even if other options are available. (See Payday Advance Credit at 31-32, 41-52.)

2. The FDIC was the first agency to warn about the potential for payday lenders to "rent" bank charters. We believe that your guidelines address this issue. Could you explain how they do so?

"Charter renting" is the term often used to describe arrangements by which a bank originates and funds payday loans through a third-party. The FDIC pays careful attention to the institutions it supervises that are involved in payday lending, with particular emphasis on the review of arrangements between these institutions and third parties. The FDIC Guidelines for Payday Lending note that payday lenders will be subject to special examination procedures, including on-site reviews at third-party locations. The Guidelines also specify that the use of third parties in no way diminishes the responsibility of the bank's board of directors and management to ensure that the third-party activities are conducted in a safe and sound manner and in compliance with applicable policies and consumer protection regulations. Our examiners scrutinize such relationships and recommend corrective action when warranted.

The term "charter renting" also arises in the context of exportation of interest rates. Federal law authorizes federal and state-chartered insured depository institutions making loans to out-of-state borrowers to "export" favorable interest rates provided under the laws of the state where the bank is located. The authority of national banks to export favorable interest rates on loans to borrowers residing in another state was recognized by the U.S. Supreme Court in Marquette National Bank v. First Omaha Service Corp., 439 U.S. 299 (1978), in the context of section 85 of the National Bank Act. To ensure a level competitive playing field, Congress extended that authority to other insured depository institutions through the Depository Institutions Deregulation and Monetary Control Act of 1980. State laws that attempt to set usury limits on out-of-state institutions are preempted by these "competitive equality" statutes.

3. Your payday lending guidelines include a number of provision designed to ensure that banks engaged in payday lending are doing so on a safe and sound basis. What are some of those key provisions?

The FDIC recognizes payday lending as one of the highest risk forms of lending, that demands close regulatory scrutiny. The Guidelines describe the FDIC's expectations for prudent risk-management practices for payday lending. Some of the key provisions of the Guidelines include rigorous requirements for managing third-party relationships and agreements. The Guidelines also note that institutions involved in payday lending will be expected to maintain higher capital levels -- perhaps up to dollar-for-dollar capital -- and sufficient loan loss allowances for their payday lending portfolios depending on the level and volatility of risk. Other key provisions include a stringent limit on the total amount of payday loans an FDIC-insured institution may extend as a total of its capital, as well as specific charge-off criteria for payday loans.

The Guidelines expressly address several consumer protection issues. With regard to the Community Reinvestment Act (CRA), the Guidelines explain that: (1) discriminatory or other illegal credit practices will adversely affect the evaluation of an institution's performance; and (2) certain payday lending practices, while not expressly prohibited by law, may be inconsistent with helping to meet the convenience and needs of an institution's community. Practices of either type would be fully described in the public CRA performance evaluation of an FDIC-supervised bank. The Guidelines also remind FDIC-supervised banks that payday lending arrangements are subject to the rules and guidelines intended to ensure the privacy, security, confidentiality, and integrity of consumer financial information.

The Guidelines also emphasize that FDIC-supervised banks will be held responsible if they engage in unfair or deceptive payday lending practices in violation of Section 5 of the Federal Trade Commission Act (FTC Act). In this context, the Guidelines instruct examiners to pay particular attention to marketing programs for payday loans and collection practices that may be abusive. To help state-chartered institutions avoid engaging in these and other forms of unfair or deceptive conduct, the FDIC and Federal Reserve provided detailed guidance to the banks under their supervision on March 11, 2004. A copy of this guidance is enclosed.

4. Given the growing demand for short-term small denomination credit and FDIC's experience with banks under the guidance, clearly the other Federal banking regulators should follow your Agency's lead. To that end, how many FDIC-regulated state banks offer payday loans? Do you expect more banks to enter this business? Is there any legal reason the OCC or OTS could not follow your lead?

Ten FDIC-supervised institutions currently offer payday loans, and we are aware of at least one additional institution that plans to enter this line of business in the very near future. The total number of insured institutions involved in payday lending has remained relatively stable over the previous two years, but several factors, including state and federal legislative initiatives, and how well insured depository institutions manage

and control the risks of their payday lending programs, may positively or negatively impact that trend.

As previously noted, payday lending is among the highest risk forms of lending and demands close regulatory scrutiny. The federal banking agencies have established guidelines that clearly identify the inherent risks of subprime lending; however, subprime lending can nonetheless be a safe and sound banking activity if bank management properly manages and controls those risks, and if the bank has adequate capital to absorb the additional risks. The FDIC's Guidelines for Payday Lending build on the existing interagency guidelines for subprime lending by establishing rigorous capital and operational standards for banks engaged in this business. For FDIC-supervised banks that have not met these standards, the FDIC takes appropriate enforcement action. In the past two years, two FDIC-supervised institutions have exited the payday lending business as a result of the FDIC concluding that enforcement action was necessary in light of examination findings.

5. Many state banks provide overdraft services that are similar to payday loans. Do you know how many state-chartered banks offer such services?

The FDIC does not require that banks report these services. However, a 2003 American Bankers Association survey indicated that over 50 percent of banks with assets under $1 billion had or planned to offer the fee-based type of overdraft protection programs that are often compared to payday lending. Industry trends indicate that this percentage will continue to grow.

Banks have always been able to pay a check presented on insufficient funds and thereby put a customer's account into an overdraft status. Another ABA survey estimates that over 90 percent of all banks offer overdraft protection programs linked to another deposit account, a line of credit, or a credit card. These programs either transfer funds from the linked account, or advance a sum to cover what would otherwise be an overdraft. Customers are then charged interest for the advance.

Is it correct that these services are not subject to the same Truth-in-Lending disclosures as payday loans?

Since 1981 fees charged for overdrafts have been excluded from Truth-in-Lending Act finance charge disclosures, subject to certain conditions. The principal condition for the exclusion is that the fee(s) charged to pay an insufficient check do not exceed the fee(s) charged to return the check. As these newly promoted overdraft programs are based on the same fees, they also can qualify for the Truth in Lending Act exclusion.

