

# Global Financial Crisis Bulletin

## The Current Financial Crisis: Frequently Asked Questions

As of December 3, 2009

### Introduction

***“Most crises, major financial crises worthy of the name depression or indeed recession, last significantly longer than a day and they can be measured in thousands of days. I think it would be unwise to say it’s over.”***

Harvard University Professor Niall Ferguson, October 29, 2009, as quoted by Bloomberg.com.

Despite some encouraging signs that the worst of the financial crisis may be behind us, the effects of the crisis will linger for some time to come. Protiviti has decided, however, to close out this publication on the Global Financial Crisis with this seventh and final edition.

Over the course of the past year, we continued to “peel back the onion” on the causes of the crisis and assess its short- and longer-term effects on organizations around the world. While not intending to be all-inclusive, our FAQ *Bulletin* was designed to provide answers to what we believed were some of the most pressing questions being asked about the crisis.

In this final version of the FAQ, we have updated a number of answers to reflect developments over the past six months. New and updated questions and answers are in boldface in the Table of Contents.

Going forward, we will continue to address a number of the topics covered in the FAQ – including Regulatory Reform, Accounting Developments and Industry Developments – in other Protiviti publications. We invite you to visit [www.protiviti.com](http://www.protiviti.com) periodically to access our most recent thought leadership.

We would like to thank once again the many readers of this *Bulletin* who provided feedback and suggested additional topics and questions.

*Please note that this information is not intended to be legal analysis or advice, nor does it purport to address every issue that may impact financial institutions and other companies or every government response. Organizations should seek the advice of legal counsel or other appropriate advisors on specific questions as they relate to their unique circumstances.*

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## Overview

### 1. What caused the meltdown in the financial services industry?

The financial meltdown had its origin in the U.S. mortgage market of the early and mid-2000s. At the time, the economy was booming, the U.S. government was intent on making home ownership affordable to more people, financial institutions were awash with liquidity, and real estate values were rising endlessly. Competition among mortgage lenders led to innovation – teaser-rate adjustable mortgages and other nontraditional mortgage terms such as no- and low-documentation loans – that opened up the real estate market to borrowers who previously would not have qualified for credit, i.e., subprime borrowers.

All was well, provided that interest rates did not rise and housing prices continued to escalate. In 2004, however, the Federal Reserve began to raise interest rates. In 2006, housing prices started to taper off after rising nearly 50 percent between 2000 and 2006.<sup>1</sup> As the market declined, borrowers who had expected to refinance their mortgages when their loans re-priced to higher interest rates coupled with higher monthly payments found they were not able to do so. Consequently, these borrowers were unable to meet payment requirements, leading to defaults that escalated as real estate values continued to decline.

Concurrent with the growth in mortgage lending, significant financial innovation was occurring in the financial markets. Pools of mortgage loans, including those extended to subprime borrowers, were aggregated into portfolios of structured products based on the cash flows of the underlying assets – in other words, these loans were securitized. These securities/investments/derivatives were marketed to both institutional and retail investors. To enhance the marketability of these instruments, credit default swaps (CDS) were issued, and the growth in the CDS market paralleled the growth in the underlying mortgage market. While some of these financial instruments ended up in hedge fund portfolios, due to the significant volume of this market and the underlying assets as well as considerable investor appetite, these instruments became widely distributed throughout the global financial system to buyers ranging from government sponsored enterprises (GSEs) and financial institutions to mutual funds/money market funds, pension funds and retail investors.

Given the sponsorship of instruments and retention of key risk components by a number of the large financial firms, concerns over the safety, soundness and credit worthiness of a number of key market participants (including Lehman Brothers, AIG and Merrill Lynch) began to impact the market negatively as the crisis began to unfold. Since many of the instruments involved are complex and lack transparent market pricing, they not only are hard to price, but illiquid, further exacerbating the funding and capital issues of a number of financial organizations.

A similar picture then emerged in other developed countries as the combination of competition, innovation, readily accessible credit, and the ballooning of securitization and resulting leverage created a massive systemic susceptibility to falls in global residential property values and mortgage defaults, in addition to huge losses incurred on exposures to the U.S. subprime market. News of massive losses by institutions most exposed to such risks evolved and escalated, eventually creating a crisis of confidence among lending banks in the money markets and increasing difficulty among banks that were most affected to raise or refinance the short- and medium-term borrowing they needed to fund their long-term assets. That lack of confidence quickly turned into a “credit crunch” in which some banks could not fund existing loans and most banks were unwilling to extend new credit either at all or at least on any terms resembling those on which they had previously extended credit.

### 2. How large is the U.S. mortgage market?

The Federal Reserve estimated in November 2008 that the U.S. residential real estate market was approximately US\$11.2 trillion dollars. Previously published Federal Reserve reports suggested that 15 to 20 percent of this total was subprime, though the percentage of subprime has likely declined given market events. To put the size of the U.S. residential real estate market into perspective, as of April 30, 2008, the combined market capitalization of the NYSE Euronext’s 4,000 listed companies was US\$30.9 trillion, a number that also has surely declined.

### 3. How are “subprime” borrowers defined?

While there is not one standard definition, subprime borrowers typically are described as borrowers who have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments and bankruptcies. These borrowers also may display reduced repayment capacity as measured by such considerations as lower credit scores or higher debt-to-income ratios.

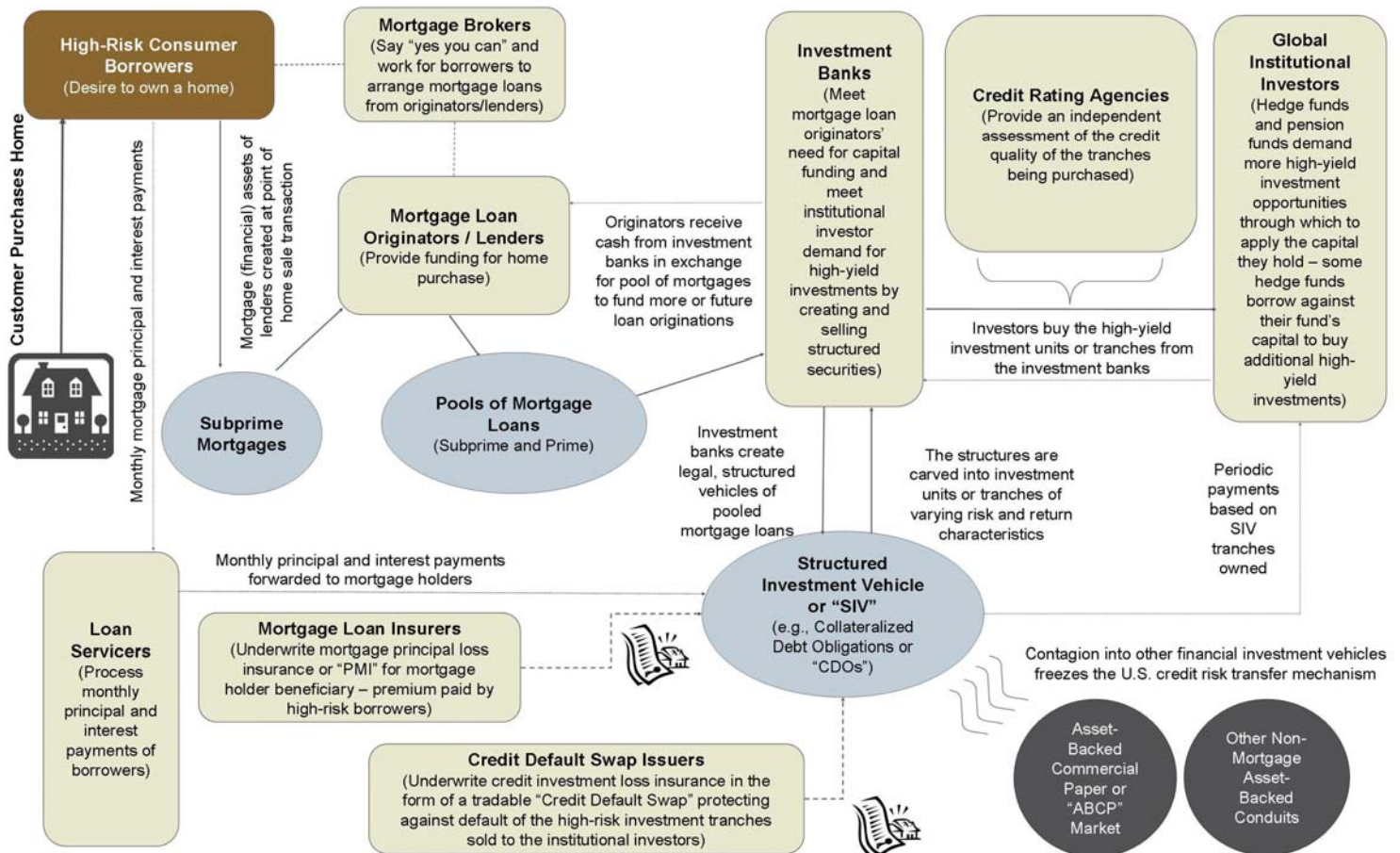
### 4. Who are the major players in the subprime market?

It is the very complexity of the subprime market that has made resolving the problem so difficult. Apart from borrowers, the other major players in the process include:

- Mortgage brokers
- Mortgage originators/lenders
- Mortgage insurers
- Loan services
- Investment banks
- Rating agencies
- Credit default issuers
- Institutional investors

The following chart depicts how all of the various players interact.

## Subprime Mortgage Market



**5. Why were financial institutions and rating agencies not able to forecast the performance of the loans?**

Subprime loans originated between 2000 and 2005 did evidence a predictable pattern. Borrowers generally kept their loans current for one year or more after origination, so performance in the early years at least was considered low risk, especially when coupled with the view that even if there were a default, the collateral value would more than offset the loan balance. This all began to change in 2006, when anecdotal evidence now suggests that weaker borrowers began to enter the market in growing numbers at the same time that real estate prices started to decline.<sup>2</sup> From 2006 on, predicting the performance of subprime loans became much less reliable.

**6. Was it only subprime loans that were of issue in the current economic crisis?**

While subprime loans were at the center of the current financial crisis, mortgage loan delinquencies have continued to escalate across all classes of mortgage loans, including Alt-A and prime loans. In its Mortgage Monitor October 2009 report, Lender Processing Services, Inc., said that one in every eight homeowners in the United States (12.5 percent) were either in default or foreclosure by the end of September 2009.<sup>3</sup> With the current high unemployment in the United States, mortgage loan delinquencies and defaults are expected to continue at high levels throughout 2010.

**7. What is an ALT-A loan?**

An ALT-A loan is one made to a borrower who has generally good credit, but the terms of which do not meet conforming loan guidelines. For example, the loan might have been originated without fully verifying the borrower's income or assets, have an interest-only or "payment option" feature that could result in no or negative amortization over some or all of the loan term, and/or have been made with no or little money down. As the market tended to place ALT-A loans in between prime and subprime loans in terms of perceived risk, these products were typically priced slightly higher than prime loans, but slightly lower than subprime ones.

A paper published by the Federal Reserve Bank of Dallas in November 2007 estimated that approximately 6 percent of all residential mortgage loans originated at that time fell into the ALT-A category,<sup>4</sup> although this percentage has almost certainly fallen significantly since then as a result of the near disappearance of the secondary market for these types of products and limited appetite on the part of originators for carrying these loans on their books.

**8. How did leverage contribute to the crisis?**

Some argue that excessive use of leverage is the root cause for the current crisis. For example, in the United States, prior to 2004, the U.S. broker/dealer net-capital rules limited firms to a maximum debt-to-net-capital ratio of 12 to 1. In 2004, the U.S. Securities and Exchange Commission (SEC) granted an exemption to five firms that allowed them to exceed this leverage rule. Goldman Sachs, Merrill Lynch, Lehman Brothers, Bear Stearns and Morgan Stanley were granted this exemption and they levered up 20, 30 and even 40 to 1.<sup>5</sup> Over-leveraging throughout the U.S. economy has, in fact, become a major theme and the United States is entering a period of significant de-leveraging.

In addition, the "originate and distribute" model that characterized the market is generally seen as magnifying the risks and the reach of the exposures. Under this model, we saw the rapid growth of off-balance-sheet vehicles and securitization practices designed to improve returns on constrained capital resources substituting for the capital-intensive holding of mortgage-backed and other assets.

**9. What makes this credit crisis different from those we have experienced in the past?**

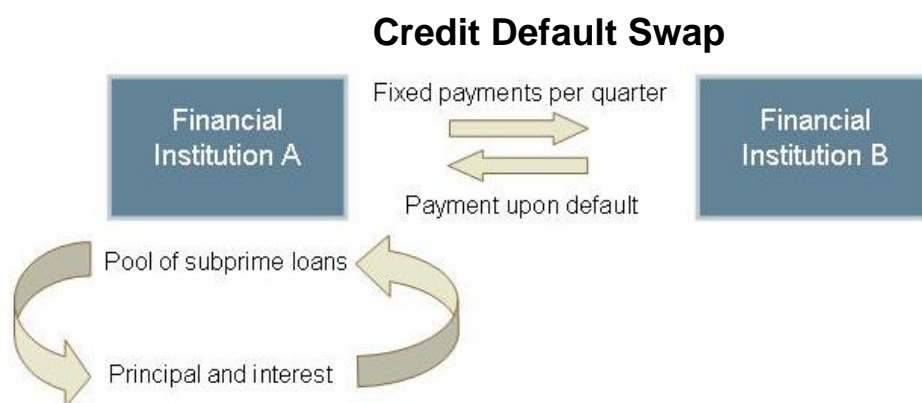
Credit crises in the past tended to be confined to the commercial banking and direct lending sectors. With the growth of the securitization market, investment banking firms became big players in the mortgage market, as well. This allowed the risk to spread far and wide, making this crisis that started with subprime lending in the United States both a bank and nonbank, as well as a global, problem.

**10. What is a credit default swap?**

A credit default swap (CDS), as its name suggests, is a transaction in which one party, the beneficiary, "swaps" the credit risk on a specified asset (for the purposes of this discussion, a pool of subprime

assets) for a guarantee of another party, the guarantor. CDSs were devised by J.P. Morgan & Co. in the early 1990s to hedge its loan risks; by some accounts, the CDS market was estimated to include US\$65 trillion in contracts at the onset of the financial crisis.<sup>6</sup> CDS transactions are done in the Over-the-Counter (OTC) market.

The following graphic illustrates how a CDS works. Financial Institution A pays Financial Institution B a certain number of basis points on the par value of the reference asset, either quarterly or annually. In return, Financial Institution B agrees to pay Financial Institution A an agreed-upon amount if there is a default, based on a formula delineated in the contract.<sup>7</sup>



### 11. What is the Over-the-Counter (OTC) market?

The OTC market is a market in which market makers negotiate over telephone or computerized networks instead of through an organized exchange. The main participants of the OTC market are investment banks, commercial banks, government sponsored enterprises and hedge funds.

### 12. How did the credit default swap market further strain market conditions?

The credit default swap (CDS) market has been estimated to range from US\$35 billion to more than US\$65 billion in notional or face value. This market grew massively in the years leading up to the financial crisis as market participants sought further derivative financial instruments to use as a means to manage (or exploit) credit risk. The buyer of a CDS generally is looking to mitigate credit risk exposure triggered by a default or other defined negative event. Sellers assume the default risk for a premium generally by executing a transaction in the OTC market (these instruments are not exchange-traded).

With the continuing credit deterioration in the financial markets, CDS spreads continued to widen, with spreads on certain financial services companies moving from basis points in the mid-20s in February 2007 to the high triple digits in late September 2008. This resulted in significant mark-to-market losses for the issuing financial institutions and diminution of capital, as well as a series of margin calls that put further pressure on liquidity positions of affected institutions. These factors, combined with the opaqueness and complexity of these instruments, contributed to further concerns over the creditworthiness and financial wherewithal not only of a number of market-making issuers, but also of those buying institutions that were relying upon those instruments to mitigate credit risk exposure in their own portfolios.

### 13. What is the outlook for the regulation of the credit default swap market?

In late December 2008, the SEC and the Commodity Futures Trading Commission announced the licensing of clearing houses for credit default swaps. The establishment of these central clearing parties is intended to provide greater transparency to the market, improve information available to market participants and regulators, and reduce counterparty risk. In addition, a number of regulatory reform proposals have advocated for a central clearing mechanism as well as enhanced transparency for the credit default swap market, although critics of some of the existing proposals argue that they still do not go far enough to control the market.

#### **14. Was the crisis really all about credit risk?**

While credit risk was at the center of the current financial crisis, the more pressing issue for many financial services companies became liquidity, fueled by a lack of trust in the transparency and reliability of information used to assess the condition of companies. Governments around the globe attempted to address the issue by injecting large amounts of funds into the market, underwriting interbank lending, guaranteeing deposits or increasing the level of existing deposit guarantee programs. .

#### **15. What is systemic risk?**

Systemic risk is the risk that affects an entire financial market or system rather than just specific participants. It results from many factors, including the interdependencies of the players in the financial markets, the flow of capital and funding through central banks and the private sector, confidence (or lack thereof) in the stability and creditworthiness of institutions, and many other factors impacting the safety and soundness of financial markets.

#### **16. Shouldn't the risk management practices of financial services companies have protected them better?**

For an industry that has prided itself as being at the forefront of risk management, the current financial crisis is almost inexplicable. On the other hand, it is an oversimplification to assert that the current crisis is due solely to poor risk management. Collateralized securities were designed by Wall Street to take advantage of financial accounting and reporting standards and they obscured the underlying economics. Government and monetary policies, rating agency practices, and the lack of effective and time-honored underwriting standards further contributed to the problem. Most importantly, deficiencies in corporate governance processes obviated the contribution of any risk management processes in place. In many cases, there was a lack of effective transparency, accountability and escalation in the institutions affected, which led directors and senior managers to a position of not knowing the extent of the risks undertaken. Collectively, these issues reach well beyond the scope of risk management and touch upon such areas as corporate governance, executive management, and the role of the board and the audit committee.

The above said, it is important to remember that countless financial services companies – large and small – have been able to weather the crisis successfully.

In March 2008, senior supervisors from five countries (France, Germany, Switzerland, the United Kingdom and the United States) released the results of their evaluation of the risk management practices of a group of large financial services companies and their effectiveness in protecting companies.<sup>8</sup> What the supervisors concluded was that the companies that had fared better through year-end 2007 shared the following firmwide risk management practices:

- Effective firmwide risk identification and analysis
- Consistent application of independent and rigorous valuation practices across the firm
- Effective management of funding liquidity, capital and balance sheet
- Informative and responsive risk measurement and management reporting and practices

By contrast, the supervisors concluded that the companies that experienced more significant problems exhibited the following common characteristics:

- They failed to discuss changing market conditions in a timely manner and left the business areas to make decisions in isolation without creating appropriate incentives for the business areas to manage risk.
- They were content to rely on rating agency valuations despite observable market changes.
- They lacked alignment between their risk management and treasury functions.
- They relied on outdated assumptions that were unchallenged by management, and did not effectively integrate market and counterparty risk to identify the size of their concentration risk.
- They often evidenced a lack of understanding by senior management of the risks, which prevented them from challenging the business units, resulted in frequent and tolerated limit exceptions, and created hierarchal structures that filtered or delayed information flows and/or organizational silos that tended to compartmentalize information.

Some simply ascribe the problems experienced by many large financial services companies to a leadership failure. Others say that in those companies that have been affected most profoundly, risk management failed to identify and support adequately the increasingly complex and risky nature of the business. The message is that the root causes of the crisis do not lie solely with risk management processes. To be effective, risk management requires transparency and effective governance. Unfortunately, both appear to be lacking in many cases.

Since the companies surveyed by the supervisors were not disclosed by name, it is not possible to determine how well the companies the supervisors deemed to have stronger risk management practices have weathered the crisis in the time since the survey was conducted. At a minimum, those companies that have been most affected will need to re-evaluate how they assess and monitor risk across the organization and the adequacy and effectiveness of the governance arrangements over those individuals who made or agreed to the strategies followed. Where necessary, organizations will need to make appropriate changes to their governance and risk arrangements to address weaknesses and gaps in their current arrangements.

**17. Why were financial institutions not able to predict the market deterioration through stress testing?**

Stress testing may have failed to give warning of the impending crisis for a number of reasons, including the use of overly optimistic assumptions (e.g., ever-increasing real estate values), and because stress test models may systematically underestimate the effect of extreme situations and the increase in the relationship among variables when volatility spikes.<sup>9</sup>

**18. Should boards of directors and senior management of financial and nonfinancial companies have expected their organizations to be protected from being affected by the crisis because of their corporate governance efforts related to implementing Sarbanes-Oxley and similar requirements of other jurisdictions?**

No. The Sarbanes-Oxley legislation focuses primarily on the reliability of financial reporting. That limited focus falls far short of the scope of the governance and risk management processes needed to reduce the financial risks created by subprime lending and other related practices to an acceptable level. While a strong system of internal control over financial reporting is vitally important, it does not dictate the practices for managing the credit, counterparty and liquidity risks that have led to the current crisis.

**19. When were the first signs of the current crisis apparent?**

While there were signs of the problems to come toward the end of 2006, the real magnitude of the problem began to surface in the first half of 2007, with such events as the bankruptcy filing of New Century in April 2007 and Bear Stearns' June 2007 US\$3.2 billion rescue of two of its hedge funds that were invested in subprime. Many would say that "crisis level" was reached in August-September 2007, when the money market sector that is critically important to banking and financial operations temporarily froze and the Federal Reserve Bank and European Central Bank added US\$100 billion in liquidity into the system, which calmed the market for a short period.

