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Bank Notes

March/April 2010

A timely information and idea statement

Mandatory Compliance Date for Regulation E Approaching

Consumers will now have a choice regarding their institution's payment of certain overdrafts. A final rule was issued under Regulation E on Nov. 12, 2009 and has a mandatory compliance date of July 1, 2010. The highlight of the rule requires consumers to affirmatively consent to overdraft services for ATM and one-time debit card transactions. If the consumer does not receive the right to affirmatively consent or opt-in, the institution may not charge a fee for covering such overdrafts. This right to opt-in applies to all consumers, including existing account holders.

The opt-in includes four requirements:

1. Provide the consumer with a notice in writing
2. Provide a reasonable opportunity for the consumer to affirmatively consent
3. Obtain the consumer's affirmative consent
4. Provide the consumer with confirmation of the consumer's consent in writing

A few items to note:

- The term "overdraft service" does not include: any payment of overdrafts pursuant to a line of credit subject to Regulation Z, a service that transfers funds from another account held by a consumer or a line of credit exempt from Regulation Z pursuant to 226.3(d).
- For existing accounts opened prior to July 1, 2010, the financial institution may not assess any fees on a consumers account on or after August 15, 2010 for paying an ATM or one-time debit card transaction unless the institution has obtained the consumer's affirmative consent.
- The opt-in notice should include the following: a description of the overdraft service, fees assessed for paying an ATM or one-time debit card transaction, limits on fees charged, disclosure of opt-in right and alternative plans for covering overdrafts. The regulation provides a model consent form in Appendix A of Regulation E.
- Disclosure of fees: The financial institution must disclose all applicable overdraft fees including but not limited to: per item or per transaction fees, daily overdraft fees, sustained overdraft fees or negative balance. If the amount of a fee may vary, the institution may indicate the assessment of a fee "up to" a maximum fee.
- The description of the institution's overdraft service should disclose the policies regarding the payment of overdrafts for other transactions including checks, ACH transactions and automatic bill payments provided that this description is not more prominent than the description of the consumer's right to opt into payment of overdrafts for ATM and one-time debit card transactions.
- The institution may pay such an overdraft without the consumer's consent, however, a fee may not be assessed.
- The new rule does not require a financial institution to pay an overdraft on an ATM or one-time debit card transaction even if the consumer has affirmatively consented to the overdraft service.
- The commentary to this section (section 17 of Regulation E) states, a financial institution provides reasonable methods for the consumer to affirmatively consent if: a form is provided and the consumer mails it back, a readily-available telephone line is provided that the consumers may call to provide consent, an electronic means is provided or a form is provided in person for the consumer to complete and present at the branch office to consent to the service.
- The consumer's affirmative consent or opt in must be obtained separately from other acknowledgements, including a consent to receive disclosures electronically. The signature line or check box is to be used solely for purposes of evidencing the consumer's choice. An affirmative consent cannot be preprinted language about the overdraft service within the contract that the consumer must sign to open an account, nor can it be a pre-selected check box on a signature card indicating the consumer is requesting the service.
- The written confirmation provided to the consumer can be a copy of the consumer's opt-in form or a letter or notice to the consumer acknowledging the consumers choice to opt into the service.
- The written confirmation must include a statement informing the consumer of his or her right to revoke the opt-in at any time.
- The rule prohibits institutions from considering the consumer's opt-in decision when deciding to pay overdrafts for other types of transactions such as checks, ACH transactions, etc.
- In a similar vein as the above bullet point, financial institutions may not vary the terms and conditions of an account provided to a consumer who does not affirmatively consent to the payment of ATM or one-time debit card transactions (overdraft service).

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Tax Consequences of Amounts Received by the Acquiring Bank in a FDIC Assisted Transaction

Tax consequences should be a consideration before entering into an acquisition of a financially troubled institution as most of the transactions will be treated as taxable asset acquisitions. These transactions can result in significantly different book and tax treatment on day one and in all subsequent periods. These differences will result in the recording of deferred tax on acquisition.

Internal Revenue Code (IRC) Section 597 governs the tax treatment of federally assisted transactions. Federal Financial Assistance (FFA) is defined as any money or property provided by the FDIC and includes Net Worth Assistance, Loss Guarantee payments, yield maintenance payments, cost to carry or cost of funds reimbursement payments, expense reimbursement or indemnity payments, and interest on an Agency Obligation.