6. The state-chartered banks that currently engage in payday lending do so with administrative and marketing support of agents. What other types of banking products and services are offered with the assistance of agents? If state-chartered

banks could not use agents to help them provide products and services what would be the impact on the consumers?

As the financial services industry continues to evolve, financial institutions are increasingly using third parties for many functions that have traditionally been performed in-house. Financial institutions also enter into various arrangements with third parties in which the institution funds certain products originated by a third-party (such as mortgage lending). These relationships can potentially lower costs to both the institution and the consumer, and make available to the consumer products and services that the institution does not or would not otherwise originate. A vast array of financial products and services offered by insured depository institutions are supported by third-party marketing and administrative functions. Common examples include:

- consumer loan products, including credit cards, mortgage and home equity loans, and auto loans;
- non-deposit investment products, including securities, mutual funds, and annuities;
- insurance products;
- brokerage services;
- trust and related services, including estate, tax, and financial planning;
- deposit products, including brokered deposits;
- cash management, including sweep arrangements; and
- information technology.

The reasons for entering into such relationships vary by institution, product, or service. Incentives may include customer demand, business strategy, competitive pressures, entry or operating costs, or complexity in offering a specific product or service. From the consumers' viewpoint, third-party arrangements can expand product and service offerings, promote competition, and potentially lower costs. For instance, customers may be able to obtain a product or service that would otherwise not be available in a particular market, or obtain products and services that are better-suited to customers' specific needs. Customers also may benefit from more favorable pricing or more efficient service. Such pricing and service enhancements often are the result of the increased competition in the marketplace as well as the specialization available through third-party relationships. If third parties were not allowed to assist financial institutions in marketing and administering financial products and services, consumers might be impacted through higher costs or reduced availability of certain products or services.

As previously indicated, the Guidelines address the management of third-party relationships. The Guidelines also state that payday lenders will be subject to special examination procedures, particularly relating to partnering with third parties and compliance with applicable consumer protection laws and regulations.

7. The FDIC has undertaken a significant financial literacy campaign, and we understand that the leading trade association for the payday lending [industry], the Community Financial Services Association, in cooperation with the National Urban

League, has undertaken its own initiative toward financial literacy that will provide for the distribution of FDIC's Money Smart program at thousands of payday lending offices nationwide. What other initiatives, if any, could the payday lending industry take to help promote financial literacy?

We too have been informed that the National Urban League will be working with the Community Financial Services Association to provide support for the financial education efforts of local Urban League affiliates. The FDIC is not involved in the Urban League/CFSA partnership. However, we understand they have chosen to use the Money Smart financial education curriculum, which is free and not copyrighted, in their endeavor.

As you know, Title V of the Fair and Accurate Credit Transactions Act of 2003 mandated the formation of the Financial Literacy and Education Commission. The Commission's goal is to promote financial education and improve the financial literacy of all Americans. The Commission, which includes representatives from the FDIC and 19 other federal agencies, is responsible for encouraging government and private sector efforts to promote financial literacy, and coordinate financial education efforts of the federal government, including the identification and promotion of best practices. Once these best practices are made public, the payday lending industry and other entities may be interested in assessing whether the suggestions are appropriate for their organization's mission.

8. Of the state-chartered banks that are currently engaged in payday lending, how many have been subject to examination since your payday lending guidelines went into effect? Of those that have been examined are you finding that the institutions are complying with the guidelines?

Since the Guidelines were issued (July 2003), the FDIC has examined all but three of the state-nonmember banks engaged in payday lending; the remaining examinations are underway or are scheduled in the very near term. The FDIC conducted visitations that specifically targeted payday lending operations at several of the banks shortly after issuing the Guidelines.

To date, FDIC-supervised institutions involved in payday lending have been in substantial compliance with the principles set forth in the Guidelines. Banks that fail to meet the rigorous standards outlined in the Guidelines could be subject to enforcement actions requiring corrective action, which could include instructions to exit the business As mentioned earlier, two FDIC-supervised banks have exited the payday lending business.

9. In consultation with many Republican and Democratic Members of Congress, state legislators, regulators and consumer groups, the industry trade associations, Community Financial Services Association, developed a responsive set of Best Practices. Despite those Best Practices, which prohibit rollovers, critics of payday lending suggest that consumers can become trapped in a cycle of debt with payday

loans. How do your payday lending guidelines address this issue? Do the guidelines not place a limit on the ability of a payday lender to "rollover" a loan?

In developing the Guidelines, the FDIC looked closely at industry practices for "rollovers" and "consecutive advances" in order to address potentially poor practices in these areas. The Guidelines mitigate concerns in these areas by requiring institutions to establish an appropriate cooling-off period between the time a payday loan is repaid and another application is made, set an appropriate limit for the number of loans per customer allowed within a designated time period, and limit the number of payday loans outstanding at any one time to only one loan per borrower. The Guidelines also direct institutions to charge-off credits that do not have an appropriate cooling-off period and require that institutions not make additional advances on such credits to finance unpaid interest and fees. Again, where insured banks engaged in this activity do not meet the rigorous capital and operational standards embodied in the Guidelines, the FDIC has taken, and will continue to take, appropriate enforcement actions.

10. Based upon your examination of state-chartered banks that are engaged in payday lending, have you collected any data on the average size of a loan, the average term of a loan, the average number of times a loan may be renewed or rolled over, or the average age or income of the borrower?

At the examination of a specific financial institution, examiners would review certain of the loan characteristics highlighted by your question. However, the FDIC does not compile this type of information for institutions involved in payday lending (or any other loan type). Several of the data elements indicated, including the average size of the loan and the average term of the loan, may vary significantly depending on state law or bank policy. As previously mentioned, the FDIC looked closely at industry practices for "rollovers" and "consecutive advances" and included certain requirements in the Guidelines to address potentially poor practices in these areas.

1. Industry consolidation

a) With the pace of industry consolidation having picked up considerably in recent months, some have made the argument that large complex banking organizations actually present relatively little risk to the deposit insurance funds, because of the diversity of their asset portfolios and sophisticated systems for managing risk. Has the FDIC performed any analysis of this theory? What is the FDIC's view of the merits of the argument?