Beginning in September 2008, the financial landscape began to change very quickly and the effects of the crisis began to be felt more broadly by myriad industries and economies across the globe. By the time 2008 came to a close, many large financial institutions had collapsed or sought government assistance, governments in many countries had announced or were in the process of crafting economic stimulus plans, companies of all types were announcing major layoffs, and the global markets were in turmoil.

In 2009 there was little relief, as evidenced by the sampling of events and actions chronicled below:

**January 2009**

Retail experts warn that dismal holiday sales will result in significant store closures and retail bankruptcies.

The U.S. Department of Labor confirms that more people lost jobs in 2008 than in any year since World War II.

The Federal Deposit Insurance Corporation (FDIC) reaches a preliminary agreement to sell IndyMac Bank to a consortium of private equity firms, at an estimated loss of US\$9.4 billion to the FDIC fund.

Citigroup announces a plan to split into two separate firms to manage its traditional banking business and its riskiest investment assets.

New York University Professor Nouriel Roubini predicts that U.S. financial losses from the credit crisis could reach US\$3.6 trillion.

Germany considers an emergency fund of up to €100 billion (US\$135 billion) in state-backed loans for companies facing a credit crunch.

Canada unveils a C\$40 billion stimulus plan.

The Australian government announces an AU\$4 billion plan to support commercial property assets of viable Australian companies to prevent additional job losses.

Official government figures confirm that the United Kingdom is now in recession for the first time since 1991.

Spain becomes the first country to lose its S&P AAA rating since Japan in 2001.

The French government announces its plan to provide €5 billion in credit guarantees to help Airbus sell aircraft to customers struggling to secure financing.

The Obama administration begins revealing plans for its stimulus program; estimates of the cost of this program range from US\$775 billion to more than US\$1 trillion.

Outgoing President Bush requests the release of the remaining US\$350 billion in Troubled Asset Relief Program (TARP) funds.

Iceland's government collapses following political turmoil prompted by the financial crisis.

### **February 2009**

From China comes the news that 20 million migrant workers (15.3 percent of a total of 130 million) have lost their jobs in the country's coastal manufacturing centers.

China announces that its exports in January suffered the largest drop in 10 years.

The Australian government passes an AU\$42 billion stimulus bill.

U.S. unemployment rises to its highest level since 1992.

U.S. Secretary of the Treasury Geithner holds a press briefing on TARP II and world markets decline given the lack of detail provided.

The U.S. government passes a US\$787 billion stimulus package.

The Spanish economy falls into recession for the first time in 15 years.

Deutsche Bank announces a €3.9 billion loss in 2008, its first since its restructuring after World War II.

Nissan Motors announces plans to cut 20,000 jobs worldwide – 8.5 percent of its workforce – because of a steep decline in sales.

U.S. banking shares hit their lowest level since 1992 on fears of nationalization of key financial institutions.

### **March 2009**

World stock markets continue to tumble on economic news ranging from China's failure to deliver a stimulus package to signs of a worsening crisis in the European Union and in Japan.

The U.K. Financial Services Authority announces sweeping reforms for the United Kingdom's regulatory regime.

The U.S. Treasury provides US\$5 billion to auto industry suppliers – much less than the industry had sought.

The White House pushes out General Motors CEO Rick Wagoner.

The U.S. Treasury announces plans to buy up to US\$1 trillion in “toxic assets” from U.S. financial institutions.

Romania receives a loan from the IMF and becomes the first eastern European country to seek external financial support.

The OECD announces that one in 10 workers in developed countries will be without a job in 2010.

### **April 2009**

The G-20 meets in London and commits US\$1 trillion to address the financial crisis.

Japan announces plans to implement another stimulus plan, this one more than 10 trillion yen.

Royal Bank of Scotland announces worldwide job cuts of up to 9,000.

The IMF reports in its *Global Financial Stability Report* that the deteriorating global economy means financial institutions now face total losses of US\$4.1 trillion on loans and other assets, and urges governments to take “bolder steps” to shore up institutions – including nationalizing them where necessary.

Microsoft reports that its revenues fell for the first time in its 34-year history.

The U.S. Commerce Department reports that the U.S. economy continued to contract in the first quarter of 2009, led by the biggest fall in exports in 40 years.

### **May 2009**

Chrysler files for Chapter 11 bankruptcy protection after U.S. President Barack Obama criticized hedge funds for blocking an out-of-court restructuring of the U.S. carmaker's US\$6.9 billion debt.

Japan offers US\$100 billion in financial assistance to Asian countries hit by the global financial crisis.

U.S. regulators order 10 of the nation's largest banks to add a total of US\$74.6 billion in equity following the completion of stress tests of 19 large financial institutions.

Electronics giant Sony reports its first annual loss in 14 years.

American Express announces that it is cutting about 4,000 jobs, approximately 6 percent of its global workforce.

GMAC, the automotive financing company, receives US\$7.5 billion of government aid, allowing it to stay in business.

Russia reports that its economy contracted sharply in April, shrinking by 10.5 percent from the same month a year ago.

Standard and Poor's downgrades its view of the United Kingdom to "negative" from "stable" for the first time since it started analyzing the country's public finances in 1978.

### **June 2009**

General Motors files for bankruptcy.

"New" Chrysler emerges from bankruptcy.

Switzerland officially enters recession.

The OECD reports that the pace of decline of the world's major economies is slowing.

Ten large U.S. financial institutions are given permission to repay the U.S. government US\$68 billion they received through the TARP.

AIG enters into a US\$25 billion debt-for-equity swap with the Federal Reserve, giving the Federal Reserve Bank of New York a large stake in AIG's most valuable businesses.

### **July 2009**

Official figures confirm that the United Kingdom suffered its worst slump in output in the last 50 years and will need to wait at least two years to regain the output lost in the last year.

The U.S. budget deficit moves above US\$1 trillion for the first time.

Russia reports that its economy shrank by more than 10 percent in the first half of the year, its worst decline since the early 1990s.

The Federal Reserve reports that the pace of economic decline in the United States has moderated.

Japan reports that industrial output has risen for the fourth month in a row.

The IMF reports that the global credit crisis has cost governments more than US\$10 trillion.

### **August 2009**

Official reports indicate that Eurozone unemployment hit 9.4 percent in June – the highest level in 10 years.

Italy reports that its economy shrank by 0.5 percent in the second half of 2009, a smaller decline than expected.

The IMF reports that the Mexican economy, the worst hit in Latin America, will fall by 7.3 percent for 2009, worse than what the country experienced in the 1995 'tequila crisis' or the debt crisis of 1982.

Both France and Germany report economic growth of 0.3 percent in the second quarter of 2009, suggesting an end to the yearlong recessions experienced by these countries.

The US\$25 billion Colonial BancGroup becomes the largest U.S. bank to fail in 2009.

Quantas Airlines posts an 88 percent drop in profits through June 2009.

President Obama announces his intention to reappoint Ben Bernanke as Chairman of the Federal Reserve Board.

FDIC information suggests that the number of U.S. banks at risk to fail is at a 15-year high.

### **September 2009**

Federal Reserve Chairman Ben Bernanke announces that the recession is technically over but that the economy will remain weak for some time.

Bank of England Governor Mervyn King reports that the U.K. economy is growing again.

The Asian Development Bank states that Asia is poised to lead the world out of the global economic crisis.

The G-20 meets in Pittsburgh and reaffirms its commitment to comprehensive financial industry regulatory reform by the end of 2010.

The FDIC announces its first sale under the PPIP program.

The European Commission announces sweeping reforms aimed at preventing another crisis in the financial services industry.

BNP Paribas announces that, earlier than expected, it will repay emergency funding that it received from the government.

The IMF cuts its forecast of the amount of bad loans and investments likely to be written off globally as a result of the crisis from US\$4 trillion to US\$3.4 trillion.

### **October 2009**

Russian President Dmitry Medvedev reports that the Russian economy will shrink by 7.5 percent in 2009.

The FTSE 100 closes at its highest level in more than a year.

The Dow Jones Industrial Average rises above 10,000 for the first time since October 3, 2008.

DSB Bank, a small Dutch bank, becomes the first western European bank to fail since the onset of the financial crisis as the authorities concluded that the markets were now stable enough to handle an outright failure.

U.S. consumer confidence falls sharply amid concerns of further job cuts.

### **November 2009**

Ford Motor Company reports it made a US\$1 billion profit in the third quarter.

CIT Group, Inc., files for bankruptcy.

Japanese authorities report better-than-expected growth in the third quarter.

The U.S. Congress continues to debate financial reform.

General Motors states its intention to start repaying its U.S. government loan later this year.

(For additional details on specific events from September 2007 through year-end 2008, please refer to earlier editions of this *Bulletin*, which are available upon request.)

## Estimating the Cost of the Financial Crisis

### 20. What are the estimates of the cost of the current crisis?

Estimates of the cost of the current crisis have continued to escalate. The most recent IMF estimate places the cost of resolving the crisis at US\$11.9 trillion, equivalent to about one-fifth of global economic output.<sup>10</sup> In human terms, the crisis means lost jobs (with one in 10 workers in developed countries projected to be without a job in 2010) and as many as 200 million additional people thrown into poverty.<sup>11</sup>

### 21. To put the current crisis into perspective, what were the costs of prior credit crises?

According to an IMF *Global Financial Stability Report* released in April 2008:

- The cost of the U.S. savings and loan crisis of the late 1980s and early 1990s is estimated to have totaled US\$273 billion.
- The Japanese banking crisis of the 1990s cost approximately US\$745 billion.
- The estimated cost of the Asian banking crisis of 1998-1999 was US\$404 billion.

### 22. What is the estimate of the cost to the U.S. government of dealing with the financial crisis?

According to information posted on its website in November, CNN estimates that as of the end of October, the U.S. government has allocated US\$11 trillion to rescue the economy, of which US\$3 trillion has already been spent.<sup>12</sup> Included in these amounts are, among other things, costs associated with the problems of the financial services and automotive industries, as well as the extension of unemployment benefits.

### 23. How does the financial crisis in the United States compare to the Great Depression?

Despite the continual comparisons between the current financial crisis and the Great Depression, history – as evidenced by the following – indicates that the Great Depression was far worse than the current crisis.<sup>13</sup>

	Current Crisis	Great Depression
<b>Bank failures</b>	149 (1.5% of banks) Dec 2007 – Nov 20, 2009	9,096 (50% of banks) Jan 1930 – Mar 1933
<b>Unemployment</b>	10.2%	25%
<b>Drop in Dow Jones Industrial Average</b>	-29.2% (Oct 9, 2007 – Nov 10, 2009)	-89.2% (Sep 3, 1929 – Jul 8, 1932)

### 24. The savings and loan crisis of the late 1980s and early 1990s involved significant allegations of fraud. How large a role does fraud play in the current crisis?

Various U.S. regulators, both at the state and federal level and including the Federal Bureau of Investigation (FBI), have revealed the existence of investigations into the collapse of the subprime mortgage market and allegations of market manipulation. The targets of these investigations include, but are not limited to, Fannie Mae, Freddie Mac, Lehman Brothers and AIG. The FBI has reported more than 1,400 investigations into brokers, appraisers, buyers and lenders. The majority of the corporate cases are said to involve accounting fraud, insider trading, and failures to disclose, with criminal intent, the proper evaluation of securitized loans and derivatives.<sup>14</sup>

## Accounting Rules and the Financial Crisis

### 25. Did accounting rules contribute to the crisis?

Some believe that existing mark-to-market rules that require companies to adjust the value of their assets based on current market values and raise capital to address any deficiencies have precipitated the crisis. They argue that when the economy is in the midst of a severe downturn, the use of fair value or mark-to-market accounting “reinforces the downward cycle of panic-falling prices-losses-illiquidity-credit contraction-more panic-further falling prices-greater reported losses-no active markets. Fair value accounting adds momentum to a destructive downside overshoot.”<sup>15</sup>

**26. In light of the criticism of fair value accounting, has there been any reconsideration of its appropriateness?**

Yes. The Emergency Economic Stabilization Act of 2008 (EESA), enacted in the United States in October 2008, mandated that the SEC, in consultation with both the Federal Reserve Board as well as the Secretary of the Treasury, conduct a study on mark-to-market accounting standards as provided by Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS No. 157), addressing the following six key issues:

- 1) The effects of fair value standards on financial institutions' balance sheets
- 2) The impact of fair value accounting on the 2008 bank failures
- 3) The impact of fair value accounting on the quality of financial information available to investors
- 4) The Financial Accounting Standards Board's (FASB) process over developing accounting standards
- 5) Alternatives to fair value accounting standards
- 6) Advisability and feasibility of modifications to fair value accounting standards

**27. Did the SEC conclude that fair value accounting was part of the problem?**

No. To the contrary, the SEC concluded that fair value accounting did not appear to play a meaningful role in the bank failures of 2008 and, further, that investors generally support measurements at fair value since they provide greater transparency.

**28. How did the SEC support this conclusion?**

The SEC pointed out that fair value measurements were used to account for a minority of financial institution instruments – 45 percent of assets and 15 percent of liabilities – and determined that the impact of changes in value on assets was less than 25 percent. Thus, the SEC concluded that bank failures in the United States “appeared to be the result of growing probable credit losses, concerns about asset quality, and, in certain cases, eroding lender and investor confidence. For the failed banks that did recognize sizable fair value losses, it does not appear that the reporting of these losses was the reason the bank failed.”<sup>16</sup>

Notwithstanding this conclusion, the SEC has offered a number of recommendations relating to fair market accounting.

**29. What are the SEC's recommendations with regard to fair value accounting?**

In its fair value study, the SEC offered the following eight recommendations:

**1) Improve, but do not suspend, SFAS No. 157**

The SEC believes that suspending SFAS No. 157 itself would only revert current practice back to inconsistent and somewhat conflicting guidance on fair value measurements.

**2) Other existing mark-to-market requirements should not be suspended**

The SEC study pointed out that mark-to-market accounting has been in place for years, and that abruptly removing it and moving back to alternative measures such as historical cost would erode investor confidence and decrease transparency in financial statements.

Additionally, it is important to note that, in general, mark-to-market accounting is limited to trading and derivative instruments. For many banks and financial institutions, these types of assets represent a minority of their total investment portfolio. Further, the SEC's study points out that over 90 percent of investments marked to market are valued based on “observable” inputs – market quotes obtained from active markets.

**3) Improvements needed regarding application and practice**

The SEC study identified five specific recommendations regarding the specific application and practice of fair value accounting, as follows:

- Develop best practices and application guidance for determining fair value in illiquid or inactive markets.

- Enhance the existing disclosure and presentation requirements related to the effect of fair value in the financial statements.
- Assess whether the incorporation of changes in credit risk in the measurement of liabilities provides useful information to investors, including whether sufficient transparency is provided.
- Reinforce the need for educational efforts in regard to management judgment in the determination of fair value estimates.
- Consider implementing changes to the FASB's Valuation Resource Group (VRG).

#### **4) Re-evaluate the existing accounting for asset impairments**

The SEC has recommended that the FASB reassess current impairment accounting models for financial instruments with the aim of reducing the number of models that currently exist under U.S. GAAP. Further, the content and consistency of information provided to investors should be improved, including the implementation of measures to provide investors with insight into management's expectations of probable cash flow declines relating to investments.

#### **5) Provide further guidance fostering sound judgment**

The SEC study pointed out that currently 85 percent of assets reported at fair value by financial institutions studied are valued based on prices other than quoted, unadjusted market prices. To value these assets, information derived from observable and non-observable inputs is incorporated into models to develop an estimate of value. Such estimation processes, by their nature, require the exercise of significant judgment. The SEC recommended, "Guidance regarding the application of judgment in connection with fair value measurements should keep pace with this increased use."<sup>17</sup>

#### **6) Needs of investors should continue to be the focus**

Simply put, financial reporting is intended to meet the needs of investors. While financial reporting may serve as a starting point for other users, the SEC strongly recommended that U.S. GAAP continue to be developed to satisfy the needs of investors.

#### **7) Formal measures are needed to address operating of existing standards**

The SEC has recommended that the following measures be adopted to facilitate the identification and resolution of issues encountered in the application of existing accounting standards in practice:

- Implementing a Financial Reporting Forum (FRF) – key constituents from the preparer, auditor, and investor and other user communities
- The implementation by the FASB of a post-adoption review process
- The establishment of a policy for standard-setting in certain circumstances that necessitate a "near-immediate" response

#### **8) Address the need to simplify the accounting for investments**

Given the complexity of accounting rules for financial instruments, the SEC believes it is advisable to work to simplify the accounting for investments in them, including the continued exploration of the feasibility of reporting all financial instruments at fair value. However, significant obstacles continue to exist – including concerns about the degree of relevance and reliability, and concerns about how changes in fair value should be recognized in the income statement.

### **30. Has the Financial Accounting Standards Board (FASB) issued any final guidance in light of the SEC's recommendations with regard to fair value accounting?**

Yes. On April 9, 2009, the FASB finalized three Financial Staff Positions (FSPs) it had issued as proposals in late March. These FSPs were, in large part, reactive to the SEC recommendations regarding fair value accounting. The three final FSPs are intended to provide additional application guidance and enhance disclosures regarding fair value measurements and impairments of securities. Reflecting mounting political pressure and the urgency expressed by legislators as well as by the business community to improve fair value accounting, the comment period for these proposals lasted for just two

weeks. Based on historical precedent, this was a very short window for users, preparers and auditors to react and respond.

The first FSP – specifically with regard to FAS 157 – provides additional guidance in determining fair values when there is no active market or where the market price inputs being used may represent distressed sales. It reaffirms what FAS 157 states is the objective of fair value measurement: to reflect how much an asset would be sold for in an orderly transaction (as opposed to a distressed or forced transaction) at the date of the financial statements under current market conditions. Specifically, the FSP reaffirms the need to use judgment to ascertain if a formerly active market has become inactive and to determine fair values when markets have become inactive.

The FSP further provides that companies should apply judgment in evaluating whether there has been a significant decrease in the volume and level of activity for the asset as compared with normal market activity for the asset or liability (or similar assets or liabilities). The FSP suggests that companies consider factors including the following:

- There are few recent transactions.
- Price quotations are not based on current information.
- Price quotations vary substantially either over time or among market makers (for example, some brokered markets).
- Indexes that previously were highly correlated with the fair values of the asset or liability are demonstrably uncorrelated with recent indications of fair value for that asset or liability.
- There is a wide bid-ask spread or significant increase in the bid-ask spread.

The second FSP provides for additional fair value disclosures for any financial instruments that are not reflected on a company's balance sheet at fair value. Prior to the issuance of this FSP, fair values for these assets and liabilities were only disclosed once a year. The FSP now requires these disclosures on a quarterly basis, providing additional qualitative and quantitative information about fair value estimates for all those financial instruments not measured on the balance sheet at fair value.

The third FSP addresses other-than-temporary impairment (OTTI). This FSP is intended to provide greater consistency in the timing of impairment recognition, and greater clarity to investors about the credit and noncredit components of impaired debt securities that are not expected to be sold. The measure of impairment in other comprehensive income (OCI) remains fair value. The FSP also requires increased and more timely disclosures sought by investors regarding expected cash flows, credit losses, and an aging of securities with unrealized losses.

This FSP changes when an impairment writedown is recorded in earnings and where the impairment is reported in the financial statements. Under current guidance, unless the severity and duration of a drop in fair value is severe, if a company can reasonably assert that it intends and is able to hold a security until the fair value recovers, it need not record an impairment charge on the income statement. The proposal also indicates that no impairment charge is required if (1) there is no current intention to sell, and (2) it is more likely than not that it will not be required to sell prior to the fair value recovering.

In general terms, the proposal changes the presentation of the impairment charge by splitting it into two pieces: income and OCI. The amount of the impairment related to credit losses will be reflected on the income statement. The amount of the impairment related to all other factors other than credit will be shown in OCI in the equity section of the balance sheet. There will be a requirement for a full gross presentation on the income statement: (1) an amount depicting the total reduction in fair value below cost, (2) the amount offsetting it that is being charged to OCI, and (3) the net amount being recorded through net income.

These three FSPs will be effective for the second quarter of 2009, though companies may elect to adopt them for their first-quarter reporting.

### **31. Have there been any concerns or questions raised about the impact of these three new accounting proposals during the comment period?**

Yes, there have been concerns raised by the user community as well as by preparers and legislators regarding reporting the credit and noncredit components of impairment separately. Other questions have surfaced with regard to whether a company would ever have to record impairment charges if it demonstrated consistently the “intent and ability” to hold a devalued investment. Further, questions were raised during the proposal stage about whether the notion of “exit price” would be disregarded as representative of fair value if all transactions in inactive markets are considered distressed. These and other relevant issues are discussed further below.

#### **Is it appropriate to separate credit and noncredit losses?**

New guidance dictates that impairment charges tied to credit losses would be reported in net income, while those related to noncredit factors would be reported in OCI. Investors have already criticized this FSP as lacking transparency, as the full impairment loss would not be charged to earnings. Others contend the FSP increases transparency by presenting both the credit and noncredit portions.

With regard to the actual separation – for credit losses and other factors – some have complained that the process would be difficult and at best would be an imprecise estimate. Others recognize that the separation would lead to enhanced discussion around both the credit and noncredit portions, which would be helpful for investors.