We believe that risk to the insurance funds is reduced as a result of the diversification benefits associated with the largest banking organizations. On the other hand, concentration risk is increased in that problems within any one of these organizations represent potential threats to the insurance funds and the overall financial system. In any case, the financial performance of large banks during the recent recession should provide some level of comfort about the risk management capabilities of these firms.

As you know, the performance of the U.S. banking system during the recent recession has indeed been truly impressive. The banking industry made record profits in 2003 and earnings were very strong in 2001 and 2002, as well. Not all of the largest banks performed as well as the industry over this period; some banks took large write-downs. However, even these banks had significant profits during the recession. Over the past decade, very large banks diversified their income sources and now receive an increasing amount of their income from trading, investment banking, insurance and other fees rather than interest income. Fee income may make banks' profits less sensitive to interest rates changes and credit losses.

Large banks also have improved their risk management practices through risk-based pricing of loans, transferring risks through the derivatives market, and other techniques. From the FDIC's perspective, these developments within the largest organizations helped to contain the risks to the deposit insurance funds.

b) The vast majority of the state-chartered banks that the FDIC supervises are community-based institutions of relatively modest asset size. How does the recent wave of consolidation that the banking industry has been experiencing potentially affect those institutions? Should we as policymakers be concerned about the increasing concentration of industry assets in a small number of "mega-banks"?

The number of community banks (banks with less than $1 billion in assets) declined by almost half between 1985 and 2001, and their market share also dropped significantly. Small community banks (those with less than $100 million in assets) have been affected the most. Taken at face value, these figures would suggest that community banks face considerable difficulties, but closer examination reveals that community banks in 2001 still made up 94 percent of the industry, essentially identical to the 1985 figure.

Moreover, community banks maintained a presence in all types of markets—urban, suburban, rural, and those that experienced both population growth and decline. Furthermore, community bank performance has been satisfactory; since 1992, their annual return on assets

averaged at least one percent, and this was even the case in markets that experienced population declines.

Community banks do face challenges—competition not only from larger banks but also from credit unions. In addition, the high fixed costs of meeting many regulatory requirements no doubt affect community banks relatively more than larger banks. Nevertheless, community banks' performance and their continued strengths as small business lenders and in providing personal service demonstrate their continued viability. Approximately 1100 new banks have been formed since 1992, showing that investors continue to be willing to risk their own money to set up new community banks.

An area of potential concern about the bank consolidation trend is the effect of concentration on competition in banking markets. However, as was noted above, new community bank formation has been strong during the past decade, and particularly in areas where merger activity was high. In addition, current law provides that an interstate banking merger cannot be approved if the resulting institution (including its affiliates) would control more than 10 percent of the total amount of deposits of insured depository institutions in the United States.

Nonetheless there are concerns that consolidation may adversely affect the availability of small business credit, an area where community banks have devoted a greater proportion of resources than have large banks. The precise effects of consolidation on small business lending are complex. However, some evidence suggests that reductions in small business lending by larger banks represent opportunities for increased lending by community banks, including increased lending through the formation of new banks. The presence of a substantial community banking sector appears therefore to be an important safeguard against a diminution of small business credit availability as the banking industry consolidates.

Of course, there also is the concern that the increasing concentration of assets in a small number of very large banks poses additional risks to the industry. This issue is addressed in the answer to question 1a.

2. Bank supervision issues

a) With many states continuing to experience budget shortfalls and with relatively high turn-over rates in the examination forces of many state banking departments, what is the FDIC doing to ensure that state-chartered, non-member banks continue to receive sufficient supervisory scrutiny so that they do not become risks to the deposit insurance funds?

Section 10(d) of the Federal Deposit Insurance Act requires the appropriate federal banking agency to perform a full-scope, on-site examination of each insured depository institution within the timeframes specified in the statute. State examinations may be accepted for this requirement on an alternating basis, and the FDIC works closely with state banking departments and the Conference of State Bank Supervisors (CSBS) to ensure that the

examination frequency requirements are met in the most efficient and least burdensome manner possible. To facilitate such state coordination, the FDIC has entered into formal working agreements with 48 state banking departments that address, among other things, the scheduling and frequency of examinations, types of examinations to be conducted, and procedures for coordinating enforcement actions. The adequacy of state budgets and staffing levels are addressed at periodic meetings between the FDIC and state banking departments to coordinate examination scheduling.

Fortunately, state banking departments as a whole have continued to support their bank supervision programs despite budget difficulties. The FDIC's Office of Inspector General (OIG) recently completed an audit of the FDIC's reliance on state safety and soundness examinations. As part of the audit, the OIG obtained and reviewed budget information for the majority of state banking departments for 2002 and 2003. The OIG found that of the 40 states that had provided budgeting data to the CSBS for 2003, 32 departments were funded at the same or higher level than in 2002. The remaining eight state departments incurred only negligible budget cuts. Regarding state staffing levels, the OIG reviewed delinquent examinations in two of the six FDIC regions, which oversee 20 states and territories. Examination delinquencies were found to be minimal; moreover, the delays were not attributable to inadequate staffing, but rather were planned delays due to pending merger activity or to banks that were changing computer systems.

Nevertheless, the statutory obligation for ensuring that examinations are conducted in accordance with Section 10(d) rests with the FDIC in the case of state-chartered, non-member banks. The FDIC takes this responsibility very seriously. If a state was not able to meet its supervisory obligations, the FDIC would ensure that state nonmember banks were examined within the statutory timeframes.

In addition to on-site examinations, the FDIC has a quarterly off-site monitoring program to detect institutions that may be experiencing rapid growth, deterioration in financial performance, sensitivity to volatile real estate markets, or other indicators that may portend a higher risk to the insurance funds. We also implemented an outreach program, where we contact all state nonmember institutions at least once during the interval between examinations. In addition to fostering improved communications with bankers, the purpose of the outreach program is to enable the FDIC to identify current and prospective issues that impact the risk profile or overall condition of a bank through ongoing discussions with management. Quarterly offsite monitoring efforts would prompt the FDIC to conduct on-site reviews or examinations where risk warrants, resulting in enhanced risk detection, supervision, and monitoring.

b) While there were only three bank failures of relatively modest dimensions in 2003, we have seen several big-dollar failures in recent years that involved institutions that got into trouble by pursuing overly aggressive and imprudent subprime lending programs. Does the subprime portion of banks' portfolios remain a concern from a safety and soundness perspective?

The FDIC and the other federal bank supervisory agencies remain concerned about the risks that subprime lending programs present to insured financial institutions and the deposit insurance funds.

Of the 9,182 institutions insured by the FDIC as of December 31, 2003, the FDIC has identified 113 as subprime lenders (defined for these purposes as institutions with 25 percent or more of their Tier 1 capital invested in subprime assets). Despite their small number, subprime lenders continue to represent a disproportionate number of troubled institutions. As of December 31, 2003, there were 116 problem financial institutions (institutions with a composite rating of "4" or "5"), with aggregate problem assets totaling $29.9 billion. Notably, subprime lenders—which compose less than 2 percent of all insured institutions—account for 11 percent of problem institutions. Moreover, the assets held by these subprime lenders represented 63 percent of the total assets of all problem institutions.

The FDIC and the other federal supervisory agencies remain vigilant in supervising those institutions that have not properly identified, measured, monitored, and controlled the higher risk associated with subprime lending programs. The agencies' standards for such activities are set forth in interagency subprime lending guidance, issued in January 2001, which directs institutions engaging in subprime lending to employ strong risk management practices, maintain higher risk-based capital, and establish appropriate loan loss reserve methodologies.

Institutions engaged in subprime credit card programs are of particular concern to the FDIC and other federal supervisory agencies, as such programs can experience rapid and exponential growth and, through the securitization market, can create both on- and off-balance sheet risks. In addition, past examinations disclosed a number of imprudent practices by certain credit card lenders, including those involved in subprime lending programs. In response to these concerns, the bank supervisory agencies issued additional interagency guidance on credit card account management in January 2003. The objective of the guidance is to assist financial institutions in conducting credit card lending activities in a safe and sound manner, while meeting the needs of their customers. The guidelines outline the supervisory agencies' expectations for prudent risk management, income recognition, and loss allowance practices. Thus far, the guidance has been instrumental in addressing the agencies' common concerns regarding imprudent credit card account management practices for certain institutions, including those associated with negative amortization, overlimit amounts, income recognition, and loss allowances.

c) In the wake of the savings and loan crisis of the 1980s, Congress gave Federal banking regulators a host of new supervisory tools for taking "prompt corrective action" when institutions become undercapitalized. In light of several bank and thrift failures in the past few years in which the losses to the insurance funds relative to the asset size of the institution that failed were high, are you concerned that the prompt corrective action regime is not working as originally intended? Are banking regulators not utilizing these tools as effectively as they could?

We believe that the Prompt Corrective Action provisions provided in Section 38 of the FDI Act have been a valuable addition to the enforcement tools available to the federal banking agencies. Since the implementation of the Prompt Corrective Action requirements in 1992, the FDIC has taken enforcement actions against over 300 banks. Based on this experience, we

believe we currently have an adequate and effective set of enforcement tools to deal with problem institutions.

Unfortunately, over the past few years unforeseen bank and thrift failures have occurred in which the losses to the insurance funds were high relative to the size of the institution. For these relatively few cases where the insurance funds have incurred a significant loss, the problems that led to the failures were primarily attributable to fraud and other abusive activities that kept these problems hidden from regulators. As a result, we were not able to use the supervisory tools for taking "prompt corrective action" because the problems in the institutions did not cause a gradual decline in capital levels as contemplated by Prompt Corrective Action. In the other 300 cases where enforcement tools were able to be used as designed, most of the problems have been resolved with little or no loss to the insurance funds. The unusual situations have been fully reviewed and we have concluded that the current Prompt Corrective Action regime is adequate and effective.

3. Deposit insurance reform

a) When the House was debating deposit insurance reform legislation last year, the issue of the so-called "free rider" problem was raised, relating to the dilution of the Bank Insurance Fund (BIF) by large infusions of insured deposits from funds previously maintained in uninsured money market accounts maintained at brokerage firms. Can you provide the Committee with an update on the "free rider" issue? Are firms continuing to shift significant amounts from uninsured brokerage accounts to insured accounts at their affiliated depository institutions, or has the pace of such transfers fallen off in the past year or so?

The pace of transfers from uninsured brokerage accounts to BIF-insured accounts at affiliated depository institutions picked up in 2003 compared to 2002. In 2003, these accounts increased by over $5.9 billion, while in 2002 they actually declined by almost $4.5 billion. The 2003 increase was entirely attributable to a new program set up by an institution that had not previously engaged in these transfers. The net cumulative total of uninsured brokerage accounts transferred to BIF-insured accounts at affiliated depository institutions is now approximately $80.9 billion. For perspective, total BIF-insured deposits are approximately $2.5 trillion.

For the SAIF, however, the pace slowed in 2003 compared to 2002. In 2003, these accounts increased by $0.8 billion, while in 2002 they increased by $4.1 billion. The net cumulative total of uninsured brokerage accounts transferred to SAIF-insured accounts at affiliated depository institutions is now approximately $9.1 billion. For perspective, total SAIF-insured deposits are approximately $900 billion.

Both funds also are diluted by new institutions that have never paid deposit insurance premiums. From 1997 to the end of 2003, 990 insured institutions were chartered that are still operating and have never had to pay an insurance premium. As of December 31, 2003, these 990 institutions had $242 billion in total assets and $166 billion in total deposits.

b) A few years ago, there was widespread concern in the banking industry that the reserve ratio of the Bank Insurance Fund would fall below the 1.25 percent level and that all banks would once again have to start paying deposit insurance premiums. The figures that the FDIC released last week indicate that the reserve ratio of the BIF is well above 1.25 percent. To what do you attribute this rise in the reserve ratio over the past two years? Is it sustainable?