#### **Does having the “intent and ability to hold” preclude recording impairment?**

This still appears to be the case. The final FSP adjusts the existing requirement that the entity’s management assert it has both the intent and ability to hold an impaired security until recovery. Under the new requirement, management must assert that (1) it does not have the intent to sell the security, and (2) it is more likely than not it will not have to sell the security before recovery of its cost basis.

#### **Does an inactive market mean that all transactions are distressed?**

Apparently not. The proposal guidance had presumed that any transaction in an inactive market may be considered distressed. The final FSP eliminates the proposed presumption that all transactions are distressed (not orderly) unless proven otherwise. The FSP instead requires an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence.

Further in regard to inactive markets and distressed transactions, the FASB received specific negative commentary in the FSP’s proposal stage from both the AICPA and the Center for Audit Quality (CAQ). The AICPA’s Accounting Standards Executive Committee (ASEC) noted that the proposal’s presumption that all transactions in a market that is not active are considered distressed is inconsistent with the objectives of FAS 157, and that the proposal as written may lead to measurements that simply ignore observable data and do not represent fair value.

Jay D. Hanson of the AICPA’s ASEC wrote, “We are unable to reconcile the fair value objective in the FSP [FASB proposal] to the underlying exit price notion embedded in FASB Statement No. 157.”<sup>18</sup>

In her comment letter to the FASB, Cindy Fornelli, executive director of the CAQ, called for more implementation guidance to support the new measurement principle used in the FASB proposal, including more specificity by the FASB regarding the objective of this new measurement. Ms. Fornelli wrote, “Without appropriate application guidance, the proposed FSP will be operationally difficult to implement and will effectively ‘shrink’ what are considered to be active markets and expand what are considered to be inactive markets, resulting in less objective measurements.”<sup>19</sup>

The CAQ also expressed concern about the cost of developing new valuation methods and the possibility that the new rule could preclude the use of pricing services and brokers to determine the fair value of an asset. In her letter, Fornelli stated, “Given the additional cost and operational burden presented by the proposed FSP, we believe that some preparers of financial statements will not be able to implement this FSP by the proposed effective date.”<sup>20</sup>

Conversely, the American Bankers Association (ABA) has been consistent in its opposition to mark-to-market (M to M) accounting since the statement became effective, citing that, "M to M accounting for banking institutions often provides misleading information to users of the financial statements and the current market has clearly demonstrated this."<sup>21</sup> The ABA weighed in favorably on the FASB's new proposal as follows:

We strongly support the Proposed FSP and encourage the FASB to finalize it during this week's Board meeting. It is a significant step in the right direction in helping preparers and their auditors understand the concepts for estimating fair value in illiquid markets. Even though the Proposed FSP should improve practice, we believe some confusion will remain and there may continue to be misapplication of SFAS 157.<sup>22</sup>

**32. As the SEC's recommendations with regard to fair value accounting were issued in late 2008, has the SEC provided an updated view on lessons learned from the financial crisis for financial reporting, standard setting and rulemaking?**

Yes. On November 17, 2009, SEC Commissioner Kathleen L. Casey gave a speech in New York at a conference sponsored by Financial Executives International. In her address, Ms. Casey discussed three key lessons learned from the financial crisis – lessons that should both inform policymakers' efforts at reform and warn against legislative and regulatory responses that would undermine the efficient functioning of markets. The three items are as follows:

First, financial stability depends upon market confidence, and investor confidence depends upon the transparency of financial statements.

Ms. Casey noted that the primary purpose of financial statements is to inform current and prospective investors about an issuer's performance and financial condition, which will enable investors to make informed decisions. As a result, transparent financial statements are considered key to the operation of efficient capital markets. If financial statements are opaque, investors are forced either to make poorly informed investment decisions or to not invest, leading to suboptimal and/or inefficient markets.

Second, financial reporting and accounting standard setting must remain focused on the needs of investors. While there are many other important stakeholders that rely on financial statement reporting, investors' interests must remain paramount.

Ms. Casey noted that the second key lesson is the importance of remaining focused on investor needs in financial reporting and accounting standard setting. Accounting standard setters should strive, above all, to promote transparency for investors. She noted that while the concerns of other stakeholders are clearly important considerations in the standard-setting process, where those interests conflict with the needs of investors, investors' interests must prevail.

Third, financial reporting must remain relevant and informative to investors, and should not impose unnecessary or costly burdens that do not add to investor understanding.

Ms. Casey noted it is important that the SEC not forget that the goal of disclosure rules must always be to provide investors with material information to facilitate their capital allocation decisions. The SEC cannot allow disclosure rules to become a means of advancing political or social agendas. Financial reporting must remain relevant and informative to investors, and should not impose unnecessary or costly burdens that do not add value.

Ms. Casey went on to comment on whether the SEC will issue interpretive guidance in this area:

My governing principle in determining whether to support any such guidance, as with my analysis of any other rules or guidance, will be that it must be driven by investor needs and designed to elicit decision-useful information for investors, rather than advancing an agenda unrelated to investor protection.<sup>23</sup>

Our challenge in adopting new disclosure requirements is to make the new disclosure useful and informative. If we are not successful in making this disclosure relevant to investors – for instance, if disclosure becomes unwieldy, confusing or boilerplate (as is too often the case) – we will have only succeeded in making an already long and cumbersome document even denser, rather than better.<sup>24</sup>

**33. Are there any other finalized or pending proposals with regard to fair value accounting currently under consideration by the FASB?**

Yes. In terms of final guidance, in September 2009 the FASB issued additional guidance on how companies should measure liabilities at fair value and confirmed practices that have evolved when measuring fair value, such as the use of quoted prices for a liability when traded as an asset.

While reconfirming the existing definition of fair value, the updated guidance reintroduces the concept of “entry value” into the fair value determination. Entry value, as defined, is the amount an entity would receive to enter into an identical liability. Additionally, under the new guidance, the fair value of a liability is not adjusted to reflect the impact of contractual restrictions that prevent its transfer.

The new guidance supplements and amends the guidance in *Fair Value Measurements and Disclosures* to clarify how an entity should measure the fair value of liabilities. Alternative valuation methods and a hierarchy for their use are outlined therein. The new guidance also points out that restrictions preventing the transfer of a liability should not be considered as a separate input or adjustment in the measurement of its fair value.

Specifically, if available, a quoted price in an active market for an identical liability must be used. If such information is not available, an entity may use one or more of the following techniques:

- The quoted price of the identical liability when traded as an asset
- Quoted prices for similar liabilities or similar liabilities traded as assets
- Another valuation technique consistent with overarching principles of fair value, such as the income approach or a market approach

The effective date is the first reporting period (including interim periods) after August 26, 2009. Early application will be allowed for financial statements for earlier periods that have not yet been issued.

Additionally, in October 2009, the FASB issued an Accounting Standards Update (ASU) that provides additional guidance on how companies should estimate the fair value of certain alternative investments, such as private equity funds, hedge funds and private equity venture capital (VC) funds.

The significant change is that the fair value of certain alternative investments can now be determined using net asset value (NAV) as a practical expedient, unless it is probable the investment will be sold at something other than the NAV. In those situations, the practical expedient cannot be used and the disclosure of any remaining actions necessary to complete the sale will be required.

Specifically, the updated standard states that a reporting entity is allowed to estimate the fair value of certain alternative investments using NAV without further adjustment if NAV is calculated consistent with the guidance in conformity with Investment Company accounting as of the reporting entity’s measurement date.

The guidance reflects the FASB’s intent to avoid arbitrary adjustments being made to NAV in determining fair value. The FASB concluded that the benefit to preparers of applying the practical expedient outweighed the costs necessary to make such adjustments. The guidance is intended to streamline the process of estimating fair value for many entities, reduce the effort involved in estimating fair value and reduce the number of arbitrary adjustments to NAV.

The effective date is the first annual or interim reporting period ending after December 15, 2009, with early application permitted. Reporting entities that elect to early adopt the provisions of the ASU are not required to early adopt the disclosure provisions.

In terms of significant proposed guidance, in September 2009 the FASB issued a proposed ASU to improve disclosures about fair value measurements. Among other provisions, the proposed disclosures include a sensitivity analysis for Level 3 measurements, gross presentation of Level 3 activity, and transfers in and out of Level 1 and 2 measurements.

Fair value accounting has been subject to wide scrutiny over the past 18 months, due primarily to the perceived lack of detail and transparency associated with fair value disclosures. These concerns have been one of the items discussed by the U.S. Congress, the FASB, the SEC and the IASB, as well as other domestic and international organizations.

As such, and as consistent with the SEC's recommendations over fair value issued late last year, the FASB added a fair value disclosure project to its agenda in February 2009 to address some of the concerns that have been raised about the existing disclosures and explore possible enhancements to *Fair Value Measurements and Disclosures*.

This proposed ASU, *Improving Disclosures about Fair Value Measurements*, was released in August 2009. It includes three major new disclosure requirements and clarifies two existing fair value disclosure requirements, as follows:

- A sensitivity analysis for Level 3 measurements showing the effects of reasonably possible alternative inputs
- Details of transfers in and out of Level 1 and Level 2 measurements
- A gross presentation of activity within the Level 3 roll forward

The guidance also clarifies the following existing disclosure requirements for both interim and annual periods:

- The level of aggregation of fair value measurements
- Disclosures regarding inputs and valuation techniques

A significant new item is the requirement to disclose the effect of reasonably possible – consistent with existing SFAS 5 requirements – alternative Level 3 inputs. This would require a reporting entity to determine if there would be a significant impact on fair value if inputs into recurring and nonrecurring Level 3 fair value measurements were changed to “reasonably possible” alternative inputs and, if so, to quantify and disclose the impact and describe how that impact was calculated.

The proposed additional disclosures are intended to apply to all entities required to make disclosures about recurring and nonrecurring fair value measurements. Except for the proposed Level 3 sensitivity disclosure, which would be required beginning in 2010, the proposed disclosures would be required for interim and annual periods ending after December 15, 2009.

The comment period ended October 12, 2009. The FASB expects to issue final guidance before the end of the year.

#### **34. How will International Financial Reporting Standards (IFRS) impact the current situation?**

The crisis has led to asset price declines in financial institutions as well as in other companies. Among the assets affected are intangibles and goodwill from acquisitions. Under current IFRS rules, companies have to perform periodic tests to determine impairment of assets. These tests are resulting in significant reductions in book value because of lower cash flow and higher interest rates. U.S. generally accepted accounting principles (GAAP) also requires periodic impairment evaluations. The principal difference between IFRS and U.S. GAAP is the level of guidance provided by the accounting standards; IFRS standards on the evaluation of fair value historically have been less proscriptive than U.S. GAAP.

As U.S. GAAP and IFRS converge, previous changes have seen U.S. GAAP move closer to IFRS; however, recent actions by the IASB have, in the area of fair value, moved and are continuing to move IFRS toward U.S. GAAP and its guidance. Consequently, with regard to fair value, the differences between U.S. GAAP and IFRS, and thus the impact of IFRS, are diminishing.

In fact, on May 28, 2009, the IASB issued for public comment an exposure draft on fair value measurement that, if adopted, would replace fair value measurement guidance contained in individual IFRS standards with a single definition of fair value, as well as provide more guidance on the application of fair value measurement in inactive markets. To ensure consistency between IFRS and U.S. GAAP, the proposals incorporate recent guidance on fair value measurement published by the FASB on April 9, 2009 (see Question 30), and are also consistent with a report published by the IASB's Expert Advisory Panel in October 2008 on fair value in illiquid markets.

This project is part of a larger effort by the IASB and FASB to achieve convergence of IFRS and U.S. GAAP, as per the boards' Memorandum of Understanding published in September 2008. It also is consistent with recent requests from G-20 leaders to sync fair value measurement in IFRS and U.S. GAAP.

The IASB's starting point for the exposure draft was the U.S. standard, SFAS 157 Fair Value Measurements, as recently adjusted and amended. As noted, the proposed definition of fair value is identical to the definition in SFAS 157 and the supporting guidance is largely consistent with current U.S. GAAP.

In introducing the exposure draft, Sir David Tweedie, chairman of the IASB, stated:

This exposure draft is an important milestone in our response to the global financial crisis. It proposes clear and consistent guidance for the measurement of fair value and also addresses valuation issues arising in markets that have become inactive. The proposed guidance ensures consistency with U.S. GAAP on issues related to fair value measurement and would achieve overall convergence with U.S. GAAP.<sup>25</sup>

The proposals in the exposure draft were open for public comment until September 2009. After reviewing the comment letters received on the proposals in the exposure draft and holding the roundtable meetings, the IASB will begin its redeliberations. The IASB currently plans to begin redeliberations in January 2010 and publish an IFRS on fair value measurement guidance later in the year.

As the IFRS world awaits large-scale guidance in regard to fair value, the IASB continues to make changes to financial instruments accounting. Last week, the European Union deferred the adoption date of the pending international accounting rule known as IFRS 9, the first part of the three-part financial instruments changes.

IFRS 9 deals with the classification and measurement of financial assets, while the other two parts, which are currently being worked on by the IASB, involve hedge accounting and the impairment of financial assets. Details of the changes in regard to IFRS 9 are presented below.

From a practical perspective, the recent deferral adjustment is not significant in content, although it does prevent early adoption. As such, the rule likely will not go into effect until 2013, and the IASB expects to have the other parts completed by the end of 2010, the same time the FASB plans to finish all three parts of its standard on financial instruments.

From a technical perspective, IFRS 9 makes the following significant changes:

- IFRS 9 replaces the multiple classification and measurement models in existing guidance with a single view with only two classification choices – amortized cost and fair value. Classification under IFRS 9 is driven by the entity's business model for managing the financial assets and the characteristics of the financial assets. (A financial asset is measured at amortized cost if two criteria are met: a) the objective of the business model is to hold the financial asset, and b) the cash flows under the instrument solely represent payments of principal and interest.)
- IFRS 9 classification principles indicate that all equity investments should be measured at fair value. However, management now has an option to present in other comprehensive income unrealized and realized fair value gains and losses on equity investments that are not held for trading. Such designation is available on initial recognition on an instrument-by-instrument basis and is irrevocable.

Other changes are as follows:

- The requirement to separate embedded derivatives from financial asset hosts is removed.
- Two of the current three FVO criteria are under IFRS 9, as a fair value-driven business model requires fair value accounting, and hybrid contracts are classified in their entirety.
- IFRS 9 prohibits reclassifications except in rare circumstances – for example, when an entity's business model changes.
- There are additions of specific guidance for contractually linked instruments that create concentrations of credit risk, such as investment tranches in a securitization.
- IFRS 9 removes the cost exemption for unquoted equities and derivatives on unquoted equities but provides additional guidance on when cost may be an appropriate estimate of fair value.

As noted, these changes represent the first milestone in the IASB's planned replacement of the IAS's existing guidance over financial instruments. The next steps involve reconsideration of the classification and measurement requirements for financial liabilities, further review of the proposed impairment approach for financial assets, and development of improved guidance on hedge accounting. The IASB is also planning to publish a request for views on the FASB exposure draft on financial instruments, which is expected to be issued in the first quarter of 2010.

Further in response to the financial crisis, the IASB continues work on a project related to off-balance-sheet (OBS) reporting to improve the accounting and disclosure standards for OBS vehicles and work with other standard setters (such as the FASB) toward international convergence. While that work continues abroad at the IASB, the FASB is working on an accelerated timetable to improve U.S. GAAP OBS reporting by calendar-year 2010. (See Question 38.)

### **35. Is there any indication whether or not the U.S. administration or Congress agrees with the SEC's view?**

President Obama has selected former Federal Reserve Chairman Paul Volcker as head of a special economic recovery board. This appointment may have significant impact for regulated banks' financial reporting standards. In January, Volcker weighed in and questioned, among other things, whether an "across-the-board application of mark-to-market accounting [is] suitable for regulated institutions."<sup>26</sup> This stand is in direct contrast with the SEC's recent affirmation of the FASB's current fair value standards.

Further, speaking on June 11, 2009, at a conference of global bankers in the Great Hall of the People, the seat of China's legislature, Volcker reiterated his plea for a review of the current fair value rules that determine the value of assets of banks, insurers and other institutions. He said recent efforts to enforce mark-to-market rules on assets have only fueled confusion and uncertainty. He went on to say that while more international consistency is required in accounting standards, politicians should avoid excessive involvement. "Political bodies in Europe and the United States or any other country are simply not the appropriate venue for reaching well-considered judgments that can be enforced internationally," he said, adding, "We need a bit [of] patience" as the International Accounting Standards Board carefully reviews the rules.<sup>27</sup>

Senator Christopher Dodd, the chairman of the Senate Banking Committee, recently reported that it might be possible to modify mark-to-market accounting rules for U.S. banks facing steep writedowns of troubled assets without abandoning the underlying accounting standard. In fact, the recent actions by the FASB in regard to evaluating and reporting impairments, inactive markets, and distressed transactions have served to adjust the fair value rules without the complete overhaul or reversal of mark-to-market accounting called for by the ABA and other financial institutions in late 2008 and early 2009.

The ABA has claimed to be the leader in raising awareness of – in its view – the misleading and destructive impact mark-to-market accounting policies have had on bank financial statements and the economy as a whole. For months, the ABA worked with policymakers to develop a new approach to the setting of accounting standards – one that appropriately considers the business model of traditional banks. It appears that the lobbying has finally paid off.

In November 2009, the House Financial Services Committee approved an ABA-backed amendment that would allow the new systemic risk regulator to weigh in on accounting standards. The ABA believes this is an important step toward ensuring that the FASB and the SEC consider the systemic impact of standards such as mark-to-market accounting.

The ABA had strongly backed the amendment, offered by legislators, and helped generate significant banker support. This support was critical to successfully challenge opposition posed by the accounting industry, the FASB, the SEC, investor groups and even the U.S. Chamber of Commerce.

Specifically, the amendment requires the newly created systemic oversight body – which includes bank regulators and the Treasury – to analyze and provide views on mark-to-market and other accounting standards. Though the council cannot overrule the FASB as the ABA sought, the amendment is likely to make it more difficult for the FASB to simply ignore the findings of this new oversight body.

Not surprisingly, the standard setters were in strong opposition. SEC Commissioner Elisse Walter fought hard against the proposal. In a hearing prior to the final votes before the House, Walter called the concept of allowing bank regulators to have a significant say in accounting rules “a grave mistake” and noted further that SEC Chairman Mary Schapiro “endorses this testimony.”<sup>28</sup>

Further, Ms. Walter noted, “Establishing a new process that would permit regulators to weaken accounting standards, reduce disclosure, or allow the basis by which economic performance is measured to fluctuate with the economic environment could provide a new avenue for particular institutions to lobby for – and potentially receive – special treatment.”<sup>29</sup>

Currently, the SEC has budget approval over the FASB, which it has designated as the main U.S. accounting standard-setting organization. Also, the SEC frequently provides input to the board’s standard-setting activities. In addition, the SEC has the ability to nominate trustees of the Financial Accounting Foundation, the FASB’s parent, which nominates and approves FASB appointments.

The concept has been fully supported by the ABA and embraced by advocates of financial institutions – many of whom have blamed fair value accounting rules for exacerbating the financial crisis. Conversely, investors, business advocates and accounting firms oppose such a move, as they fear it would harm the FASB’s independence.

The Council of Institutional Investors, the Center for Audit Quality and the U.S. Chamber of Commerce were strongly against the proposal. These groups believe changing the FASB’s oversight would modify rules in favor of the needs of the bankers, without regard for other industries and the overall needs of investors.

### **36. Have any of the many groups that have studied the root causes of the financial crisis offered a view on fair value accounting?**

The Group of Thirty, an international body of prominent finance officials and economists that Volcker chairs, recently published its report titled *Financial Reform: A Framework for Financial Stability*.

In terms of financial reporting and fair value, the report specifically recommends:

- Fair value accounting principles and standards should be re-evaluated with a view to developing more realistic guidelines for dealing with less liquid instruments and distressed markets.
- The tension between the business purpose served by regulated financial institutions that intermediate credit and liquidity risk and the interests of investors and creditors should be resolved by development of principles-based standards that better reflect the business model of these institutions.
- Accounting principles should also be made more flexible in regard to the prudential need for regulated institutions to maintain adequate credit loss reserves sufficient to cover expected losses across their portfolios over the life of assets in those portfolios.<sup>30</sup>

### **37. Have other constituencies weighed in on fair value accounting in light of recent economic and regulatory events?**

Yes. In terms of the audit profession, the Center for Audit Quality recently warned in a letter to the Treasury, the Federal Reserve Board and the SEC that caving to political pressure to change accounting standards because of valuation challenges is not the way to solve current regulatory capital problems:

We appreciate the challenges of dealing with the financial instability resulting from the toxic assets held by banks. However, changing financial accounting standards because of valuation challenges is not the way to solve regulatory capital problems. Retreating from fair value in response to political pressure would raise suspicions that the rules were changed in order to falsely inflate asset values.