The FDIC attributes the rise in the BIF reserve ratio over the past two years primarily to the following factors:

- For 2002 and 2003 combined, net reversals of the provisions for insurance losses slightly exceeded $1 billion.
- During 2002, net unrealized gains on Treasury securities exceeded $500 million.
- During 2003, insured deposits grew only 1.2 percent. However, the FDIC does not expect the BIF and SAIF reserve ratios to continue to rise going forward. Although the FDIC forecasts little in the way of insurance losses in the near term, we expect at least moderate deposit growth. BIF and SAIF reserves for expected bank failures are already at low levels and the funds will not benefit from unrealized gains on their portfolios of Treasury securities in a moderately increasing or stable interest rate environment. In fact, at least initially, increasing interest rates may create unrealized losses. Thus, it is likely that the interest income generated by the funds will not support the expected rate of insured deposit growth, and the reserve ratio will decline even in the absence of significant bank failure activity.

4. Community Reinvestment Act (CRA)

a) The FDIC and its fellow banking regulators have recently proposed regulations that would update the Community Reinvestment Act (CRA). Many on the Committee are concerned that the CRA, while a well-intentioned attempt to promote investments by banks in the communities where they accept deposits, often has exactly the opposite effect of strangling community banks with red tape, making it more difficult for them to meet their customers credit needs. Can you explain to the Committee how the recently proposed CRA regulations address that concern? Are there other reforms that the regulators are considering that would further CRA's underlying objectives while at the same time easing the compliance burden on small community banks?

Please see 4(b) below.

b) Chairman Powell stated that the "consolidation trend [in the banking industry] has led to concerns about the long-term viability of community banking," as these smaller institutions are unable to spread the fixed, regulatory costs of regulatory compliance in the same way that larger banks can. Wouldn't one effective way to reduce the regulatory burden on small community banks – and thereby assure their long-term viability – be to

raise the asset size threshold for streamlined CRA examinations from the $500 million level established by your current regulatory proposal to $1 billion, or perhaps even $2 billion?

A key component of the notice of proposed rulemaking (NPR) on CRA published by the federal banking regulatory agencies on February 6, 2004, is the change in the criteria used to distinguish "small" and "large" institutions. The NPR proposes a two-pronged change to the regulatory definition of "small bank," that would: a) raise the asset threshold from $250 million to $500 million; and b) drop existing tie-in to the size of a bank holding company.

This change, if adopted, would reduce burden on banks below $500 million in assets by eliminating data collection and reporting requirements pertaining to small business and small farm loans. It also would simplify the evaluation process for these banks by focusing on their lending performance in their local communities. This change would be directly responsive to assertions by small banks that local community-based lending is their primary business function and that business success is largely dependent on serving their local customers. Small banks could continue to have their community development investments and services considered as part of this evaluation as provided for in the CRA regulations, but would not be subject to the investment or service tests that apply to large banks.

This proposal was made after careful consideration of comments received by the agencies to an advanced notice of proposed rulemaking (ANPR) issued in 2001. On balance, the comments received from financial institutions and community organizations alike indicated that the 1995 amendments to the CRA regulations had succeeded, at least in part, in shifting the emphasis of CRA evaluations from process to performance.

We expect that there will be much public comment on the most recent proposed changes. Comments received to date on the asset size threshold issue indicate there are wide differences of opinion about the matter. We also expect that there will be considerable discussion among the agencies as we consider a final rulemaking on the threshold.

In addition, the NPR indicates that the agencies will be addressing other CRA regulatory issues raised by financial institutions and community organizations through the future release of revised examination procedures, examiner guidance, and additions to the "questions and answers" document that the agencies use to communicate details about the CRA regulation. For example, as described in the NPR, the agencies will seek to clarify how qualitative factors are considered by examiners in the context of an institution's quantitative lending performance, and develop additional interagency guidance to clarify that the investment test is not intended to be a source of pressure on institutions to make imprudent equity investments. These clarifications are intended to address any industry uncertainty with regard to the CRA regulation.

5. Corporate governance

a) In the FDIC-supervised institutions that have failed in recent years, are there lessons to be learned about how principles of good corporate governance can be applied to guard against insider abuse and inattentive or unqualified boards of directors? At least for those

publicly-traded institutions that the FDIC supervises, have the reforms made by the Sarbanes-Oxley Act had a positive effect on the culture of corporate governance?

The FDIC has long recognized the importance of corporate governance in maintaining the integrity and stability of the nation's banking system. The FDIC's experience, particularly during the financial crisis of the late 1980s and early 1990s, shows that weak corporate governance policies and practices can result in enormous financial losses not only for individual corporations, but also for society generally.

Therefore, as a result of congressional legislation and the efforts of the banking regulators, banks learned many lessons a decade ago. As a result, the banking industry has weathered commercial credit losses during the recession perhaps better than could have been expected. FDIC-insured institutions earned a record $105.4 billion in 2002, marking the first time the combined annual earnings of commercial banks and savings associations topped $100 billion—and this occurred during the height of the corporate governance scandals in other industries. In part, this milestone in annual earnings by commercial banks was reached because of initiatives launched by individual institutions to improve their governance structures and business models.

The SEC has adopted a set of new rules covering corporate disclosure, auditing, and conflicts of interest, as required under last year's Sarbanes-Oxley reform legislation. These rules come hard on the heels of new rules filed in 2002 by the New York Stock Exchange and NASDAQ that deal with codes of conduct, independent directors, audit committees, and other issues. The new Public Company Accounting Oversight Board has begun operation and has issued rules for its inspections of accounting firms and proposed auditing standards for internal control.

However, the impact of these changes on the banking industry has been relatively small, especially when compared with other industries that have suffered due to recent corporate governance scandals. Much of the improvement in the banking industry is a result of the efforts previously mentioned, including bank regulations and policy statements established during the banking crises a decade ago.

6. Basel II proposal

a) What is the FDIC's position on the current state of the Basel II proposal? Late last year the FDIC issued a report in which it raised several concerns relating to the potential for a significant reduction in capital holdings—a reduction well below the current requirements for Prompt Corrective Action. With the changes that have been made to the expected-loss framework and the treatment of securitizations, does the FDIC still have this concern?

The FDIC's concerns about the Basel II capital requirements are being reflected in current discussions of the framework in which banks set their "loss given default" estimates. It is likely that the capital impact of Basel II will be driven primarily by a judgmental assessment of bank risk inputs. The FDIC will have an ongoing interest in this issue.

The FDIC fully supports the principles of heightened risk management processes under Basel II. The U.S. regulatory agencies continue to work together to address and make progress on a variety of remaining issues. We recognize the importance of presenting a united front with regard to Basel II discussions, and we have established a sound domestic working relationship in this regard. The open vetting of issues is an inherent strength in this process.

Domestic regulatory authorities will conduct a fourth quantitative impact study late this year, which may result in recommendations for additional changes in the framework. However, as highlighted in our 2003 study, quantitative impact studies are "point-in-time" analyses, which have inherent limitations. As insurer of the nation's financial institutions, the FDIC is responsible for ensuring that implementation of the New Accord will not result in undue reductions in system-wide capital. Accordingly, we will continue to perform any additional independent analytical studies deemed necessary in order to better assess the impact of Basel II.

b) The FDIC has stated that the current leverage ratio, which governs the amount of capital that banks must hold in order to be considered well capitalized, should be set as the floor in the Basel II proposal. What reaction have you received from your fellow regulators on this proposal? If this change is not made, what effect will the current Basel II proposal have on domestic banks and their ability to comply with FDICIA?

I testified previously that the FDIC will continue to stress the need for regulatory minimums in order to protect against inherent model uncertainty. Minimum thresholds enabled through Prompt Corrective Action legislation have been proven effective through the last economic cycle, and our view remains that elimination of such minimums would be imprudent.

There are currently no plans to change the leverage ratio requirement, and no U.S. regulator has expressed a desire for such a change. The FDIC expects, however, that there will be a robust debate about the appropriate level of the leverage ratio—and that the outcome of that debate will be a regulatory framework that combines a leverage ratio with Basel II in a way that strengthens our financial system.

The FDIC also has recommended that specific language be added to the Accord, which would recognize existing laws and regulations of various jurisdictions with regard to minimum capital levels. This recommendation was well received by domestic and international regulatory authorities and will be incorporated into the New Accord.

c) The Federal Reserve recently issued a staff report claiming that regulatory capital is not taken into consideration and does not have a significant impact on mergers or competitiveness. Was the FDIC consulted on this study? Would you agree with these basic findings?

The Federal Reserve Board (FRB) has published the first two of four papers focusing on the competitive impact of Basel II. The FRB invited the FDIC, OCC, and OTS to comment on

these studies, and FDIC staff also participated with the FRB in briefing Congressional Committee staff on the results of the first two studies.

We commend the FRB for its efforts in addressing this difficult issue. However, all of the agencies acknowledge that there are significant limitations of such research. In essence, there is inherent uncertainty of conclusions that rely on historical data to predict the impact of a future bifurcated capital structure.

d) One of our banking system's strengths is certainly our comprehensive system of supervision. How can you be sure that Basel II will be applied uniformly elsewhere in the world? Is there a danger that U.S. banks will face more stringent requirements than EU or Japanese banks? Some say this can be fixed with the explicit capital charge for operational risk, but the experience in Japan makes clear that explicit capital charges can be sideswiped if effective supervision is not in place. Do you agree with this assessment?

Our domestic supervisory framework is arguably among the most stringent in the world today, and we view this as a strength, not a potential danger. This framework will not change with the implementation of Basel II.

"Pillar 2" (supervisory oversight) will be key in ensuring that the New Accord is functioning as intended. Domestic regulatory agencies are working closely together to develop robust examination guidance and procedures and ensure that regulatory expectations are clear prior to implementation. A primary goal of this effort is to ensure uniformity in domestic implementation.

There will always be differences in the way international rules are interpreted and implemented. This will certainly be the case for Basel II, as many other jurisdictions simply do not have access to the resources that we take for granted in the U.S. This fact alone will make a uniform implementation difficult to achieve.

7. Government-Sponsored Enterprises (GSEs)

a) There has been a lot of discussion in Washington regarding the oversight of Fannie Mae, Freddie Mac and the Federal Home Loan Banks. The GSE debt is currently measured in the 20% risk weighted assets category. If there is not implicit government backing for this debt—as stated on every GSE issuance as well as in public statements by the government and the GSE leadership—why are these securities given such special treatment when this leverage ratio is reserved specifically for state and local government obligations and obligations conditionally guaranteed by the U.S. government? Doesn't this treatment reinforce the impression that there is an implicit subsidy for the GSEs? Would raising the risk-weight of these securities be a prudent signal to the market that they are not backed by the government?

Under the current risk-based capital framework, a bank's balance sheet assets and credit-equivalent amounts of off-balance sheet items are assigned to one of four broad categories based

on the credit risk characteristics of the obligor, or, if relevant, the guarantor or nature of the collateral. Accordingly, the 20 percent risk weight category is *not* specifically reserved for state and local government obligations and obligations conditionally guaranteed by the U.S. government. In fact, numerous categories of assets that are held by insured depository institutions are accorded a 20 percent risk weighting. These include, among other things, all obligations of U.S. depository institutions, regardless of whether the specific obligations are FDIC-insured. Moreover, state and local government bonds that are dependent on independent revenue streams for repayment (such as a toll road) are considered to pose a greater credit risk and are assigned a 50 percent risk weighting.

The banking agencies' risk-based capital standards issued in 1991 recognized the lower risk profile of GSE debt, which was judged to be of relatively lower credit risk because of an assumption that close monitoring and conservative business practices would accompany government sponsorship. Even without an implicit government guarantee, GSE debt might still warrant a 20 percent risk weight. Mortgage-backed securities issued by the GSEs also are provided a 20 percent risk weight given the reduced credit risk associated with these investments. Mortgage obligations are currently risk-weighted at 50 percent; it is logical that securities collateralized by large pools of low credit risk conforming mortgages would be entitled to a risk weight lower than 50 percent. Also, the banking agencies capital rules continue to evolve towards even more risk-sensitive measures. For example, risk weights for all asset-backed securities consider the credit rating of the issue. Since January 2002, any asset-backed security issued by a company that has no government relationship can get a risk weight of 20 percent as long as the bond is rated at least AA.