We must avoid a further crisis of investor confidence in our government and the regulatory bodies overseeing those institutions. We should not confuse the independent private sector Financial Accounting Standards Board's role to develop and improve financial accounting and reporting standards with the role and responsibilities of the regulatory bodies charged with the oversight of the safety and soundness of financial institutions. We do not believe the FASB is the body to effect capital adequacy goals for the financial institution sector.<sup>31</sup>

Further, Kevin Bailey, Deputy Comptroller, Office of the Comptroller of the Currency (OCC), in his testimony on March 12, 2009, to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, summarized the OCC's view on fair value measurement as follows:

- Fair value measurement provides critical information on the value of financial instruments to investors, supervisors and other users of financial statements. For many types of financial instruments, especially trading assets, fair value represents the best estimate of value as of the measurement date. While additional steps can and should be taken to enhance existing standards, the OCC believes that it is inappropriate to suspend current fair value measurement. In view of the concerns identified, however, additional analysis is needed before consideration is given to expanding fair value measurement to other financial instruments.
- Additional measures should be taken to improve the application of existing fair value requirements. We support the current efforts of the SEC, standard-setters, the Basel Committee and other groups to enhance current practices, especially as they relate to the application of fair value measurement in illiquid markets and the treatment of assets whose value is impaired on a more permanent basis.
- In assessing the application of GAAP-based requirements in regulatory capital, the banking agencies should continue to consider the critical need for risk sensitivity in regulatory capital while seeking to limit volatility that is temporary in nature from resulting capital requirements. In that process, the agencies should continue to evaluate relevant supervisory, financial reporting and macro-prudential considerations.<sup>32</sup>

The banking industry has been largely consistent in its opposition of fair value and mark-to-market accounting, arguing that lower prices and market values of financial instruments are so-called "paper losses" and have forced banks and other financial institutions into "fire sales" that have undermined their regulatory capital cushions at a time when they could least afford it.

Not all in the industry share this view, however. Lloyd Blankfein, chief executive officer of Goldman Sachs, recently weighed in on fair value and stated that expanded use of fair value might have provided an early warning signal to the global crisis. Blankfein's comments are largely contrarian and controversial in the financial sector because of the significant efforts made by other banks to have fair value accounting repealed outright or at least softened.

Speaking at the annual conference of the International Organization of Securities Commissions in Tel Aviv in June 2009, Blankfein offered the following comments:

It's painful to mark these things down, but it's more painful to have to mark them down beyond the point where you can no longer afford the capital [to hold them] ... Had fair market been implemented more widely ... then people would have had an early warning and seen value erode.<sup>33</sup>

**38. Other than “fair value measurement,” are there other highly significant accounting and reporting or regulatory changes pending that will impact U.S. public companies?**

Yes. In regard to off-balance-sheet accounting, on June 12, 2009, the FASB published Financial Accounting Statements No. 166, *Accounting for Transfers of Financial Assets*, and No. 167, *Amendments to FASB Interpretation No. 46(R)*, which change the way entities account for securitizations and special-purpose entities. The new standards will impact financial institution balance sheets beginning in 2010. The impact of both new standards has been taken into account by regulators in the recent “stress tests.”

Statement No. 166 is a revision to Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and will require more information about transfers of financial assets, including securitization transactions, and where companies have continuing exposure to the risks related to transferred financial assets. It eliminates the concept of a “qualifying special-purpose entity,” changes the requirements for derecognizing financial assets and requires additional disclosures.<sup>34</sup>

Qualifying special-purpose entities generally are off-balance-sheet entities that are exempt from consolidation. The new standard eliminates that exemption from consolidation. Many qualifying special-purpose entities that currently are off-balance-sheet will become subject to the revised consolidation guidance in the proposal on consolidations of variable interest entities.

The standard on derecognition restricts when a company may transfer a portion of a financial asset and account for the transferred portion as being sold. Existing guidance permits companies to report many transfers of portions or components of financial assets as sales. Under the new standard, a transfer of a portion of a financial asset may be reported as a sale only when that transferred portion is a pro-rata portion of an entire financial asset, no portion is subordinate to another, and other restrictive criteria are met.<sup>35</sup>

Statement No. 167 is a revision to FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities*, and changes how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance.

SFAS 167 will require companies to perform not only a quantitative analysis – which is currently required – but also a qualitative analysis of control or involvement in off-balance-sheet assets to determine when they should be consolidated. Under the new standard, the quantitative analysis often used previously is no longer, by itself, determinative.<sup>36</sup>

This new standard also requires ongoing reassessments to determine if a company must consolidate a variable interest entity. This differs from existing guidance, which requires a company to determine if it consolidates a variable interest entity only when specific events occur. Under existing guidance, as expected credit losses increased significantly due to unpredicted market events, some companies did not reconsider whether they should consolidate a variable interest entity. The new standard requires a company to update its consolidation analysis on an ongoing basis.<sup>37</sup>

The approved standards originally were designed to become effective as of the beginning of 2010 and will apply to existing entities, including existing QSPEs. The amendments on how to account for transfers of financial assets, however, will apply prospectively to transfers occurring on or after the effective date. **[The FASB has subsequently deferred certain provisions of SFAS 167, as noted further below in this section.]**

In introducing the new standards, Robert Herz, chairman of the FASB, said the following:

These changes were proposed and considered to improve existing standards and to address concerns about companies who were stretching the use of off-balance-sheet entities to the detriment of investors. The new standards eliminate existing exceptions, strengthen the standards relating to securitizations and special-purpose entities, and enhance disclosure requirements. They'll provide better transparency for investors about a company's activities and risks in these areas."<sup>38</sup>

The Federal Reserve, also on June 12, issued a press release that acknowledged the publication of the two FASB standards and also the anticipated material effect [of the new standards] on banking organizations' accounting for off-balance-sheet vehicles:

The Federal Reserve is reviewing regulatory capital requirements associated with the adoption of the new accounting standards. In conducting this review, the Federal Reserve is considering a broad range of factors, including the maintenance of prudent capital levels, the record of recent bank experiences with off-balance-sheet vehicles, and the results of the recent Supervisory Capital Assessment Program (SCAP). As part of the SCAP, participating banking organizations' capital adequacy was assessed using assumptions consistent with standards ultimately included in FAS 166 and FAS 167.<sup>39</sup>

The Federal Reserve went on to say that banks should consider in their own internal capital planning processes the comprehensive impact of SFAS 166 and 167, and perform an assessment of whether additional capital is necessary to mitigate the risks associated with financial instruments affected by the new accounting standards.

In November 2009, the FASB decided to propose a deferral of FAS 167, *Amendments to FASB Interpretation No. 46(R)*, for asset managers that would allow them to apply the current accounting guidance to investment entities that have the attributes of entities subject to existing Investment Company accounting. However, as proposed, an investment entity would not be eligible under the deferral if the asset manager has an obligation to fund potentially significant losses of the entity or has an interest in the entity that absorbs a disproportionate share of the entity's losses.

It is the FASB's belief that securitization, asset-backed financing, collateralized debt obligations and qualifying special-purpose entities will be unlikely to qualify for this deferral, while many mutual funds, hedge funds, private equity funds, venture capital funds and certain mortgage REITs would likely qualify for the deferral. The FASB also decided to propose a deferral from applying FAS 167 to money market funds subject to the Investment Company Act of 1940.

This proposed deferral will allow the FASB and IASB to jointly develop an accounting model that considers the relationship between asset managers and the investment structures they manage as part of their broader consolidation project.

The FASB plans to issue a proposed accounting standard update with a 30-day public comment period, and a proposed effective date coinciding with the adoption of FAS 167 (i.e., January 1, 2010, for calendar year-end companies).

In regard to executive compensation matters, on June 10, 2009, SEC Chair Mary Schapiro commented on executive compensation disclosures in a statement issued by the commission. In her remarks, she noted that the SEC is "actively considering a package of new proxy disclosure rules that will provide further sunshine on compensation decisions." These rules would require companies, among other things, to disclose how the issuer – and its board – manages risk, and analyze how their compensation practices impact risk-taking and the implications for long-term corporate health of the behavior those compensation practices incent. These matters are of particular interest because many believe that the incentive compensation structures of some financial institutions contributed to the current economic crisis by creating incentives that undermined shareholder value over the long term.<sup>40</sup>

In particular, Ms. Schapiro announced that the SEC is considering several proposals requiring greater disclosure:<sup>41</sup>

- About how a company – and its board – manages risks.
- About a company’s overall compensation approach. Incentive structures that rewarded short-term risk-taking without taking into account the potential long-term effects on the company are widely believed to have contributed to the economic crisis.
- About potential conflicts of interest by compensation consultants, including disclosure of relationships between the consultants and the company and their affiliates, so both compensation committees and investors will be better able to assess the advice the consultants provide.
- And about director nominees, including their experience and qualifications to serve on the board or on particular board committees – and about why a board has chosen its particular leadership structure.

Schapiro said the SEC would formally release the proposals in July 2009, and also pointed out that her focus in this initiative was to provide full disclosure to investors on compensation matters and not to set pay scales or to cap executive compensation.

### **39. What are the accounting considerations in regard to the TARP Capital Purchase Program?**

In terms of background, in October 2008, the Treasury Department announced a voluntary Capital Purchase Program as part of the Troubled Asset Relief Program (TARP). The intended purpose of the Capital Purchase Program is to restore liquidity and stability to the U.S. economy by providing equity capital to Qualifying Financial Institutions (QFIs). These QFIs must demonstrate their eligibility to participate in the program, and if accepted, they are permitted to sell preferred stock and warrants to the Treasury in exchange for cash.

The Treasury Department reports that (as of June 10, 2009) the government has invested almost US\$395 billion in 605 banks and other financial institutions under the US\$700 billion financial industry bailout program.

A publicly traded QFI that has sold preferred stock and warrants to the government in exchange for cash must consider certain accounting issues. The QFI receiving funds is required to allocate the proceeds received between the preferred stock and the warrants and must properly classify each instrument in its financial statements.

Proceeds received should be allocated based on the relative fair values of the instruments issued in a manner consistent with the existing guidance for debt issued with detachable warrants.<sup>42</sup> Direct issuance costs should be allocated to the preferred stock and warrants on a similar basis.

In terms of balance sheet classification, the preferred stock generally would be considered equity of the issuer at the time of issuance. It would not be redeemable by the holder (in this case the Treasury), and it does not otherwise meet the existing definition of a liability under GAAP.<sup>43</sup>

In regard to the warrants, while certain provisions in the warrants would appear to require the warrants to be accounted for as liabilities under existing GAAP, in October 2008, the SEC and the FASB jointly provided guidance to the Treasury indicating that they “would not object to a publicly traded QFI accounting for the warrants as permanent equity under GAAP, provided that the QFI issuer has sufficient authorized and unissued shares required for warrant settlement. If the issuer does not have sufficient shares or does not obtain required shareholder approval, permanent equity classification would not be precluded as long as any necessary approvals are obtained prior to the end of the fiscal quarter in which the warrants are issued.”<sup>44</sup>

#### **40. Have any banks announced plans to repay borrowed TARP funds?**

Yes. The Treasury Department announced on June 10 that up to 10 of the nation's largest banks have received approval to repay their TARP funds and are expected to do so. The Treasury Department expects an initial payback from these banks of approximately US\$68 billion of original bailout funds.

The actual timing of the repayments will be left up to the individual banks and the Treasury, which also must consider how to handle the warrants the government received at the time of its initial investment. The warrants gave the government the right to purchase common stock at a stated price for a period of 10 years. The Treasury stated in May that financial institutions will get the right of first refusal on buying back their warrants. If the banks cannot reach an agreement with Treasury on a price, the government may look to potentially sell them at auction to third parties.

While the Treasury did not expect firms to repay TARP funds on such an accelerated basis, specific legislation passed by Congress earlier in 2009, in fact, included an early repayment option. As a condition to receiving governmental approval, financial institutions had to prove they could raise capital without a safety net from the FDIC. Many banks have been eager to pay back TARP funds to demonstrate financial independence to investors. Further, many were unhappy with the significant restrictions that came with the governmental ownership, including restrictions on executive compensation, the ability to declare and pay dividends, as well as engaging in stock buyback activity. For banks to completely rid themselves of governmental restrictions, they must also buy out the Treasury's stake in the warrants. "Until you've basically evened up with the government on the warrants, you're still technically in the program," said V. Gerard "Jerry" Comizio, a former SEC lawyer and now senior partner for banking and financial institutions at Paul, Hastings, Janofsky & Walker LLP.<sup>45</sup>

In regard to the TARP repayments, former Treasury Secretary Henry Paulson weighed in as follows:

Repayment of TARP capital investments is only the beginning of unwinding the broad array of temporary programs in place to support the financial system. The recovery of our capital markets must remain a top priority, as some sectors are still not performing as normal. I look forward to the day when our system and our economy are sufficiently strong that we can end the FDIC debt guarantee, close the Fed's liquidity programs, and resolve the permanent status of Fannie Mae and Freddie Mac.<sup>46</sup>

### **Early Government Responses to the Financial Services Industry**

#### **41. How did the main European public bodies and regulators initially react to the crisis?**

Early reactions to the financial crisis took a variety of forms that can be grouped into two broad categories: emergency and structural responses.<sup>47</sup>

Emergency responses typically were effected on a national level since each crisis was unique to the financial structure of the country, as were the remedies. However, common principles of approach emerged, with various national variations, based on a combination of injecting equity into institutions in return for various commitments, providing liquidity support, guaranteeing retail deposits and underwriting interbank lending.

From very early on in the crisis, various bodies began making recommendations for structural reform, i.e., the steps that need to be taken to make the system more resilient for the future. However, the consensus has been and remains that structural reforms such as changes to capital requirements will need to be coordinated globally.

#### **42. Why did the U.K. government decide to inject capital directly into the U.K. banking system?**

The U.K. authorities determined that the injection of capital directly into the system, along with providing additional loans and loan guarantees to its banks, were necessary to stabilize the market. The U.S. government and other European governments subsequently followed suit.

**43. What conditions did H.M. Treasury impose on the U.K. banks that opted into the government's capital plan?**

The U.K. banks that agreed to participate in the government's capital plan granted the U.K. government a capital stake and will commit to limitations on executive compensation and the payment of dividends until the government's capital is repaid.

**44. Why did the U.S. government nationalize Fannie Mae and Freddie Mac?**

Fannie Mae and Freddie Mac are U.S. government sponsored enterprises (GSEs) that hold more than US\$5 trillion in mortgage-backed securities and debt outstanding and have a market share of more than 80 percent of all new mortgages originated this year. After many months of speculation regarding the entities' ability to fund themselves and maintain acceptable capital levels, the Office of Federal Housing Enterprise Oversight (OFHEO), the primary regulator for Fannie and Freddie, along with the Federal Reserve and the Office of the Comptroller of the Currency (OCC), which were brought in to consult with OFHEO, determined that the mortgage giants were unable to operate safely and soundly to fulfill their critical public mission of stabilizing the residential housing market in the United States. Thus, they placed the two GSEs into conservatorship. This was the biggest bailout and nationalization in history.

**45. What is a conservatorship?**

A conservatorship is the legal process by which a regulator gains full control and oversight of a company to manage its business in a safe and sound manner and to preserve asset and franchise values. Under a conservatorship, all of the powers of the company's directors, officers and shareholders are transferred to the designated conservator.

**46. What is administration?**

Administration is a U.K. process under which the management of a company that may not be able to pay its debts is put into the hands of one or more "administrators" (typically accounting firm partners) who seek to rescue the company as a going concern and will typically try to sell either the business as a whole or parts of it. If this is not possible, the business will be liquidated. The U.K./European operations of Lehman Brothers were put into administration, as was the U.K. subsidiary of Icelandic bank Kaupthing, Kaupthing Singer & Friedlander Limited.

**47. What is the form of support the U.S. government offered to the GSEs?**

Beyond the general statements of support by the U.S. Treasury Department that confirm the GSEs' viability and their pivotal role in the U.S. mortgage markets, the Treasury also announced two forms of liquidity support through December 31, 2009: a secured credit facility and a commitment to purchase newly issued mortgage-backed securities (MBS). The Treasury also agreed to purchase senior preferred stock (up to US\$100 billion, as needed) to provide equity support for the GSEs.

**48. Has the business of the GSEs changed under the conservatorship?**

Fannie Mae's and Freddie Mac's policy role of providing liquidity to the broader mortgage markets has not changed under conservatorship. However, under the covenants of the senior preferred stock purchase agreements, the GSEs face restrictions on the growth of their indebtedness and mortgage assets held in the retained portfolio. These restrictions are intended to reduce the size of the GSEs to limit concerns over future systemic risk.

**49. Why did the U.S. government rescue Bear Stearns but not Lehman Brothers?**

In the Bear Stearns case, the government (1) allowed Bear Stearns to borrow from the Federal Reserve – something that had not been permitted for an investment banking firm since the Great Depression – to avert its sudden collapse and allow time for the sale of the company to JPMorgan Chase, and (2) provided a 10-year loan for US\$29 billion secured by US\$30 billion of Bear Stearns' assets in a limited liability company established for the purpose of holding these assets. The U.S. government defended this transaction based on the perceived systemic risk a collapse of Bear Stearns would have on the market.

The government decided to leave the resolution of Lehman Brothers to the private sector, apparently believing that the consequences of the failure of Lehman as a predominantly wholesale institution would not affect the overall market in terms of systemic risk as profoundly as Bear Stearns or, certainly, AIG.

The Federal Reserve did work behind the scenes to encourage merger talks between Lehman and large global banks. In the end, no other bank reportedly was willing to take on Lehman's problems. Thus, the company declared bankruptcy on September 15, 2008. Since that time, Barclays, Nomura Securities and other parties purchased some Lehman businesses, and others are being managed under bankruptcy.

**50. Why did the U.S. government rescue AIG, which is not a “traditional” banking or investment banking firm?**

The U.S. government elected to step in and rescue AIG because the company essentially was the largest and most significant insurer, or backstop, for financial institutions worldwide. The government's rationale for supporting AIG was to prevent systemic risk. Some estimates suggested that the loss to other financial institutions caused by the failure of AIG would exceed US\$180 billion.

In this rescue, which was amended twice, the U.S. government provided more than US\$180 billion in support to AIG in exchange for an 80 percent stake in the company. In November 2009, Moody's Investor Service predicted that AIG will ultimately be able to repay the government and buy back much of the government's stake.<sup>48</sup>

**51. Why did Morgan Stanley and Goldman Sachs convert to bank holding companies?**

Conversion to bank holding company status allowed Morgan Stanley and Goldman Sachs, as well as a host of other companies that subsequently sought bank holding company status, to access the retail deposit market as well as the Federal Reserve's discount window. Retail deposits are viewed as a much more stable funding than the wholesale funding on which a traditional investment banking or other nonbank financial firm relies.

**52. How are these new bank holding companies affected by their decisions to become bank holding companies?**

In addition to restrictions, such as limitations on executive compensation and dividends, which may have been imposed by the Federal Reserve as a condition of approval, some of the new bank holding companies face divestiture requirements and/or changes in ownership in order to conform to the Federal Reserve's nonbanking activities restrictions. All of the new bank holding companies will be subject to supervision by the Federal Reserve. For some of these companies, the new regulatory regime will be very different from that which they previously experienced. In addition to dealing with a more hands-on regulator, these companies also will be subject to a host of new and different regulatory requirements and supervisory considerations including, but not limited to, the following:

- On-site inspections/assignment of rating
- Restrictions on activities/regulatory approvals
- Restrictions of related transactions
- Regulatory reporting
- Capital adequacy requirements
- Organizationwide information security programs
- Internal audit/financial controls
- Enforcement actions

**53. How was U.S. legislation intended to help address the current financial crisis?**

The Troubled Asset Relief Program (TARP), which was at the heart of the Emergency Economic Stabilization Act of 2008 (EESA), provided US\$700 billion to the Secretary of the Treasury to purchase or guarantee troubled assets (defined as residential or commercial mortgages that were originated before March 14, 2008, any securities or other instruments that are based on or related to such mortgages and were issued before March 14, 2008, and any other instruments as determined by the Secretary of the Treasury after consultation with the Chairman of the Federal Reserve deemed necessary to promote market stability). These assets could be purchased from financial institutions, including banks, savings associations, credit unions, broker/dealers and insurance companies.

Institutions that chose to avail themselves of TARP became subject to limitations on executive compensation and to requirements giving the Treasury Department an economic interest in the institutions.

The Treasury Department was required to issue implementing regulations to operationalize TARP within 45 days of enactment or sooner if the Secretary exercised his authority to purchase troubled assets. In developing the regulations, the Secretary was required to consult with the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Chairman of the National Credit Union Association, and the Secretary of Housing and Urban Development. Ongoing oversight of TARP will be provided by a newly formed Financial Stability Oversight Board, whose members include the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Director of the Federal Housing Finance Agency, the Chairman of the Securities and Exchange Commission, and the Secretary of Housing and Urban Development.

Shortly after the enactment of EESA, the Treasury also indicated that it might use the funds to invest directly in U.S. financial institutions and, indeed, this was how the Treasury Department first used its available funds.

**54. Does TARP authorize or require anything other than the asset purchase/guarantee program?**

In addition to the asset purchase/guarantee program, the following are among the other provisions included in TARP:

- Provides for an increase, until December 31, 2009, in deposit insurance coverage from US\$100,000 to US\$250,000.
- Authorizes the SEC to suspend the mark-to-market accounting standards of FAS 157 for any issuer or class of transactions if the SEC determines that such suspension is in the public interest.
- Requires reports to Congress by the Secretary of the Treasury and the special Congressional oversight committee mandated by TARP on the state of the U.S. regulatory system and adequacy of existing public disclosure for financial institutions, along with recommendations for enhancement.
- Establishes a new office, “The Office of Financial Stability established within the Office of Domestic Finance in the Department of the Treasury.” This is headed by a new Assistant Secretary.
- Establishes a Financial Stability Oversight Board responsible for “reviewing the exercise of authority under a program developed in accordance with this Act ...”
- Requires the Comptroller General of the United States to study and report by June 1, 2009, on the role of leverage as a factor in the current crisis.