It is not possible to determine market perception with any certainty. It does not seem likely that raising the risk weight for GSE debt, assuming such an action was advisable, would eliminate the market's perception that GSE securities have an implicit government guarantee. The market's perception may be more strongly based in a belief that the GSEs are 'too big to fail' and as such would be supported by government intervention. Also, the market's perception may be supported by the presence of a collection of benefits extended to the GSEs, not just the risk-based capital treatment of certain GSE securities.

b) Congress has been examining the organization and operation of the federal financial regulators with an eye to creating a new regulator for the GSEs. Can you share with the committee the strengths as well as the drawbacks that a board such as the FDIC possesses when seeking to regulate financial institutions? In your view, would a structure similar to the FDIC be a good model for the regulation of GSEs?

The FDIC Board is composed of five members, each appointed by the President with Senate advice and consent. The Board's strength is grounded in its independence from domination and control by the executive branch; political balance in its membership; its independent source of funding; and the regulatory and enforcement authorities granted to it by the FDI Act, including its receivership authority. Only Congress has the power to diminish the FDIC's independence and authority. This long-standing independence has been critical to the Board's effectiveness throughout the FDIC's history.

With a multi-member board, issues can be fully deliberated and timely resolved. Although vacancies tend to occur more frequently than they might with fewer members or a single Director, when vacancies occur the remaining Board members can continue to act authoritatively and with minimal disruption.

In our view, constructing the new GSE regulator along the lines of the FDIC model would help insulate the new regulator from undue political control and secure its effectiveness.

c) Earlier this month the FDIC issued a paper stating that if the GSEs were privatized there would be little or no impact on the balance sheet of banks holding GSE securities since such an action would only reduce Tier 1 capital by 47 basis points. Are you aware of any institutions that would become "adequately capitalized" as opposed to "well capitalized" if the GSEs were privatized? How many of these institutions are there?

Based on the assumptions outlined in the referenced paper, as of September 30, 2003, 600 institutions would experience a decline in their Total Risk-Based Capital ratio that would cause them to fall below the 10 percent threshold for "well capitalized." Only 15 insured institutions would experience a decline in their Total Risk-Based Capital ratio to below 8 percent, the "adequately capitalized" threshold.

d) Federally insured institutions currently hold approximately $300 billion in GSE direct obligations and $770 billion in Mortgage-Backed Securities (MBS). As a safety and soundness regulator are you concerned that there is too much GSE debt concentrated in the portfolios of federally insured institutions? Why or why not?

The research outlined in our March 1, 2004, FYI publication entitled *Assessing the Banking Industry's Exposure to an Implicit Government Guarantee of GSEs* was undertaken to understand how insured institutions might be affected by concentrations in GSE-related securities. The paper concludes that strong capital levels at insured institutions would help insured institutions manage changes in the status of GSEs. Concentrations to individual obligors are assessed institution-specific. As noted in our paper, concentrations in direct obligations are significantly less than for mortgage-backed securities (MBS). Evaluations of credit-risk concentrations would center mostly on direct obligations because the GSE guarantee of MBS is only a secondary source of repayment, which is not likely to be used given the high-quality nature of residential mortgage collateral.

Concentrations in the direct debt obligations of a single GSE would cause concern if they were excessive at the institution level. Examiner guidance suggests that concentrations of 25 percent or more of Tier 1 Capital to an individual obligor (such as Fannie Mae, Freddie Mac, or a Federal Home Loan Bank) should be considered carefully in evaluating the adequacy of risk diversification within an institution's asset structure. An insured institution may have significant investments in GSE debt but have these investments sufficiently distributed among the various GSEs to mitigate concern about credit concentrations.

With regard to MBS, safety and soundness examiners become concerned about excessive concentrations when institutions do not have adequate systems for monitoring the interest rate risk associated with the level of investment.

8. Industrial loan companies (ILCs)

a) There has been a lot of discussion in the halls of Congress over the past year regarding the supervision of so-called industrial loan companies, which are state-chartered, FDIC-supervised depository institutions that operate in several western states. Some, including Federal Reserve Board Alan Greenspan, have asserted that because the owners of ILCs are exempt from consolidated holding company supervision by the Federal Reserve Board, they represent a significant risk to the deposit insurance funds. Others worry that Wal-Mart or another large retailer could use the ILC charter to directly compete with small community banks across the country. How do you respond to these arguments? What can the FDIC do to ensure that parent companies of the industrial loan companies that it supervises do not place the deposit insurance funds at risk?

The FDIC views concerns that commercial companies may use ILCs to compete with financial institutions as a distinct issue from that of the risk posed by ILCs to the deposit insurance funds. In many respects, community banks already compete indirectly with large commercial firms. In addition, commercial firms have been allowed for many years to operate, or to acquire and control, existing or newly formed financial institutions exempted from the Bank Holding Company Act (BHCA). This exemption applies to institutions chartered as industrial loan companies as well as certain credit card banks and trust companies. The domestic automobile manufacturers and dozens of retailers are examples of this longstanding practice. Congress, in passing the Gramm-Leach-Bliley Act (GLBA), lifted certain restrictions on the affiliations of banks and financial-services firms, and generally left in place exemptions from the BHCA.

The FDIC is not a proponent of any particular charter type, as we consider that to be a decision for an institution's shareholders and management to be made in accordance with their strategic vision and business plan. However, the FDIC's substantial supervisory experience with ILCs suggests that the ILC charter poses no greater safety and soundness risk than do other charter types. The risk posed by any insured depository institution is a factor of the appropriateness of the business plan and model, management's competency in administering the institution's affairs, and the quality and implementation of risk management programs. Similar to institutions with other charter types, an ILC's capital adequacy and overall safety and soundness posture is driven by the composition and stability of the institution's lending, investing, and funding activities and the competence of management. Accordingly, the FDIC concentrates on these elements when considering a new application for deposit insurance as well as in supervising existing ILCs.

To become an insured depository institution, the FDIC must consider the same statutory factors of section 6 of the FDI Act, 12 U.S.C. § 1816, for an ILC that it considers for all other applications for deposit insurance. These factors are:

- The financial history and condition of the depository institution;
- The adequacy of its capital structure;
- Its future earnings prospects;
- The general character and fitness of its management;
- The risk presented by such depository institution to the deposit insurance fund;
- The convenience and needs of the community to be served by the depository institution; and
- Whether its corporate powers are consistent with the purposes of the FDI Act.

In approving insurance for new ILCs, the FDIC may impose significant restrictions or prudential conditions on the applicants and the new entity. The measures imposed generally depend on the purpose and placement of the ILC within the overall organizational structure. Examples of such safeguards include requiring on-site management rather than management from a distant corporate headquarters, independent boards of directors, and strict guidelines to ensure arms-length transactions with the parent and other affiliates.

As with any other state-chartered insured institution, existing and newly insured ILCs are subject to on-site examinations and other supervisory activities of the FDIC as well as the appropriate state chartering authority. While the FDIC does not have explicit statutory authority to supervise parent companies of ILCs, the FDIC does have the authority to examine any affiliate of the insured ILC—including its parent—as may be necessary to determine the relationship between the ILC and the affiliates, and the effect of that relationship on the ILC. The FDIC's authority to pursue formal or informal enforcement actions against an ILC is virtually the same as our authority with respect to any other state nonmember bank.

ILCs also must comply with the FDIC's Rules and Regulations, including but not limited to requirements for capital standards, safe and sound operations, consumer compliance, and community reinvestment. Likewise, ILCs are subject to the limitations on transactions with parent companies and other affiliates set forth in Sections 23A and 23B of the Federal Reserve Act, as well as the restrictions governing extensions of credit to insiders and their related interests embodied in Federal Reserve Board's Regulation O. The FDIC does not have the same authority as that applicable to other state nonmember banks with respect to imposing "cross-guaranty liability" or to prohibiting "golden parachute" payments by ILCs. We requested these authorities, and suitable provisions are now included in the House regulatory relief bill. We look forward to working with the Senate in this regard.

9. Information securities issues

a) The GAO's recently completed audit of the FDIC notes the existence of weaknesses in FDIC's information security systems that have placed those systems at risk of unauthorized access, which could in turn lead to unauthorized disclosure, disruption of critical operations, and loss of assets. Has the FDIC experienced any instances in the past year where an unauthorized outsider was able to exploit any of the weaknesses identified by the GAO to disrupt your information systems?

The FDIC has never had any incidents where an unauthorized outside individual gained access to FDIC systems or information. Security is an ongoing challenge for all organizations, especially identifying vulnerabilities in commercial software, and testing and applying system patches in a timely manner. The FDIC is aggressive in its patch management process. The Corporation has a very stringent policy and process in place, and a tight timeframe for acquiring, testing and deploying critical security patches throughout the organization.

During the past year, viruses have been the single major external threat to the FDIC information technology resources and the FDIC has been able to successfully defend services against those threats. Corporate data security has long been a top priority that the FDIC has been addressing in maturing the corporate information security program. Over the past 12 months, FDIC information security activities included scanning email for viruses, blocking malicious software (malware), expanding and upgrading firewalls and network intrusion detection systems, and ensuring the timely update of anti-virus software on servers, workstations, laptops, and e-mail gateways. Finally, the FDIC worked with the FBI and FDIC OIG in investigating the "phishing" fraud that referenced the FDIC. FDIC information security was able to provide significant and critical information to both FBI and FDIC OIG regarding that scam.

As part of the FDIC growth of the security program, a self-assessment program has been established that requires determining information sensitivity, assessing risk, and ensuring that systems have security plans. As part of the assessment program, the FDIC has network vulnerability scanners that proactively scan the FDIC network and identify vulnerabilities to critical FDIC and contractor connected systems. These vulnerabilities are addressed in a timely manner further reducing risk to FDIC information technology resources.

Over the next 12 months, the FDIC will continue to mature the security program. Program activities currently underway include completing certification and accreditation of a majority of FDIC general support systems and major applications, as well as cross-certifying the FDIC's Public Key Infrastructure (PKI) with the Federal Bridge Certificate Authority. The FDIC also will establish a security monitoring program that will correlate and assess the network activity information to further identify potential vulnerabilities.

b) The GAO has stated that the FDIC has made significant progress in correcting the computer security weaknesses previously identified in GAO reports. In fact, GAO's most recent audit found that the FDIC took action to address all of the 22 weaknesses that remained open from GAO's 2001 audit and 28 of the 29 weaknesses from the 2002 audit. However, GAO's work in 2003 identified 22 new security weaknesses in FDIC information systems. Do you have plans in place to address these weaknesses and, if so, when do you expect these security issues to be resolved.

Each of the 22 new weaknesses identified by the GAO in their Matters for Further Consideration (MFC's) has a detailed action plan that identifies corrective actions already taken and those planned for the future. This information was provided to GAO in February. In addition, the status of FDIC's progress toward remediating these weaknesses is being reviewed monthly with the FDIC Audit Committee, chaired by the FDIC Vice Chairman. The Audit Committee established a special Security Subcommittee that also meets monthly to review the

status of security issues for the Corporation including outstanding GAO issues. This Subcommittee includes the Vice Chairman, the Chief Operating Officer, the Chief Financial Officer, the Chief Information Officer, the Assistant Director of Security, the Inspector General for Audit, as well as additional representatives from the Division of Administration and the Office of Internal Control Management. The current target date for completion of the last corrective action associated with the 22 weaknesses identified in 2003 is December 15, 2004.

c) The GAO has previously reported that as of June of 2003, the Corporation had not performed unannounced testing of its business continuity plan. According to the GAO, these tests are more realistic than announced tests and more accurately measure the readiness of staff for emergency situations. Has the FDIC conducted any unannounced tests yet, and if not, do you have plans to do so in the near future.

In accordance with the GAO's recommendation, the FDIC conducted an unannounced test of its business continuity plan on December 18, 2003. Additional unannounced plans will be conducted during 2004, consistent with the GAO recommendation.

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