**55. What oversight is there of the U.S. Treasury’s activities under TARP?**

The Treasury Secretary is required to submit periodically to Congress detailed reports on all financial transactions and the “types of parties involved.” In addition, every quarter, a specially appointed inspector general will provide Congress with a report including all purchases made and income received from government’s investments. The most recent IG report, which was issued in October 2009, remained critical of the TARP program.

**56. How do the provisions of TARP apply to U.S.-based operations of foreign banking organizations?**

Based on information currently available, it appears that U.S. branches and agencies, U.S. banks, and U.S. nonbank subsidiaries of foreign banking organizations are eligible to participate in the TARP Asset Purchase and TARP Guarantee programs, but are excluded from the TARP Capital Purchase program.

**57. Since the initial focus of TARP was on the purchase of troubled assets, why did the U.S. Treasury Department decide to use available TARP funds for other purposes?**

Amid continuing market turmoil after the passage of the U.S. legislation, the U.S. Treasury determined that direct investment, through the TARP Capital Purchase Plan, was necessary to stabilize the market, even though it initially had signaled that this was not a course of action it favored.

**58. Was participation in the TARP Capital Purchase Plan voluntary for U.S. banks?**

In theory, participation is voluntary; however, it has been reported that the U.S. government used moral suasion to encourage the country's nine largest banks to participate in the Capital Purchase Program as a show of support. Most of these banks repaid their TARP funds in mid-year 2009.

The United States' approach differs from that of some other countries. In the United Kingdom, for example, two of the country's largest banks, Barclays and HSBC, have opted, without the objection of the government, not to participate in the government's capital program, instead choosing, as necessary, to raise capital on their own, which they would suggest is a sign of strength. In fact, there now are some stronger, albeit smaller, banks in the United States that are signaling they do not plan to participate in the program.

**59. How will the preferred stock acquired by the U.S. Treasury Department in U.S. banks be treated for capital adequacy purposes?**

The Federal Reserve Board announced the adoption of an interim final rule that will allow bank holding companies to include in their Tier 1 capital without restriction the senior perpetual preferred stock issued to the Treasury Department under the capital purchase program announced by the Treasury on October 14, 2008. The other U.S. bank regulators are expected to promulgate similar rules.

**60. What is LIBOR and why is it important?**

LIBOR, the London Interbank Offered Rate, is the interest rate that the most creditworthy banks around the world charge each other for loans. LIBOR is important because it is used as the base for pricing variable-rate government and corporate loans and derivative-based products such as credit swaps.

**61. What is an OIS rate?**

The OIS rate is the fixed rate of interest that an investor receives on the notional value of an overnight indexed swap (OIS).

**62. What is the LIBOR-OIS spread and why is it important?**

The LIBOR-OIS spread is a comparison between LIBOR and the OIS rate and is considered a good summary indicator of liquidity in the market. When the spread increases, it means that banks believe that the other banks they are lending to have a higher risk of defaulting, so they charge a higher rate to offset this risk. When the spread decreases, it means that banks are less concerned about the possibility of default of the banks to which they are lending.<sup>49</sup>

**63. Why don't the interest rates charged by banks reduce as quickly as "official" central bank rates?**

Banks traditionally have relied on retail depositors and wholesale sources of funding rather than central banks as their principal sources of funding. These wholesale and retail funding sources are still in short supply relative to the needs of banks and other lending institutions. Prior to the credit crunch, banks were also big issuers of debt through a securitization process whereby they bundled and sold their loans to investors to free-up capital for new lending. This source of funding has all but dried up in most markets. Banks also seek to fund themselves over a variety of different terms, ranging from overnight to 15 years or more. Banks are not seen to be as attractive a long-term risk as they were before the credit crunch. Therefore, the return sought by longer-term investors in banks (including governments and other banks) is high and is likely to remain so relative to the rates of the central banks until the weaknesses investors perceive in the banking sector have been remedied. Since it would be unprofitable for banks to lend to customers at a rate lower than the costs to banks to borrow money to lend, banks' funding costs will remain high relative to central bank rates until confidence in the banking sector returns.

**64. Are the actions that have been taken by governments around the world a bailout of the financial services industry and the individuals who managed these companies?**

Many people undoubtedly consider the actions taken to be a bailout of the industry and its management. This concern, for example, was the basis for the U.S. House of Representatives' defeat of the Emergency Economic Stabilization Act of 2008 legislation when it was first considered in late September 2008. However, the U.S. Congress and other governments ultimately believed that the drastic actions taken

were necessary to prevent the crisis from spreading further, to dispel depositors' concerns over the security of their money, and to encourage loosening of the credit markets. As the situation has evolved, the United States and other governments have explored ways such as capping compensation to ensure that management of companies receiving government funds pay a price for government assistance.

## **Impact Beyond the Mortgage Market**

### **65. Has the crisis spread to loans other than mortgage loans?**

The crisis has spread to all lending sectors. In particular, the impacts on the liquidity markets interrupted the availability of credit for some credit card issuers in late 2008 and into early 2009. Since then, we have seen the liquidity markets stabilize, although some liquidity vehicles have experienced continued higher pricing even following the initial impacts – this affects interest rates that are offered to credit card consumers, causing them to be higher. Credit card delinquencies and default rates have reached historic levels for large credit card issuers, and they are expected to remain at these levels as high unemployment continues.

### **66. What impact have the economic conditions had on consumer credit?**

The availability of consumer credit has been impacted significantly. Additionally, interest rates offered for unsecured consumer lending have generally increased. The higher interest rates charged and the tightening of underwriting standards for unsecured consumer credit have resulted in less credit availability. The Federal Reserve monitors the level of consumer credit in the United States. In November 2009, the Fed reported that consumer credit decreased at an annual rate of 6.0 percent for the third quarter of 2009, and decreased in September 2009 at an annual rate of 7.25 percent.

### **67. Why is credit card debt of particular concern?**

With declines in real estate values and the loss of home equity as a source of funds, consumers increasingly are turning to credit cards as the only available means for maintaining purchasing power. Credit card debt has increased, and as the economy continues to deteriorate, credit card delinquencies have continued to be high. Although some credit card issuers recently have seen flattening of delinquencies and default rates, these rates remain at higher levels than experienced a year ago. The tightened availability of credit cards will continue to limit and restrict consumers' purchasing power.

### **68. How much credit card debt is outstanding?**

Notwithstanding significant growth in the credit card market in a number of emerging economies, consumers in the United States remain the world's biggest users and holders of credit cards. Credit card firms in the United States manage approximately US\$1 trillion in debt, of which a significant portion is estimated to be owed by subprime borrowers.<sup>50</sup>

### **69. Are there similarities between credit card debt defaults and mortgage loan defaults?**

Credit card debt, similar to mortgage debt, is sold to investors in the form of asset-backed securities. The more consumers default on their credit card debt, the more investors experience losses. Dissatisfied holders of credit card debt begin to move away from these asset-backed securities, much like the situation with mortgage-backed securities. As a result, lenders are less willing to extend credit to consumers. Although some banks are able to compensate for defaults on mortgages through foreclosure on the real properties, credit card defaults generally result in a 100 percent default on the amount owed.

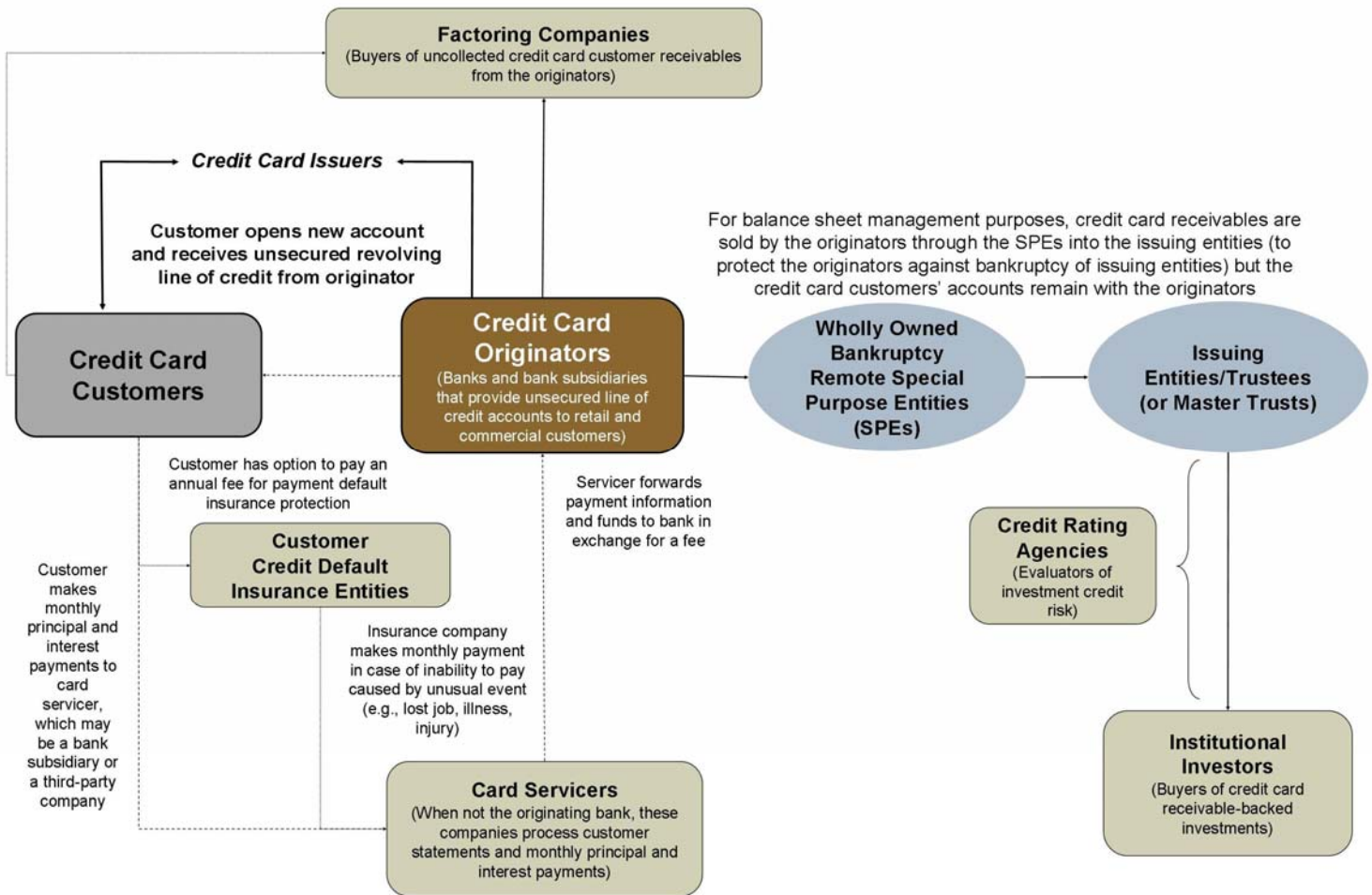
### **70. Who are the major players in the credit card industry?**

Apart from credit card holders, the other major players in the process are:

- Customer credit default insurance entities
- Credit card originators
- Factoring companies
- Card servicers
- Credit rating agencies
- Institutional investors

The following chart depicts how the various players interact.

## Credit Card Market



### 71. What is the impact on consumers of the growing concerns about credit card debt?

Consumers are being impacted in a number of ways, including:

#### 1) Tighter underwriting standards

Credit card companies respond to rising delinquencies and charge-offs by making it harder for consumers to access credit. Customers who pose a higher risk – late payments, low credit scores – may find it difficult to obtain or retain credit cards. Tighter underwriting standards were adopted by most credit card issuers, although recent surveys indicate that the tightening of these standards may have abated for a period of time.

#### 2) Reduced credit lines

Credit card companies continually track customers' card activity, credit scores and other debts, using complex algorithms to predict the risk of a customer becoming delinquent. When a customer is flagged as an increased risk, lenders take steps to protect themselves. Historically, the most widely used tactic to address this risk was to increase a customer's interest rate. Through a practice called "universal default," a credit card company could increase the customer rate even if he/she always paid the company's bills on time but was late on a payment with another bank's account. In the United States, largely in response to public outcry and because of increased consumer protection legislation such as the Credit Card Accountability, Responsibility and Disclosure Act of

2009, which takes effect in February 2010, universal default and other credit risk management practices have largely been discontinued by most credit card issuers. Accordingly, Congress is taking a closer look at credit card practices that have not yet been addressed by recent legislation, and credit card companies are turning to other options, such as reducing the amount of credit they extend. By some estimates, the U.S. credit card industry is projected to continue to pull back available lines of credit, thus further reducing already limited available consumer credit.

### 3) Enhanced collections efforts

The collections industry may be the only beneficiary of the growing problems in the industry. Collectors acquire past-due accounts from credit card companies and keep a portion of each dollar they collect. How soon an account is sold to a third-party collections agency varies by lender, but as delinquencies rise, lenders are increasing their collection efforts, including the passing along of delinquent accounts much sooner. By selling their receivables to collectors, lenders cut the costs of servicing a debt that they may not be able to collect anyway.

## **72. Did banks tighten their underwriting standards?**

The most recent *Senior Loan Officer Opinion Survey on Bank Lending Practices* in the United States, which was released by the Federal Reserve in October 2009, showed that domestic banks continued to tighten standards and terms over the last three months on all major types of business and consumer loans, although the net percentage of banks that tightened standards and terms continued to decline from the peaks reached in 2008. Survey respondents reported a weakening for nearly all types of loans.

## **73. How significantly did the financial crisis impact the mutual funds industry?**

According to an article published in the *Financial Times* on January 1, 2009, investors in 2008 withdrew a net of US\$320 billion from mutual funds (excluding money market funds), 73 percent in equity funds and the remainder in bond funds.<sup>51</sup> The total withdrawals set a record in terms of both dollar value and percentage of assets. The beneficiaries of these withdrawals were money market funds, which registered inflows of more than US\$420 billion during 2008, as well as bank deposits, which also increased during the year.

## **74. What has been the effect of the financial crisis on hedge funds?**

As with every other segment of the financial services industry, hedge funds have been affected by the financial crisis. In fact, there are estimates that as many as half of the 10,000 funds that existed earlier this year could fail or be wound up within a year's time as assets under management by hedge funds continue to decline dramatically.<sup>52</sup>

## **75. What was the impact of the crisis on the municipal bond market?**

The municipal bond market has been seriously impacted by the crisis. In early April 2009, Moody's Investor Service assigned a negative outlook to the creditworthiness of all local governments in the United States. This is the first time Moody's has ever issued such a blanket report on municipals. The market, apparently unsurprised by Moody's action, seemed to take the news in stride.<sup>53</sup>

## **76. Have government actions had any impact on the credit markets?**

The financial crisis resulted in a significant slowdown, if not a freezing, of credit markets around the world. Credit spreads widened substantially and hit record levels in October 2008. This, in part, prompted central banks and governments around the world both to inject additional liquidity into the financial system and to cut interest rates. As of mid-November 2009, the LIBOR-OIS spread was 0.1 basis points (down from 365 basis points in October 2008).<sup>54</sup> The narrowing of the spread to pre-2007 levels is not necessarily viewed as a positive development, leading some, including former Federal Reserve Governor Laurence Meyer, to caution that investors may be underpricing market risks.<sup>55</sup>

## “Toxic Assets”

### 77. What are “toxic assets”?

There is no single agreed-upon definition of “toxic assets.” The term is often used to refer to the U.S.-based subprime mortgages and collateralized debt obligations that are at the center of the financial crisis – loans that are now nonperforming and securities that are too illiquid to value. However, other countries define the term more broadly to include assets collateralized by mortgages in their national markets.

### 78. How much in “toxic assets” are on the books of global financial institutions?

A forecast by the IMF suggested that “toxic assets” could reach US\$4 trillion dollars – US\$3.1 trillion in U.S.-originated assets and US\$900 billion in assets originated in Europe and Asia. This represents a significant increase over prior estimates and reflects continued degradation of loan portfolios beyond subprime mortgages into prime mortgages, commercial loans and credit cards.<sup>56</sup>

### 79. Why were governments seemingly slow in dealing with “toxic assets”?

Perhaps the biggest challenge faced by governments in attempting to remove “toxic assets” from the balance sheets of financial institutions has been how to value these assets. Another contributing factor that many have considered important is the impact of fair value accounting on the valuation of these assets.

### 80. What steps has the United States taken to deal with “toxic assets”?

On March 23, 2009, the U.S. Treasury announced a framework for a Public-Private Investment Program (PPIP) to purchase “legacy” assets (a nice name for “toxic assets”) from U.S. financial institutions. Government funding for the program will be drawn from TARP and will be leveraged with private capital. The Treasury estimates that the combined government-private sector buying power will be in the range of US\$500 billion to US\$1 trillion. This program solves the above-mentioned problem of valuing these assets by (1) subjecting loans to an auction process with final price determined by the highest bidder, and (2) allowing for a dollar-for-dollar government fund match for private sector investment in securities. (Additional details on the PPIP can be found in Protiviti’s Financial Crisis Bulletin entitled “The Public-Private Investment Program: Private Party – Public Money.”)

The FDIC’s first PPIP transaction was announced in September 2009.

### 81. Did other countries adopt plans to deal with “toxic assets”?

The United Kingdom, the Netherlands and Germany have suggested plans.<sup>57</sup> The U.K. and Dutch models would offer insurance or a guarantee against losses on impaired assets. The German plan would create a “bad bank” into which German banks would transfer their bad assets. Switzerland has not adopted a national plan, but it did set up a government fund to deal with the “toxic assets” of UBS. To the disappointment of some industry observers, at its April meeting in London, the G-20 failed to come to any specific agreement on how to deal with “toxic assets,” despite statements from the likes of IMF Managing Director Dominique Strauss-Kahn that IMF’s experience suggests the economy “never recover[s] before the cleaning up of the banking sector has been done.”<sup>58</sup>

## Beyond the Financial Services Industry

### 82. Is it only financial services companies that have been impacted by current market conditions?

The current crisis in the financial services industry has affected all sectors of the economy. With financial institutions having their own liquidity problems, the availability and cost of borrowing for other companies likewise have been impacted adversely. In mid-year 2009, it was reported that investment-grade borrowers were paying interest rates equivalent to what junk bond issuers paid a year earlier. Particularly hard hit have been the retail, airline and automotive industry sectors, which were experiencing some financial problems even before the current crisis unfolded.

### **83. What makes some industries more vulnerable to the crisis than others?**

A *Forbes* magazine article focused on five variables: leverage (i.e., a company's debt-to-equity ratio), interest coverage, sales growth from 2005 to 2007, pretax profit growth for the same period, and cash cushion.<sup>59</sup> The article identified the following 15 industries as vulnerable in the current environment:

- Wood product manufacturing
- Motor vehicle and parts dealers
- Credit intermediation and related activities
- Traveler accommodations
- Gas stations
- Non-Internet broadcasters
- Truck transportation
- Nonmetallic mineral product manufacturers
- Rental and leasing services
- Printing and related services
- Real estate
- Nursing and residential care facilities
- Merchant wholesalers/durable goods
- Transit and ground passenger transportation
- Forestry and logging

### **84. Have there been any U.S. governmental actions directed at assisting companies outside of the financial services industry?**

In early October 2008, the Federal Reserve authorized a commercial paper funding facility (CPFF), which became available on October 27, 2008, and was intended to cease on April 30, 2009. The CPFF is intended to improve liquidity in short-term funding markets and increase the availability of credit for businesses and households.

Under the CPFF, the Federal Reserve Bank of New York will finance the purchase of unsecured and asset-backed commercial paper from eligible issuers through its primary dealers. The CPFF will finance only highly rated, U.S. dollar-denominated, three-month commercial paper.

Governments globally have undertaken a variety of actions to try to address the effects of the economic crisis. These have included, but are not limited to, guaranty programs for deposits and mutual funds, prohibitions against short-selling of financial company shares, loan guaranty programs for small businesses and other affected industry sectors, and direct capital injections into financial companies and companies in other hard-hit sectors.

### **85. How does the U.S. \$787 billion plan rank among other U.S. government programs or initiatives?**

To put the United States' \$787 billion stimulus plan into perspective, as of June 2009:<sup>60</sup>

- It represents 5.5 percent of the U.S. economy.
- It represents 27 percent of the total outlays by the U.S. government in 2008.
- It is approximately 1.3 times the cost of the Iraq war so far.
- It is about 1.7 times the size of the largest U.S. budget deficit, which was recorded in 2008.
- It is, in terms of GDP, slightly larger than the 1947 Marshall Plan and comparable in size to Roosevelt's New Deal.
- It is about US\$116 for every person on the planet.

### **86. How many countries have enacted stimulus plans?**

Sources suggest that 30 to 40 countries globally enacted financial stimulus plans. Early in 2009, the investment bank UBS estimated that these plans collectively equaled approximately 2.8 percent of the world's gross domestic product.<sup>61</sup> This was before new plans were announced by, among others, China, Japan and Taiwan. In addition, it is important to note that in many countries, governments have spent as much as the size of their stimulus plans, if not more, on financial rescues, including the recapitalization of banks and guarantees for troubled assets.<sup>62</sup>

### **87. How important is global coordination to solving the crisis?**

There is a consensus that failure to coordinate on fiscal plans will open the door to forms of protectionism that are not in the best interest of the global economy.

### **88. What issues have been considered key to solving the crisis?**

With respect to the global financial crisis, the G-20 leaders have focused broadly on five issues: (1) the need to recapitalize banks and get credit flowing again; (2) restoring growth and jobs through stimulus plans; (3) strengthening financial supervision and regulation; (4) strengthening international financial institutions (e.g., the World Bank, IMF) to allow them to continue to support the developing world; and (5) resisting protectionism and promoting trade and investment.<sup>63</sup>

### **89. How has the financial crisis affected the U.S. dollar's role as the world's main reserve currency?**

Despite many predictions in the earlier days of the economic crisis that the U.S. dollar would lose its role as the world's designated reserve currency, it has surged against most major currencies in recent months. This may seem ironic and counterintuitive to anyone who recalls how previous financial crises devastated local currencies. The explanations provided for this phenomenon are varied, but most seem to hinge on a combination of the theory of lesser evils – there is just nowhere else to invest that is not also suffering the impact of the crisis. There is a view that since the U.S. dollar was the first to fall, it will be the first to recover, and there also is a concern that the European response has not been coordinated, thereby adversely affecting the euro.<sup>64</sup> More recently, however, there are signs that the USD reserve-currency system may be fraying with the call by China for consideration by the United Nations of a new global reserve currency.<sup>65</sup>

## **Regulatory Reform for the Financial Services Industry**

### **90. Did the financial services regulatory system fail?**

Many parties share blame for the current problems. The objectives of most regulatory frameworks are, among others, to protect customers and ensure stable and orderly markets. Current events suggest the regimes are found wanting. Undoubtedly the actions of governments, central banks and regulators will be scrutinized heavily over the coming weeks and months, but the business and funding models adopted by certain companies in various jurisdictions, their cultures and behaviors of senior management within them also will be the subject of debate and possibly legal action. Reform of the global regulatory system itself will need to be considered carefully in order to avoid further unintended outcomes.

### **91. What type of regulatory reform is being suggested to address the financial crisis?**

Suggestions for regulatory reform include, but certainly are not limited to:

- Enhancing regulatory oversight for systemically significant institutions
- Reforming capital rules/revising Basel II
- Reinstating previously used standards, such as prescribed levels of liquidity
- Limiting dependence on wholesale funding
- Limiting leverage, in various ways
- Regulating hedge funds more directly
- Instituting limitations on compensation
- Changing accounting rules
- Establishing minimum requirements for risk management
- Enacting additional consumer protection laws
- Supervising credit rating agencies
- Broadening use of stress testing and scenario analysis to test the ability of financial organizations to deal with extreme conditions and events regardless of likelihood

Myriad regulatory reform proposals have been proffered by regulators and other interested parties across the globe. Some of the more noteworthy among these include: the January 2009 Report of the Group of Thirty ("Financial Reform, A Framework for Financial Stability")<sup>66</sup>; the de Larosière (European Union)

Report, also issued in January 2009<sup>67</sup>; the report of the Turner Commission in the United Kingdom in March 2009<sup>68</sup>; the four reports issued by the Financial Stability Forum (FSF) in April 2009 in preparation for the April G-20 summit in London<sup>69</sup>; and the Obama administration's reform proposals released in the summer of 2009 and now being debated and modified by committees of the U.S. House of Representatives and the U.S. Senate.

## **92. Are changes needed in existing capital rules to protect banks?**

An article in the *Financial Times* in 2008 suggested several flaws in Basel II:<sup>70</sup>

- Reliance on internal risk models to determine capital requirements in instances where banks may be overly optimistic about their risk exposures
- Lack of non-risk-weighted leverage ratios (The United States, unlike its counterparts in Europe, does limit the leverage ratio.)
- Lack of adequate market discipline, which could be addressed through the issuance of uninsured subordinated debt

Others add that an additional area for improvement would be to take a more forward-looking rather than historical approach to determining risk and to encourage higher buffers of capital (the difference between the "required" and the "desired" level of capital) to provide a cushion in difficult times. This point, among others, was noted in the Group of Thirty's January 2009 report entitled *Financial Reform, A Framework for Financial Stability*.

## **93. Will Solvency II, which is still in the making, need to change in light of recent events?**

Recent events have thrown into doubt key principles underlying Solvency II, such as the fair value of both assets and liabilities, while confidence in the reliability of internal capital models also has been severely undermined. Members of the European Parliament and the European Commission, as well as local regulatory authorities, have gone on record saying that Solvency II foundation principles will not change and that the directive is still on track for implementation in 2012. However, regulatory authorities increasingly are emphasizing the importance of Solvency II ownership at the board and senior management levels within insurance firms, while emphasizing the need to overhaul governance arrangements together with the crucial importance of stress and scenario testing focusing on macro events and not historic data such as the one in a 200-year event. This said, it could be possible that forthcoming Solvency II implementing measures are more rules-based than originally anticipated.

## **94. Is the crisis likely to impact the application of the Market in Financial Instruments Directive (MiFID) in Europe?**

Not directly. MiFID is concerned mainly with enhancing the European single market in securities trading and in ensuring minimum standards of investor protection across Europe in relation to sales and trading practices. It does not cover capital, solvency or liquidity rules, or – in any detail – risk management requirements. These are dealt with by the separate revised Capital Adequacy Directive, based on Basel II. However, the impact of consolidation of major banking and securities players on competition, new perspectives on the suitability and appropriateness of complex securities for investors, counterparty risk as a relevant factor in choice of execution venues, and the MiFID requirements on internal control, compliance management and conflicts of interest are all examples of MiFID issues that will need to be reconsidered in light of the consequences of the current financial crisis.

## **Impact on the Automotive Industry**

### **95. What caused the current crisis in the automotive industry?**

In the United States, the Big Three auto companies faced market challenges well before the current global financial crisis. For example:

- **Product mix** – Market demand for sport-utility vehicles (SUVs) and trucks drove the Big Three to focus on those higher-margin vehicles, rather than midsize and compact cars or alternative fuel vehicles, which became more popular once gas prices began to escalate. In addition, the Big Three are perceived to be slower to bring new vehicles to the market than some of their international competitors.

- **Labor costs** – The majority of Big Three operations are unionized and the United Auto Workers (UAW) has successfully negotiated a number of generous fringe benefits, including pension and health benefits, over the years. With a ratio of retirees to active workers well above 1:1, the Big Three carry high legacy labor costs. Therefore, while the hourly wage rate may be on par with competitors, the total labor cost is higher.
- **Market** – Relatively cheaper models are available from non-U.S. companies, either as direct imports or as “transports” (foreign vehicles manufactured in the United States). Competitors have effectively marketed a perception of higher quality and better reliability, and consumers have responded. In the past 10 years, the Big Three experienced a decline in market share from 70 percent in 1998 to 53 percent in 2008, according to data published by *Fortune* magazine.

Prior to the onset of the current economic crisis, the Big Three had begun restructuring efforts to address these issues, including workforce reductions, portfolio changes and renegotiated contracts. However, in 2008, the automotive industry’s challenges were exacerbated by two factors:

- A surge in gas prices to more than US\$4/gallon caused a significant and immediate drop in demand for higher-margin SUVs and trucks. Consumers quickly changed their focus to smaller cars or alternative-fuel vehicles.
- The subprime mortgage meltdown creating the current financial crisis affected the appetite and capacity of consumers to purchase new vehicles. A car is typically the second biggest purchase for consumers after a house, so reduced market confidence drove consumers to rein in such big-ticket purchases. Active buyers remaining in the market found that credit was not always available from the automotive companies’ financing arms or banks, thereby limiting their abilities to purchase new vehicles. As a result, annualized sales fell 35 percent, from 16.4 million units in 2007 to 10.6 million units in 2008, based on sales through December 31.

With diminishing access to credit to complete existing restructuring plans, falling stock prices and significantly reduced sales, the Big Three burned through a combined US\$25 billion in cash flow in the third quarter of 2008 and liquidity became the primary focus.

#### **96. How significant is the impact of the automotive crisis in the United States?**

The current industry pressures have reached into historically strong automotive companies, as even the world’s largest automaker, Toyota, reported its first-ever operating loss in its 70 years of operation, close to US\$4.7 billion for the year ended March 31, 2009.

Estimates have varied widely, but the reach of the automotive industry is deep:

- Approximately 3 million (or one out of every 10) jobs in the United States are tied to the automotive industry.
- Approximately 3 percent of U.S. economic output is generated by the automotive industry.
- Approximately 20 percent of the national manufacturing sector is tied to the automotive industry.

These numbers include automotive manufacturers as well as tiers of suppliers, dealerships and aftermarket businesses, including parts and services.

Furthermore, the reach is broad. The current economic crisis is impacting consumers, manufacturers, suppliers, dealers and aftermarket businesses across Europe and the Asia-Pacific region, with decreased sales and capital driving restructuring plans worldwide. U.S. and non-U.S. automakers share many of the same suppliers, and the supply chain is under severe financial stress.

Based on the continued downside in demand, there is considerable concern about a number of Tier 1 suppliers that directly supply all three Detroit automakers. When considering their support of Tier 2, Tier 3 and beyond suppliers, a recent report estimated that several hundred U.S. suppliers would be at high risk of failure. Indeed, a number of suppliers have filed for bankruptcy in 2009 to date, including Visteon, Metaldyne, Foamex and Noble International.

In mid-March, GM announced a program to pay Tier 2 suppliers directly, rather than waiting up to 60 days for payments from the Tier 1 buyers, a common industry practice. While orders are down significantly over the last several months, the program should help both Tier 1 and Tier 2 suppliers by relieving some of the pressure on Tier 1s and expediting payments to Tier 2s to improve cash flow.

In early April, the U.S. Treasury announced a program whereby suppliers could qualify for up to US\$5 billion in federal aid to ease cash flow concerns. Suppliers must apply with the automakers to participate and, if approved, the automakers must then pay 5 percent of the requested funds into the supplier bailout program. Suppliers can benefit from this program by either being paid faster than normal payable terms for parts already delivered (for a 3 percent fee) or using the funds to guarantee their receivables as collateral for loans.

#### **97. How have U.S. automakers responded in light of current industry conditions?**

To respond to the market challenges over the last several years, the Big Three had taken action to restructure through production cuts, plant closures, layoffs, and promotions and incentives to spur sales.

In light of increased fuel prices and the economic crisis hitting in 2008, the industry needed capital funding to retool factories to produce more fuel-efficient cars, as well as short-term liquidity for operations to weather the current crisis. The Big Three presented their restructuring plans to Congress in December to support their requested “bridge loans” for ongoing operations. These plans included:

- Cutting capital expenditures
- Reducing their workforce, including white-collar positions
- Seeking additional labor concessions, particularly around health benefits funding and payments to laid-off workers
- Temporarily closing or idling plants, with certain plants shut down through early February
- Closing dealerships (a challenge due to state laws that protect dealerships)
- Selling divisions to help rationalize the number of brand offerings
- Changing their fleets to offer smaller, more fuel-efficient and alternative-fuel vehicles by 2012, including regular hybrids, plug-in hybrids, battery electric and flex-fuel cars

General Motors asked for US\$18 billion in loans for ongoing operations and US\$3.6 billion for Department of Energy funds to retool factories to make more fuel-efficient vehicles. Chrysler said it needed a US\$7 billion bridge loan and US\$8.5 billion from the Energy Department to retool plants. Ford has not requested current funds, but has sought a US\$9 billion line of credit from the government to access funding if needed in the future, as well as a US\$5 billion loan from the Energy Department.

#### **98. What federal financial aid was extended to the automotive industry and under what terms/conditions?**

In response to the surge in oil prices in 2008, a resolution was enacted on September 30 for up to US\$25 billion of Department of Energy low-cost loans to help automobile and parts manufacturers with the cost of retooling, expanding or building facilities to produce advanced-technology cars and parts.

With the continued downturn in the economy in October, a U.S. Senate hearing was held on November 19 to discuss an additional request by the Big Three for US\$25 billion in bridge loans to sustain operations in light of liquidity concerns. However, under intense questioning and criticism of the auto executives, a Senate vote was deferred.

On December 2, the Big Three submitted to Congress their plans outlining the steps they believe they need to take to make their companies viable, including cutting executive pay, reducing the number of brands and refinancing company debt. The request now totaled US\$34 billion in bridge loans. Congress drafted a package requiring certain stipulations for aid, including designating a “car czar” to oversee the Big Three restructuring efforts, restricting executive bonuses, prohibiting golden parachute packages and requiring the divestiture of company aircraft. By December 11, the House had passed such a bill, but the Senate did not, thus forcing any aid assistance to come from the Executive Branch.

On December 19, President Bush announced a US\$17.4 billion bailout package, consisting of US\$13.4 billion in short-term financing for General Motors (US\$9.4B) and Chrysler (US\$4B), with an additional US\$4 billion available to General Motors in February, contingent on a second round of TARP funds being approved by Congress. The low-interest loans are for a period of three years.

The companies were required to use the funds to become “financially viable” by March 31, 2009. “Financially viable” means that a company has positive net present value, taking into account all current and future costs, and can fully repay the government loan. If a company was not deemed financially viable by March 31, the loan would be called and all funds returned to the Treasury. The companies were required to submit plans to achieve and sustain long-term viability by February 17, 2009.

The loans carried various terms and conditions, including:

- Warrants for nonvoting company stock to the U.S. Treasury equal to 20 percent of the federal loan amount
- Limits on executive compensation and elimination of perks such as corporate jets
- Debt owed to the government that would be senior to other debts
- Right to the government to examine the company’s books and records
- Reporting of and power of the government to block any large transactions (over US\$100,000)
- Compliance with federal fuel-efficiency and emissions requirements
- No payment of dividends while the company owes the government money

The following targets were also outlined for the companies to achieve:

- Reduce debt by two-thirds via debt-for-equity exchange.
- Make half of Voluntary Employee Benefits Association (VEBA) payments in the form of stock.
- Eliminate the job bank, which under current union agreements requires continued payments to laid-off workers.
- Implement work rules competitive with “transplant” automotive manufacturers by December 31, 2009.
- Institute wages competitive with “transplant” automotive manufacturers by December 31, 2009.

The above targets could be waived by the White House, but the company must explain why such targets should be waived and make the business case to achieve long-term viability, despite any waiver.

The companies also were required to conclude new agreements with other major stakeholders (including dealers and suppliers) by March 31, 2009, as part of their viability plans.

### **99. How did the automakers propose to restructure to achieve long-term viability and repay the government loans?**

Chrysler and General Motors submitted plans to the Presidential Task Force on Autos in late February, detailing the actions each company would execute to return to profitability, the additional government loans needed to achieve the plan and the expected repayment timing on these working capital loans.

Chrysler’s plan noted the company would require a total of US\$9 billion in loans (inclusive of the US\$4 billion received to date) because of continued decline in estimated annual units during the first quarter of 2009. Key action items to return to profitability include:

- A robust product plan, including 24 launches in 48 months and the introduction of electric vehicles to help meet current federal fuel economy standards, and the elimination of three existing models in 2009: the Chrysler Aspen and PT Cruiser, and the Dodge Durango.
- Reduction of 3,000 employees, reducing 100,000 units of production capacity, reducing a manufacturing shift, cutting fixed costs by US\$700 million, and selling US\$300 million in “non-earning assets” in 2009.
- Concessions from the United Auto Workers (UAW) union, dealers, suppliers and second lien lenders. These concessions have been implemented or fundamentally agreed upon, including signed terms sheets with the UAW agreeing to work toward a reduction in retiree healthcare costs.
- The Chrysler plan was based on being viable as a stand-alone company versus dependent on alliances. However, the company was proceeding with an alliance with Italian automaker Fiat SpA to

leverage fuel-efficient technology and improve its portfolio of small cars. The company stated it would also explore other partnership opportunities, if necessary.

While Chrysler reported a net loss of US\$8 billion in 2008 on net revenue of US\$47.6 billion, the company said it expects to post a profit in 2010, and payback of the government's working capital loans with a premium would begin in 2012.

General Motors' plan noted a need for a total of US\$30 billion in government loans, or an additional US\$16.6 billion in loans and credit lines in addition to the US\$13.4 billion granted, in order to weather the continued auto sales downturn. Key action items to return to profitability include:

- Eliminating a total of 47,000 jobs globally in 2009, including cuts already announced, equaling approximately 19 percent of GM's total workforce. The company expects to have 72,000 hourly and salaried workers in the United States by 2012, down from 92,000.
- Plans to close another five U.S. factories for a total of 14 closed, bringing the number of its plants to 33 by 2012.
- Product portfolio reductions from 48 vehicle models to 36 models by 2012, as well as five new vehicle launches by 2012, with rollout of the Chevrolet Volt electric car to remain on track for 2010. Chevrolet, Cadillac, Buick and GMC will remain key brands, while Pontiac will become a niche brand. The company seeks to sell or spin off the Saturn division or will wind down production of Saturn models by 2011 if no buyers emerge by March 31. GM's plan includes seeking aid from other countries with local GM operations, including the Swedish government's support of Saab.
- Plans to reduce the number of dealerships by 25 percent, from 6,246 in 2008 to 4,700 in 2012.
- As required by the government's loan conditions, the company was still working to restructure US\$27 billion of debt with its bondholders by the March 31 deadline. GM was also negotiating with the UAW to lower labor costs and pay up to half of a US\$20 billion retiree healthcare liability in stock instead of cash by the March 31 deadline.

By implementing these changes, GM planned to begin repaying the government loans in 2012 and fully repay such amounts by 2017. In March 2009, GM also announced that it would not need US\$2 billion in government loans previously requested for March to fund operations at this time, due to the cost-cutting measures taken to date starting to take positive effect.

#### **100. How has the U.S. government responded to the automakers' restructuring plans?**

The new Obama administration was tasked with critical decisions impacting the industry going forward. The president has focused on and is supportive of alternative energy sources and higher fuel economy standards. He inherited the existing bridge loan package and would make the "financial viability" decision based on the automakers' March 31 restructuring plans, balancing his vision for the automotive industry with the needs of the auto manufacturers, unions, dealerships, debt holders, suppliers and other auto-related groups, as well as the needs of the broader economy.

In February, instead of naming a single "car czar" with broad oversight powers, the administration announced that a government task force would be formed to restructure the auto industry. The Presidential Task Force on Autos is comprised of members across various government departments, including the departments of Treasury, Transportation, Energy, Labor and Commerce. The panel is co-lead by Treasury Secretary Timothy Geithner and National Economic Council Director Lawrence Summers. Since its formation, the Task Force has had to get up to speed quickly in order to determine the best strategy for the future of the auto industry, as it assessed the restructuring plans for long-term viability to ensure repayment of the government loans.

At the end of March, the president unveiled his administration's plans for ongoing aid to the industry. Overall, the Task Force stated that the restructuring plans were not "sufficient to justify a substantial new investment of taxpayer resources" because they did not "establish a credible path to viability." The plans need to "go deeper, go harder and go faster."

Specifically, the Task Force concluded that Chrysler could not be viable as a stand-alone company and that an alliance with Fiat could provide a way to viability. The government would consider an additional US\$6 billion in loans to Chrysler if:

- A partnership agreement with Fiat is completed within 30 days. (Fiat will not be able to own a majority interest in Chrysler until the federal loans are repaid.)
- Greater concessions are reached with the UAW.
- The vast majority of its secured debt and all unsecured debt and equity are extinguished.
- Chrysler and Fiat provide a more detailed operating plan for the alliance operation.

Chrysler received 30 days of working capital to complete the above actions to ensure its long-term viability. The administration has set aside US\$500 million for such working capital needs through April 30.

The Task Force concluded that the GM plan would not be viable over the long term even if the economy improved, but GM could be viable with more restructuring. Therefore, the government would consider additional loans for an amount to be determined if:

- Chairman and CEO Rick Wagoner steps down and the majority of the board of directors is reconstituted over the next several months. Effective March 30, President and COO Fritz Henderson stepped in as CEO. GM board member and Northrop Grumman Chairman Emeritus Kent Kresa will serve as interim nonexecutive chairman.
- Substantial concessions are reached with bondholders and the UAW to reduce existing balance sheet debt and liabilities substantially.
- A more aggressive restructuring plan is submitted regarding its manufacturing operations, headcount, brands and dealer network.

GM received 60 days of working capital to complete the above actions towards restructuring for a smaller market. The administration was prepared to fund up to US\$5 billion for such working capital through May 31.

If the above restructurings cannot be completed out of court, the Task Force stated that an expedited bankruptcy process could then help GM or Chrysler eliminate unsustainable debt loads. To address consumer concerns that the companies could go out of business, the government announced that it will back the warranties of all new GM and Chrysler vehicles sold during the turnaround period. The administration also eventually appointed a new car czar to oversee the turnaround. Edward Montgomery is a labor economist and former deputy secretary of labor who will serve as director of recovery for autoworkers and communities.

### **101. Why did Chrysler and GM file for bankruptcy?**

Chrysler was able to advance its agreements with Fiat and the UAW. However, the company was unable to reach agreement with all of its debt holders, thus it filed under Chapter 11 on April 30, 2009, to force a court-approved reorganization. With most of the parties in agreement on the reorganization plan and with court approval, Chrysler proceeded with a transaction called a Section 363 sale, whereby its ongoing or viable assets are sold to a new company called Chrysler Group LLC, free and clear of liens and claims. The remaining assets and claims remain with the old Chrysler LLC to work through the normal course of a Chapter 11 bankruptcy, including liquidation of such assets to settle prebankruptcy claims. While initially challenged by certain Indiana state pension funds up to the U.S. Supreme Court, the sale was cleared for closure on June 10, just 42 days after filing for protection. With the start of the new company, Chrysler will soon resume production at its plants, which had been shuttered during the bankruptcy period, reportedly costing US\$100 million per day.

GM was also able to advance its reorganization plan during the 60-day extension period, cutting brands, dealers and debt deeper and faster. However, the company could not reach a settlement agreement with enough of its bondholders, thus filing for Chapter 11 protection on June 1. The company emerged from bankruptcy in just 39 days on July 10 by completing a Section 363 sale of its stronger, viable assets to a new GM company, called Auto Acquisition Corp. The excess plant, equipment and other assets would remain in Chapter 11 to be settled in the ordinary course of bankruptcy proceedings, likely over the next

several years. As part of its reorganization plan, GM has also reached agreements to sell certain of its well-known brands:

- Hummer is under agreement to be sold to Sichuan Tengzhong Heavy Industrial Machinery Co., but will need to clear China's regulatory hurdles.
- Saturn was under agreement to be sold to the Penske Automotive Group by October. However, Penske could not reach agreement with a third-party manufacturer to produce the vehicles after 2011 and cancelled the purchase agreement, causing GM to wind down the brand's production and dealerships.
- A majority of Europe's Opel operations were under an agreement to be sold to Canadian manufacturer Magna Automotive and Russia's Sberbank, with GM and its employees retaining a minority share. In November, GM decided not to sell Opel and will restructure the operations itself.
- Saab was to be acquired by Swedish super sports car maker Koenigsegg. In November, Koenigsegg pulled out of the deal, likely leaving GM to dissolve the brand, similar to Saturn.

The above sales actions enabled the new GM to emerge as a smaller, leaner company focused on only four core brands: GMC, Chevy, Buick and Cadillac.

### **102. Who will own the "Big 3" going forward?**

Ford continues to be a publicly traded company, having weathered the recession thus far without any government-backed support.

The ownership of the new Chrysler Group LLC is shared:

- 55 percent by the UAW retiree health care trust, in concession for retiree payments owed
- 20 percent by Fiat, in return for small car and engine technology
- 10 percent by the U.S. and Canadian governments, in exchange for US\$6.5 billion in financing for the new company

The Fiat ownership share will grow incrementally to 35 percent, but Fiat cannot take majority control of Chrysler until the U.S. Treasury loans are repaid. While not the majority owner, Fiat has management control of Chrysler. Former CEO Robert Nardelli has been replaced, and Fiat CEO Sergio Marchionne has named former Chrysler President Jim Press as his deputy CEO. Chrysler Group LLC has a nine-member board of directors, with three directors appointed by Fiat, four members by the U.S. Treasury, one member representing the Canadian government and one seat for the UAW health care trust.

While GM is currently negotiating to complete its Section 363 sale, the new GM is expected to be owned:

- 60 percent by the U.S. government, in return for US\$30 billion of bankruptcy financing
- 12 percent by the Canadian government, in return for US\$9.5 billion of loans
- 17.5 percent by the UAW retiree health care trust, in return for US\$20 billion of payment concessions
- 10 percent by the bondholders, in a debt-for-equity swap

The new GM board of directors has 13 members, headed by retired AT&T Chairman and CEO Ed Whitacre. At the time of the restructuring, six existing board members stayed on, including new CEO Fritz Henderson. The remaining existing board members retired before GM emerged from bankruptcy. The UAW health care trust gained one seat on the new board, as did the Canadian government. The U.S. government named the remainder of the board. Subsequently, on December 1, 2009, CEO Fritz Henderson announced his resignation. Chairman Ed Whitacre is serving as interim CEO until a permanent successor is named.

### **103. What impact did the recent U.S. stimulus package have on the automotive industry?**

From a tax perspective, the final compromised plan included a scaled-back tax break estimated at US\$1.7 billion to allow new car buyers to deduct a purchase's sales tax from taxable income. (The original proposal included US\$11 billion to allow the sales tax, as well as the interest paid on auto loans, to be deductible on new vehicles less than US\$50,000.) It is expected that this provision will have a modest impact on the auto market, as the credit availability for new car buyers is still a significant issue.

From a spend perspective, a US\$300 million provision to allow the federal government to buy more fuel-efficient vehicles was also included in the stimulus plan. In April, the administration announced that the General Services Administration (GSA) would accelerate its purchase of new cars for the government fleet to buy more than 17,000 new fuel-efficient vehicles by June 1, 2009, in an effort to increase demand for vehicles from American auto companies during the current economic downturn.

After seeing the success of similar programs in Germany, Italy, Spain and France, the U.S. government allocated US\$3 billion for a “Cash for Clunkers” program in July and August 2009, providing credits for consumers who sold old cars and bought new, more fuel-efficient vehicles.

**104. Does the U.S. Treasury Department’s approval of GMAC’s application to become a bank holding company have a direct or indirect impact on the financial condition of General Motors?**

On a direct basis, one of the conditions of the Treasury Department’s approval is that General Motors reduce its ownership of GMAC. Although the majority stake in GMAC is currently controlled by a private equity firm, General Motors still owns a significant portion of the company. However, since neither the private equity firm nor General Motors (by virtue of the other businesses in which they are engaged) is able to comply with the nonbanking activities restrictions imposed on bank holding companies, both companies will be required to reduce their ownership levels. In the case of General Motors, its ownership interest in GMAC must be reduced to less than 10 percent of the voting and total equity interest of GMAC, and its remaining interest must be transferred to a trust that will be managed entirely independent of General Motors. The trustee will have sole discretion to vote and dispose of the GMAC equity interests.

On an indirect basis, it is important to note that GMAC historically has been the primary source of financing to General Motors’ dealerships and to customers buying or leasing General Motors cars. To the extent that its bank holding company status strengthens GMAC’s ability to fund the purchase of vehicles, General Motors will benefit. However, a condition of the approval of GMAC’s bank holding company application did require GMAC to give up exclusive right to provide low-interest loans to borrowers who buy General Motors cars and trucks.

**105. How are governments outside of the United States responding to the automotive crisis?**

Because of the global reach of the automotive industry crisis, many other governments also have taken action to provide aid to local automotive companies:

- France allocated €7 billion to support its struggling auto industry, including a significant portion for Renault SA and PSA Peugeot Citroen SA. In March, the Peugeot board ousted its CEO based on its recent and projected operating losses.
- Sweden pledged US\$3.5 billion in support for Saab (owned by General Motors) and Volvo (owned by Ford).
- Portugal authorized a credit line for auto plants.
- Germany approved guarantees to Opel (owned by General Motors), and Volkswagen Bank applied for guarantees under the German federal financial crisis program. As an incentive to stimulate sales, the government is offering a “bonus” of €2500 for owners of nine-year-and-older cars to trade in for new models. In addition, an Abu Dhabi investment firm purchased a 9 percent stake in German automaker Daimler for US\$2.7 billion.
- Following the U.S. bailout announcement in December, Canada announced that US\$3.3 billion would be made available to the Canadian units of General Motors and Chrysler.
- The United Kingdom is guaranteeing up to £2.3 billion of loans to the British auto industry, most of which is foreign-owned.
- Spain approved a €4 billion package to support its car industry, including €1.2 billion in credits for car purchases in 2009 and 2010.
- Italy provided a US\$1.7 billion package to help its auto sector, including sales incentives for scrapped vehicles, while its biggest carmaker, Fiat, agreed to form a partnership with Chrysler.
- Japan’s Toyota Financial Services asked for a US\$2 billion loan. The Finance Ministry said it will provide an additional US\$5 billion from its foreign reserves to the Japan Bank for International Cooperation to make sure there is ample cash for needy businesses.

- China slashed the sales tax on cars with smaller engines from 10 percent to 5 percent to encourage purchases of smaller, more fuel-efficient vehicles, while also lowering road taxes and fuel prices, which are set by the government.

#### **106. What does the future hold for the automotive industry?**

It likely will be a long and costly road to recovery, with the final price tag to be determined. One positive factor is that fuel prices have dropped since last year's peak above US\$4 per gallon. However, the price volatility in 2008 demonstrated that an appropriate product portfolio mix, with an adequate margin, is required by the auto companies to weather commodity price changes. And gasoline prices crept upward again throughout 2009.

For the first nine months of 2009, auto sales were down 27 percent year-over-year. The "Cash for Clunkers" program in the United States during July and August provided a rebate to car buyers up to US\$4,500 if they traded in older, less fuel-efficient cars for newer, more fuel-efficient vehicles. With a US\$3 billion allotment, this sparked more than 600,000 car sales over the summer, lowering excess inventories and boosting production. As a result, September sales were down significantly, but the overall impact to third quarter GDP was a positive boost to the economy.

October sales are expected to be back on track. The relatively fast-moving bankruptcy proceedings in the United States, combined with government-backed support globally, may at least help boost consumer confidence from an auto manufacturer viability standpoint. Indeed, major auto suppliers are reporting improved third quarter results, as a result of intense cost-cutting over the past year. GM reported better than expected results, with a US\$1.2 billion loss in the third quarter versus the US\$2.5 billion loss estimated by analysts. GM also reported that the company would repay the government loans much earlier than expected, paying down US\$1 billion per quarter beginning in December 2009 through July 2011.

The outlook for 2010 is upbeat, but cautious, with indications that the worst is behind the automotive industry. Sales for 2010 are forecasted to be in the 11-12 million units range – well below 16 million units in 2007, but above expected volume of 10 million vehicles in 2009.

The automotive companies will need to reinvent themselves to lead again in technology, quality and design in response to consumer demands. The players in the automotive market are clearly changing, with new or expanded ownership by companies in Canada, Russia, Italy and China. In the end, the "survivors" up and down the automotive supply chain should be stronger going forward as a result of these changes. This is clearly a watershed period in the industry.

### **Impact on the Retail Industry**

#### **107. How has the financial crisis affected the retail industry?**

The retail industry reflects the broader economy. In 2008 and 2009, in the United States alone, more than a dozen large retailers, including Circuit City, Linens 'n Things and Sharper Image, declared bankruptcy. The International Council of Shopping Centers estimated U.S. store closings at 148,000, and more than 73,000 stores were expected to be closed in the first half of 2009.<sup>71</sup> U.S. job losses in the retail sector are estimated at 500,000.

#### **108. Why don't retail job losses get attention in Washington?**

The retail industry lost more than three times the 163,000 manufacturing jobs shed by the auto industry. Most experts do not have a good reason as to why the retail industry has not been as effective as other industries in highlighting the issue of escalating job losses. However, among the largest differences between the two industry labor forces are union representation and geographic concentration. There is no one single organization or location that represents those employed in the retail sector. Additionally, although the absolute number of jobs lost in retailing is much higher, the percentage of the total is not as high as that for the auto industry. Retail employs an estimated 15 million workers versus 800,000 in the auto industry.

**109. How is the real estate market being impacted by the large number of store closures?**

The credit crisis is having a significant effect on the real estate market. In particular, the commercial segment that includes shopping and retail centers is being dragged down, as evidenced, for example, by falling stock prices and financial straits of mall and property developers across the globe. In many locations, developers have overbuilt during the past eight years and may now be forced to drop future mall plans or discount existing spaces to attract retailers. In order to prevent “ghost” malls, landlords have eagerly renegotiated leases to keep retail tenants in their buildings.

**110. Is there any upside for retailers given the state of the commercial real estate market?**

For retailers, the glut of commercial property can have an upside: cheaper rents, shorter lease terms and better tenant improvement allowances from landlords for outfitting stores. A retailer that can stay afloat may be able to take advantage of the situation and negotiate lower lease costs or other benefits.

**111. Beyond the real estate market, how are other segments of the economy affected by the problems in the retail industry?**

A recent *International Herald Tribune* article on the liquidation of a large electronics retailer highlights the far-reaching effects the demise of a retailer can have.<sup>72</sup>

- Electronics vendors have one less outlet for their products.
- Newspapers, already suffering from lost ad revenue, will have one less glossy insert in their Sunday editions.
- The freelance photographer who photographed people and products for the company’s advertisements has lost one of his biggest accounts.
- Business is down at a local café next to a suburban store since customers and workers no longer come.
- The cell phone and cable providers that operated mini-stores in the retailer’s locations will have to shut them down and decide what to do with the employees who staffed them.

**112. Has any segment of the retail industry been spared from the effects of the economic crisis?**

Retailers that cater to bargain-hunting consumers are the exception to the trend of slowing sales. “Discount retailers have become increasingly appealing to value-oriented shoppers,” says Sam Chandan, chief economist at researcher Reis Inc.<sup>73</sup> Discount retailers were among the first groups to seek IPOs in 2009 as their businesses hold promise and are growing.

**113. How are retailers attempting to compete for customers?**

Sales alone have not been enough to lure customers. Coupons and creativity are among the tactics being used by retailers. Following the holidays, some upscale retailers sent special customers letters of appreciation with gift cards or promises of discounts at the next visit. A New York city-based business is luring customers with free parking. An expensive cosmetics line is offering free facials to its best customers. Former competitors like Bed, Bath and Beyond are accepting the gift cards of their bankrupt counterpart, Linens ‘n Things. Clothes retailer T.J. Maxx has started a layaway program, even though analysts suggest layaway is not very profitable.<sup>74</sup> Retailers are emphasizing value in these tough times, with perhaps no more dramatic example than Starbucks’ recent announcement of its plan to offer instant coffee.

**114. Is it only the U.S. retail sector that is suffering?**

As previously noted, the problems for the retail sector extend beyond the United States. In Western Europe, where some countries are just now feeling the real impact of the financial crisis, the retail market is expected to be listless in 2009. In Japan, where economic prospects are also dim, shoppers’ focus – similar to that in the United States – will be on quality goods at low prices.<sup>75</sup>

**115. What can retailers do to survive the crisis?**

Retailers must focus on the changing needs and wants of their customers and react quickly to meet them. Some keys to survival include the following:

- **Focus on working capital.** Accurate cash flow forecasting is essential during this period.

- **Focus on customer service.** Customers can and will choose where to shop, especially now. Long lines at the checkout and uninformed store staff can turn off potential buyers.
- **Differentiate yourself from the pack.** Focus on ways to give shoppers value beyond the price. This can include free shipping, cleaner stores, better service, product variety, etc.
- **Look for opportunities to renegotiate leases.** The commercial real estate market has been hit hard. Take this chance to negotiate better rates or incentives.
- **Keep staff levels appropriate.** While layoffs are inevitable, simply cutting jobs for the sake of cost saving may impact customer service and hurt revenue. This can become a vicious cycle. This is a good time to remove inefficiencies from the business but without sacrificing service.
- **Position yourself for the turnaround.** Your competitors may be laying off talented employees to cut costs. Take this opportunity to cherry pick their top employees to build your teams.
- **Re-evaluate your stores and close underperforming locations.** This is one of the basics of retail and something every retailer should be doing regardless of economic conditions.

#### **116. Is there any light at the end of the tunnel for retailers?**

Most retailers are showing flat to slightly positive same-store comparison sales from a year ago. Several are extending earnings outlooks. The holiday shopping season officially started the earliest ever this year.<sup>76</sup> Consumers are still expecting concessions such as free shipping, deep discounts and extended hours. High-end retailers have added more midpriced merchandise, several luxury brands are expected to do well because of lower inventories, and several retailers have developed new brands to address the economy. More and more budget-focused shoppers plan to leave their credit cards in their wallets this year and use cash or debit cards to help them stay within their spending limits.<sup>77</sup> Retailers are offering US\$25 practical gifts this year where the magic number in prior years was US\$50 or US\$100.<sup>78</sup>

### **Impact on the Airline, Hospitality and Gaming Industries**

#### **117. How have world airlines been affected by the economic crisis?**

Giovanni Bisignani, the head of the International Air Transport Association (IATA), reported in September 2009 that the financial impact of the global economic crisis on the airline industry, totaling US\$27.8 billion, was worse than that of the September 11 terrorist attacks. Bisignani estimated that the industry will lose US\$11 billion in 2009; this is a US\$2 billion increase from what IATA had estimated in June 2009. Additionally, IATA expects passenger traffic to fall 4 percent compared with its June estimate of 8 percent, and for cargo demand to fall 14 percent.<sup>79</sup>

#### **118. How have dramatic fluctuations in oil prices contributed to the airlines' problems?**

As oil prices spiked in mid-2008 to nearly US\$150 per barrel, airline carriers were forced to cut costs dramatically (e.g., reduce capacity) and secure additional revenue streams (e.g., checked baggage fees) to mitigate increasing fuel prices. Currently, oil prices are now fluctuating between US\$70 and US\$80 per barrel. As a result, many airline carriers have been left holding upside-down fuel hedges, leading some preemptively to declare significant Q1 losses.<sup>80</sup>

The recent strengthening of the dollar in combination with fuel prices would ordinarily serve to increase margins; however, the favorable exchange rate and cost savings may not be enough to offset decreased demand.<sup>81</sup> Additionally, as Bisignani cautions, "the slightest glimmer of economic hope sends oil prices higher."<sup>82</sup>

#### **119. How has the economic downturn affected airlines' ability to manage fluctuating fuel costs?**

In November 2009, shares of most large U.S. airlines actually rose as oil prices fell on weak energy demand from consumers and businesses. The price of benchmark crude oil for December delivery dropped US\$2.09 to US\$77.19 a barrel, after the government reported consumers and businesses are using less oil and gas; this is compared to the 2008 high near US\$150.<sup>83</sup> Whereas most analysts predict prices will rebound, a growing number of analysts anticipate oil prices will remain low in the long term.<sup>84</sup> Fuel prices are being influenced by an ever-growing number of factors ranging from domestic and international environmental policy to OPEC capacity restrictions. Given this changing environment,

airlines have an increased need to ensure the adequacy of existing fuel hedging operations to manage future price fluctuations effectively.

#### **120. Is the Green Revolution still viable in the midst of the economic crisis?**

Despite the economic downturn, both the European Union and the United Kingdom have included the airline industry in the scope of CO<sub>2</sub> capping and reduction measures.<sup>85</sup> U.S.-based carriers have also begun taking initiative to reduce carbon emissions. American Airlines recently announced it has joined Climate Leaders, a program sponsored by the Environmental Protection Agency (EPA) whose members commit to reducing greenhouse emissions.<sup>86</sup> Boeing has also made contributions to the Green Revolution by developing a flight path program that reportedly helps identify the most fuel-efficient arrival path according to weather, vehicle performance and other factors.<sup>87</sup>

In October 2009, Southwest Airlines was the first to test eco-friendly products onboard an airplane when it flew its first “green plane,” a Boeing 737-700. The plane included recyclable carpet, environmentally friendly seat covers made from recycled materials, and lighter-weight seats and canvas containers. Reducing an airplane’s weight is a significant factor in emissions and fuel use, and this has pushed airlines to go green in order to improve their bottom line, save fuel costs and gain public favor among eco-conscious consumers.<sup>88</sup>

#### **121. How has the credit crisis affected the ability of airline carriers to replace aging fleets?**

Across all markets and industries, credit availability has become scarcer and, consequently, more expensive and difficult to obtain. Airline carriers looking to renew their fleets via direct purchase will find there are fewer financiers in the marketplace, and they are charging higher interest rates and requiring higher credit standards. Airline carriers looking to renew their fleets via leases will find similar difficulties.

The U.S. airline industry, as an example, leases nearly half of its fleet. The two largest companies financing these leases, International Lease Finance Corp (ILFC) and General Electric Commercial Aviation Services (GECAS), represent both Boeing’s and Airbus’ largest customers. Both companies have recently been subject to increased scrutiny by credit agencies due, in part, to their relation to their respective parent companies. ILFC is a subsidiary of the insurance giant AIG and GECAS, as the name suggests, is a subsidiary of General Electric.

Prior to recent economic events, both ILFC and GECAS were able to obtain cheap financing because of their respective parent companies’ strong credit ratings. However, due to the near collapse of AIG, prevented only by federal intervention, and GE’s writedown of various commercial and property loans, credit agencies either have downgraded the parent companies’ credit ratings or are currently in the process of reassessing them. These conditions have decreased capital availability severely for both ILFC and GECAS, resulting in a decrease in demand for Boeing and Airbus and a decrease of supply in leased jets for the airline industry.<sup>89</sup>

#### **122. What are airlines doing to differentiate themselves in a market of more selective and price-conscious consumers?**

In an industry with traditionally unpronounced differentiation, many airlines are attempting to win and retain customers through new services and features. Many major carriers, including Alaska Airlines, American Airlines, Delta, Southwest and Virgin America, have begun rolling out in-flight Wi-Fi service. The advent of Wi-Fi is expected to give passengers greater freedom on how they choose to spend their travel time and improve their overall in-flight experience.<sup>90</sup>

Airlines have also taken the competition for customers to the ground. Many major global carriers like American Airlines, Lufthansa and Qantas recently have invested millions of dollars on remodeling and expanding airport lounges to attract and retain the highest-paying customers. After spending US\$190 million to upgrade its Frankfurt airport lounge, Lufthansa reported a 25 percent increase in business from its most profitable customers.<sup>91</sup>

In addition, low-cost carriers like Southwest Airlines and AirTran Airways are making an impact on the airline industry as they have captured 30 percent of the U.S. airline industry's domestic market, significantly decreasing the market share of legacy carriers like United Airlines and Delta Air Lines. The reasons for their success are lower pricing and, more importantly, increased flight availability options. Low-cost carriers have a point-to-point system, which tends to decrease the number of connections made by travelers, whereas legacy carriers are heavily reliant on connecting flights from their hub airports. As such, low-cost airlines have forced legacy carriers to cut routes, close hubs, and merge with other legacy airlines.<sup>92</sup>

### **123. What opportunities has the economic downturn presented the airline industry?**

The economic downturn has led to increased costs and lower profitability for most airlines. In an effort to cut costs, many airlines have grounded planes to reduce capacity. This decrease in competition by the major players on certain routes has presented an opportunity for low-cost leaders to gain market share.

Europe's discount airfare leader, Ryanair, has ordered 40 new jets from Boeing and is in negotiations to obtain 200 more. Canadian discounter WestJet plans to expand flights by 5 percent this year. Whereas U.S. discounters generally are not increasing capacity, many, like JetBlue and AirTran, are using the opportunity to focus current resources and capacity on entering new markets.<sup>93</sup>

Another ancillary benefit to decreased capacity by airlines is that it has strengthened airlines' bargaining position in airport gate negotiations. As airlines have decreased capacity, airport gate supply has exceeded demand, thereby creating an opportunity for airline titans and discounters alike to enter new markets at reduced cost or renegotiate existing contracts for more favorable terms.<sup>94</sup>

### **124. Have governments stepped in to bail out airlines?**

To date, airlines have been trying to weather the crisis through cost-cutting and consolidation; however, there are countries where government support reportedly is being made available or is at least being considered, including India and Ireland.<sup>95</sup> There is also speculation that the U.S. government might take over one or two large U.S. airlines if they were to go into bankruptcy.<sup>96</sup>

In late 2009, it was announced that Japan Airlines (JAL) sought government aid to rescue the over-expanded and over-invested airline. The Tokyo government will force JAL to cut not only its redundant workforce but also pensions for all retired staff. The restructuring plan between JAL and the government is expected to cost 1.6 trillion yen (US\$17.7 billion) in state-guaranteed funds through March 2010.<sup>97</sup>

### **125. How has the hospitality industry been affected by the global economic crisis?**

Not dissimilar to the airline industry, the hospitality industry has been impacted significantly by a drop in business travel as well as a decline in personal spending stemming from recession fears and decreasing disposable income. A large portion of business travel has been supplanted by an increased reliance on technology, including teleconferencing and conference calls.<sup>98</sup> More recently, the industry also has been affected by concerns over the H1N1 virus.

### **126. How has the hospitality industry responded to the financial crisis?**

Companies in the hospitality industry have taken various steps in an effort to survive the financial crisis, including layoffs, reductions in services and amenities, and aggressive management of working capital and cash flow availability. However, while it is possible for companies to trim certain labor costs, because of the service-based nature of the industry, cuts can only go so far before they begin to affect customer service levels.

### **127. How is the financial crisis affecting projects currently under construction?**

The credit crunch that began in 2007 has created a scarcity of capital across all industries. Traditional lenders are reserving cash for the most highly qualified borrowers. Borrowers who can obtain financing are doing so at a relatively higher cost in the form of higher interest rates, stricter loan covenants, lower loan-to-value ratios and higher debt-service coverage ratios. Alternative sources of financing, such as private equity and venture capital, are also drying up as most alternative capital sources are waiting for asset prices to drop further before investing.

The increased scarcity and cost of capital have resulted in delays in the creation of new lodging supply. Highly levered hotels currently undertaking construction projects may find it difficult to furnish the capital to pay their minimum debt-service obligations, which could result in mass defaults. Consequently, some lenders have already instituted a blanket moratorium on issuing real estate or construction loans.

The increased supply of distressed and defaulted hotel portfolios could create a buyers' market for private equity and venture capital firms that will buy up the distressed properties, instituting a new ownership cycle.

**128. Are both the mid-tier/budget and luxury lodging markets being affected to the same degree?**

There are some indications that mid-tier and budget brands are holding up better, as people traveling for personal reasons try to stay within their budgets and business travelers are forced to justify their travel spend more than they have had to in the past.<sup>99</sup>

The luxury segment, on the other hand, is suffering from the fact that the very word "luxury" is being viewed as synonymous with "dirty."<sup>100</sup> There is perhaps no better example of this than the St. Regis Monarch Beach, a luxury resort that garnered unwanted news as the location where AIG hosted a retreat right after receiving government bailout funds.<sup>101</sup>

**129. How has the economic downturn affected relations between local governments and the hospitality industry?**

As consumers' disposable incomes decrease, so does their consumption. This decrease in demand has not only affected business revenues, but government revenues as well, in the form of income, sales and other taxes. Whereas the federal government can seek debt to bridge budget gaps caused by decreased revenues, local governments generally are forced to resolve deficits by other means. Currently, municipal governments around the country are fighting Internet travel providers (ITPs) such as Expedia for back transient occupancy taxes (TOT). Whereas ITPs have paid TOT on their purchase price of hotel rooms, they have not paid the tax on the mark-up at which they re-sell the rooms to end consumers.<sup>102</sup> In Massachusetts, the state legislature, in a move that distributors, hotels and restaurant owners are saying will further hurt their already-suffering businesses, is considering extending sales tax to alcohol sales.<sup>103</sup> The State of New Jersey has proposed a 25 percent increase in the excise tax on wine and spirits.<sup>104</sup>

As governments' balance sheets weaken, hoteliers can expect an increased frequency of similar pursuits from local municipalities to bridge the budget gap.

**130. Has the influence of the Green Revolution diminished in light of recent events?**

Despite recent economic events, the Green Revolution is predicted to continue to gain momentum. Due in part to legislation and government-sponsored green tourism campaigns, the niche market of green travelers is expected to grow.

In order to increase revenues in these difficult economic times, some hoteliers are attracting the ever-more selective consumer by creating new brands designed to provide an entire eco-friendly experience. In addition to branding and amenities, hoteliers are also seeking eco-friendly certifications, such as LEED (Leadership in Energy and Environmental Design) certification, in the actual construction of physical facilities.

**131. How has the economic downturn affected gaming revenue?**

According to an American Gaming Association (AGA) study of nontribal casinos, gaming revenue nationwide has dropped US\$1.45 billion, or 4.3 percent, to US\$32.6 billion in 2008 compared with 2007. The AGA also reported that gaming revenue fell US\$1.2 billion in Nevada alone.<sup>105</sup> Overall, "high rollers," or high-stakes players, can account for as much as 20 percent of a casino's net revenue.<sup>106</sup> The economic downturn effectively has reduced the net worth of these players and consequently reduced their overall disposable income. This equates to less money being spent in gaming establishments – especially in destination casino resorts in Las Vegas, Atlantic City and Macau. In an effort to re-stimulate high-roller spending, casinos have increased complimentary offerings such as private gaming salons, free flights and other luxuries.

Despite the overall trends, certain local markets are experiencing varied degrees of success. In a study published by Fantini research, commercial casino revenues outside of Nevada rose by 1.17 percent in January 2009. Several reasons were noted for this growth, such as liberalized rules in Missouri, and Louisiana casinos tapping into the Houston market. In addition, a year after instituting smoking bans, Colorado and Illinois casinos' revenue decline is beginning to level off.<sup>107</sup>

### **132. How has the credit crisis affected consolidation in the gaming industry?**

There is still much speculation as to how the credit crisis will affect consolidation efforts in the gaming industry. As certain casinos fail to service their debt obligations, gaming companies looking for acquisitions may be able to obtain new properties at bargain prices. On the other hand, whereas gaming companies looking for acquisitions may be in relatively better financial condition than their peers, credit to finance these bargain acquisitions may still be unavailable. Additionally, the recent economic downturn may have caused would-be acquirers to become more risk averse and remove themselves from the market.

## **Mortgage Loan Modifications**

### **133. What has been done in the United States to address the foreclosure problem to date?**

There are a number of private and public sector initiatives underway or in the process of implementation. One of the first formal attempts to address the problem came with the establishment of the HOPE NOW coalition in July 2007. Many of the country's leading mortgage servicers, industry trade groups and homeownership counseling organizations are members of HOPE NOW. The coalition seeks to establish consistent standards and frameworks for helping at-risk borrowers keep their homes and claims to have assisted more than 5.5 million borrowers since inception.<sup>108</sup> Critics note, however, that fewer than 40 percent of these borrowers have received permanent loan modifications, with the majority having been placed into temporary repayment or workout plans, which are typically considered less likely to stabilize the borrower's financial situation on a permanent basis.

Several other programs, such as the "Mod in a Box" approach promoted by the FDIC and the "Hope 4 Homeowners" government-sponsored refinancing program, were launched in 2008. Most of these experienced only modest success and, for the most part, have been replaced formally or practically by the Treasury Department's Home Affordable Refinancing and Home Affordable Modification Programs, announced in early 2009 and discussed in more detail below.

### **134. What are some of the common elements of large-scale loan modification programs?**

Most of the large-scale modification programs that are being or have been utilized during the economic crisis share at least the following common elements:

- **A streamlined approach** that involves the application of eligibility criteria to all or large portions of a servicing portfolio, followed by a mass mailing of or otherwise making modification offers to all borrowers who meet the criteria.
- **The application of an "expected value" or "net present value" test** to assess whether a proposed modification represents a more favorable solution for the loan holder than taking a loan into foreclosure. Modification offers generally are only made to borrowers whose loans satisfy the EV or NPV standard established by the servicer.
- **A calculation to determine the new monthly mortgage payment that would be affordable for each borrower**, based on his or her verified income. Generally, most servicers have established a debt-to-income (DTI) ratio standard of 31 percent to 38 percent for this purpose. Servicers then consider whether one or more steps from a pool of options, including rate reductions, temporary principal forbearance and/or an extension of the loan repayment term, can feasibly be taken to achieve the required monthly payment reduction.
- **Historically, considering modification only for those borrowers who are already substantially delinquent** (e.g., 60 to 90 days past due). However, concerns have arisen about the unintended consequences of giving borrowers an incentive to default, and mounting evidence suggests that loans perform much better if they are modified prior to delinquency. As a result, many servicers (including

Fannie Mae and Freddie Mac) are beginning to consider modifications for borrowers who are viewed as “at risk” but are not yet actually delinquent.

Importantly, one option that has been suggested by many legislators and consumer groups – but so far resisted by industry, for the most part – is that of permanently reducing principal balances. Although this practice results in lower monthly payments and also provides an incentive for borrowers to repay their loans post-modification by giving them an increased or renewed equity stake in the property (thus improving repayment performance post-modification), servicers have been reluctant to “lock in” losses on their part while opening up the possibility that borrowers will reap a windfall when property values increase. However, the threat to re-introduce “cram-down” modifications to bankruptcy laws (where bankruptcy judges would be given the unilateral authority to write down mortgage balances) are being used to pressure servicers to consider more widespread principal writedowns on a voluntary basis. We have also seen an increase in the willingness of servicers to consider “short-refi” requests, whereby they accept a reduced pay-off amount from another lender in order to get the loan off of their books.

### **135. What is the Home Affordable Modification Program (HAMP)?**

In February 2009, the Treasury Department released preliminary details of a long-awaited national standard for loan modification programs under the banner of “Making Home Affordable.”<sup>109</sup> Broadly, the guidelines provide governmental financial incentives to mortgage loan holders, servicers and borrowers to offer and participate in comprehensive loan modifications, and to ensure that these loans can be and are repaid as agreed following modification.

Further details of the HAMP standards were released on March 4, 2009, and industry participants were urged to begin offering covered modifications as soon as possible. Treasury officials have estimated that as many as four million homeowners eventually may qualify for assistance under the program.

### **136. Who is eligible for a HAMP modification?**

In general, candidate loans for HAMP must be:

- Held by a servicer that chooses or is required to participate in the program;
- First-lien mortgage loans with principal balances of less than US\$729,750;
- Secured by the principal residences of the owners;
- Originated prior to January 1, 2009; and
- Delinquent, or at risk of becoming delinquent, as a result of the borrower having experienced a financial hardship. Examples of financial hardships include the loss of a job or other event resulting in a reduction of income, or higher mortgage payments as the result of an adjustable rate increase.

In addition, all candidate loans will be evaluated using an NPV model of the type described earlier. If a servicer chooses to participate in the program, all eligible loans must be screened against the model, and modifications must be offered to all borrowers whose loans satisfy the NPV test.

Borrowers who successfully pass the NPV test are offered a “trial period” modification, which generally requires that borrowers make three payments at the new (i.e., modified) payment amount before a permanent modification will be completed. If the borrower does not successfully complete the trial period, the loan is no longer eligible for a HAMP modification, although servicers are still expected to explore other workout solutions before proceeding with foreclosure.

### **137. What form of relief does a HAMP modification provide to eligible borrowers?**

Generally, HAMP modifications must reduce the borrower’s first-lien monthly mortgage payment (including principal, interest, taxes, and insurance or condominium fees, where applicable) by at least 10 percent, and to an amount that is no more than 31 percent of his or her gross monthly income. These payment reductions are achieved first by reducing the borrower’s interest rate, then by extending the amortization term to as long as 40 years from the date of the modification, and finally, by forbearing a portion of the principal balance. Servicers and loan holders may, but are not required to, permanently reduce the principal amount of the loan.

In addition to the payment reduction component, borrowers are also given a financial incentive to continue to pay as agreed according to the terms of the modified loan. Borrowers whose loans remain current following modification will have their principal balances reduced by US\$1,000 per year for the first five years after the modification, with the cost borne by the Treasury department.

### **138. What incentives are provided to loan servicers and investors to participate in HAMP?**

The Treasury department is offering a number of financial inducements to participate in HAMP, including:

- A US\$1,000 up-front payment to loan servicers for making an eligible HAMP modification;
- “Pay for Success” payments to the servicer of up to US\$1,000 per year for up to three years following the modification when borrowers remain in the program; and
- Additional incentive payments of US\$1,500 to the asset holder and US\$500 to the servicer for modifying loans that are not yet delinquent but are at risk of becoming delinquent.

In addition, the Treasury will match the cost required to reduce the borrower’s monthly payment from a level that results in a 38 percent first-lien DTI ratio to one that results in a 31 percent DTI ratio.

### **139. What are some of the key issues that loan holders and servicers should consider when deciding whether to participate in HAMP?**

Questions to consider include:

- How many of the loans that we service would potentially be eligible for the program (broken down by product type, geography, loan amount and LTV, credit quality, and other pertinent factors)?
- Are these loans serviced on behalf of third-party investors? If so, would HAMP modifications be permitted under the terms of the servicing agreement? If not, what would we need to do in order to obtain investors’ approval to modify the agreement?
- Do we currently maintain all of the data elements that will be required to be collected and reported under the program? If so, how comfortable are we with the integrity of our existing data, and what steps should be taken to validate and/or “scrub” it prior to launching the program? If not, how much time and funding would be necessary to enhance our processes and systems to facilitate collection of the data?
- If we offer a loan modification program today, how do the HAMP standards compare to what we’re currently doing? If we were to participate in HAMP, can we project how that would change the number of modifications completed and the expected performance of loans post-modification?
- Participation in HAMP will require a significant investment on the part of servicers to develop appropriate documentation, reporting and risk management programs. What would be the cost and time required to put these programs in place, and what are the results when we compare those projected costs to the financial benefits we would expect to receive from participating in the program?
- If we do not currently offer a modification program, what level of staffing (roles, skills, experience) will be necessary to design, implement and monitor the program, field borrower inquiries and applications for modifications, underwrite and render decisions on modifications, etc.?
- If a purely objective cost/benefit analysis of HAMP would dictate that we not participate in the program:
  - a. Do we anticipate any possibility that we would need to apply for Financial Stability Plan assistance in the future?
  - b. What view would our regulatory agency examiners take of our decision not to participate in the program? Can we demonstrate alternative steps that we have taken or will take to mitigate our mortgage servicing risks from a safety and soundness perspective?
  - c. Firms that have large mortgage portfolios will likely face significant legislative and public pressure to participate. How are we prepared to address these concerns from a government and public relations perspective if we choose not to do so?
  - d. What is our exposure to bankruptcy cram-down legislation, and how would that exposure be impacted by a failure to offer modifications to borrowers who request them prior to filing for bankruptcy?

#### **140. How effective has HAMP been to date?**

After a relatively slow start – and extensive criticism of industry ramp-up efforts by lawmakers and Treasury officials – the pace of HAMP modifications has increased significantly. As of the end of October 2009:

- 71 private label servicers, and by default, all Fannie Mae and Freddie Mac servicers, had agreed to participate in the program.
- Approximately 85 percent of all U.S. consumer mortgage debt is held by HAMP-participating servicers.
- More than 650,000 borrowers had entered the trial period for a HAMP modification.

However, whether HAMP is considered a success in the long run will be determined primarily by the number of borrowers who are able to remain in their homes and continue to pay as agreed on a sustainable basis. While increasing the number of trial modifications offered is a key first step toward this objective, a significant number of trial modifications likely will fail to become permanent, sustainable modifications, for reasons discussed in more detail below. Extrapolating the number of trial modification offers made to date to measure progress against the administration's goal of 3 to 4 million permanent, sustainable modifications over the life of HAMP seems overly optimistic at this stage.

#### **141. What obstacles stand in the way of the success of HAMP?**

Obstacles challenging the success of HAMP include the following:

**Administrative burden** – As noted above, a vast amount of press has been devoted to servicers' perceived failures to devote sufficient resources to HAMP. Although the progress made by HAMP participants has, at best, been uneven, many critics fail to take into account the inherent conflict between beginning to modify huge numbers of loans as quickly as possible, and doing so in an efficient, well-controlled and well-documented manner. This challenge has been exacerbated significantly by the disjointed and constantly changing nature of the HAMP requirements themselves. As of November 16, 2009, servicers are required to comply with the HAMP participation agreement itself, eight "Supplemental Directives" that establish their own requirements, and a Frequently Asked Questions guide concerning the collective requirements. For an industry used to a rulemaking process in which regulations are proposed for comment, finalized and subject to a phase-in period of at least several months, the expectation to comply immediately with new guidelines and/or changes to existing guidelines that are often issued on a weekly basis, and often seem to conflict with one another, is a daunting challenge.

**Eligibility requirements** – Since the beginning of the economic crisis, government-supported loan modification programs have created heated arguments between those who thought such programs were necessary to prevent an outright collapse of the real estate market (which obviously would harm all property owners, including those who had continued to pay their mortgages as agreed) and those who believed these programs represented an inappropriate redistribution of wealth to borrowers who had made irresponsible financial decisions. The HAMP program standards reflect a compromise between these two viewpoints, and carry significant restrictions designed to prevent windfalls to what the administration views as undeserving borrowers. For example, loans secured by non-owner occupied properties are not eligible for the program, nor are borrowers who have a 31 percent housing debt-to-income ratio to start with (and therefore are presumed able to repay their loan without a modification). While the logic behind these restrictions is clear, their inevitable result is that the number of modifications that may be offered is lower – and the broader impact of HAMP on the real estate market is less – than it might otherwise have been.

Critics also point out that although HAMP provides for principal forbearance in some cases, it does not require permanent principal forgiveness. Although a good argument can be made that it would be unfair to shift losses caused by falling property values from the property owner to the loan holder or the government, many borrowers who might otherwise qualify for a modification are not interested in pursuing one when they would continue to owe far more than their houses are worth, thus pushing foreclosure rates even higher than they might otherwise go.

**Root cause of delinquencies** – In general, modification programs work best when the loan terms themselves are the cause of the delinquency. For example, a borrower who has stable income and was able to repay his or her mortgage before, but not after, an adjustable rate change usually represents an excellent candidate for a modification that would reduce the payment back down to or near its pre-adjustment level. However, particularly in light of persistent severe weaknesses in the job market, many borrowers have become delinquent because they have lost their jobs or had their salaries reduced or bonuses cut, and thus have been unable to replace the lost income. If a borrower has no, or drastically reduced, income, servicers are unable to offer a permanent modification that would satisfy the HAMP or any similar NPV test.

#### **142. What is the risk that borrowers whose loans have been modified will re-default?**

The latest quarterly figures from the joint Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTS) Mortgage Metrics Report suggest that, consistent with prior quarters, more than 60 percent of all modified loans have re-defaulted (i.e., had become at least 30 days delinquent) within nine months after the modification.<sup>110</sup>

Behind that sobering statistic, however, underlying information in the OCC/OTS report suggests a few reasons to be optimistic that HAMP modifications are likely to perform better than other types.

Specifically:

- The OCC/OTS found that modifications in which borrowers' payments were reduced by at least 10 percent – as required by HAMP – re-defaulted at a rate of less than 45 percent.
- Although the HAMP program is too new for its re-default data to appear in the latest report published by the OCC/OTS, re-default rates for the most recent modifications of all other types (i.e., those from late 2008 and early 2009) were marginally lower than for older vintages. This is important from the perspective that, during this time period, servicers increasingly began to shift away from offering temporary repayment plans (which continue to show very high re-default rates) to permanent modifications that more closely resemble those that are now being performed under HAMP.

### **Lessons Learned**

#### **143. What lessons can be learned from the financial crisis?**

We began to see stories in the media on “lessons learned” from the financial crisis almost as soon as the crisis started unfolding. Indeed, there have been a number of lessons learned, including:

- **If it sounds too good to be true, it probably is.** It was never realistic to believe that real estate prices could only go up.
- **We live in a global economy.** If the largest economy in the world falters, the rest of the world will be affected.
- **Incentives influence behavior.** Bad incentives, among other things, caused financial institutions not to raise sufficient capital to withstand an economic downturn, not to develop effective risk management systems, and to reward management and employees for performance indifferent to the risk their actions presented to the institutions.
- **Liquidity can be as important as solvency.** If stakeholders lose confidence in a business, the seeming strength of the business' balance sheet may not matter.
- **Lack of transparency can fuel a crisis.** When the market cannot be sure of the exposures that exist among its counterparties, it may stop functioning altogether.

The strange thing about these lessons is that we should have already known them. How long will it be before we forget them again?

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