FFA is includable as ordinary income of the recipient at the time the FFA is received or accrued in accordance with the recipient's method of accounting. Net Worth Assistance received by the acquiring institution at acquisition is deemed received by the failed institution and is treated as an asset acquired by acquiring.

As a taxable asset acquisition, the purchase price is allocated among the assets in accordance with IRC regulation section 1.338-6 and IRC section 1060. Purchase price is first allocated to Class I assets (cash and certain general deposit accounts other than certificates of deposit), then to Class II assets (actively traded securities, certificates of deposit and foreign currency), then to Class III through Class VII assets. Basis is not allocated to Loss Guarantees, yield maintenance payments, cost to carry or cost of funds reimbursement payments, or expense reimbursement or indemnity payments as these are not considered purchase price. Tax attributes such as net operating losses do not transfer to the acquiring institution.

If the fair market value of the Class I and Class II assets exceeds the purchase price, this amount will more than likely be considered taxable income recognized by the buyer over six years. FFA received with respect to property that has been charged off for income tax purposes is treated as a recovery and taxable.

If the transaction involves FFA provided pursuant to a Loss Guarantee on covered assets, the book and tax treatment are significantly different. The Loss Guarantee might be recognized as an asset on day one for GAAP purposes, but is allocated to loans and other acquired assets for tax purposes which are Class II assets. The amount allocated to these covered assets is the greater of their fair market value or their highest guaranteed value.

It is expected in most cases amounts received under the capital loss guarantee will not yield taxable income from the receipt of the payment because the amount received from the disposition of the asset and the guarantee will not exceed the amount of basis allocated to those assets. However, if the amount realized on disposition of the assets exceeds the allocated basis, there will be taxable income.

Income from income maintenance agreements will be treated as yield from the asset and will result in taxable income because no tax basis will be allocated upon purchase to this component of the assistance. Likewise, expense reimbursements will also yield taxable income as no tax basis is allocated upon purchase.

The tax tracking and reporting requirements can be onerous and complex. Consideration should be given to these requirements during the planning phase to ensure the necessary information can be obtained. Additionally, basis differences can result in deferred tax recognition.

Definitions:

Net Worth Assistance
Amounts contributed at the time of acquisition to bring the acquired institutions net worth to zero. Will not yield taxable income to the acquiring bank.

Capital loss guarantees
Amounts FDIC promised to pay the acquiring bank to guarantee a designated amount from a specific asset. Basis should be allocated to the specified asset equal to the fair market value. May yield taxable income if the amount received from disposition of the asset and the guarantee exceed the amount of basis allocated.

Yield maintenance agreements
Amounts that the FDIC pays to insure the acquiring bank earns a minimum amount of income for a designated period of time from specified assets. Basis should not be allocated and the income will generally yield taxable income to the acquiring bank.

Reimbursements
Amounts paid by the FDIC to reimburse the acquiring bank for expenses it incurs or will incur in the transaction or in maintaining or disposing of acquired assets. Basis should not be allocated and amounts received should be included in taxable income generally offset by the deduction arising from the expense.

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S Corporation Banks Win in Vainisi Case

The 7th Circuit Court of Appeals ruled in favor of subchapter S corporation bank's treatment of Section 291 interest expense disallowance. The court upheld the interpretation of Internal Revenue Code Section 1363(b)(4) which states "the taxable income of an S corporation shall be computed in the same manner as in the case of an individual, except that Section 291 shall apply if the S corporation (or any predecessor) was a C corporation for any of the three immediately preceding taxable years."

Based on this court decision banks that have been S corporations or qualified subchapter S subsidiaries for their entire existence or for the previous three years are not required to calculate a 20 percent interest expense disallowance on bank-qualified obligations. There is a proposed regulation that exists in which the Treasury has proposed to subject all subchapter S banks to Section 291. Until this regulation is adopted the court states that subchapter S banks that have not been a C corporation for any of the three immediately preceding years are not required to calculate Section 291 interest expense disallowance.

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The final rule can be found at:
http://edocket.access.gpo.gov/2009/pdf/E9-27474.pdf.

Additional Regulation E guidance was released on March 1, 2010, as public comment was requested on proposed amendments. The key planned provision included in this new guidance dictates that institutions will be unable to assess a fee for ATM or one-time debit card overdrafts without the consent of the consumer if an authorized transaction settles on insufficient funds, regardless of existing practices and policies. Additionally, the guidance explains other situations where an institution may not assess an overdraft fee without an opt in. An example of this is when an authorization has been given for a transaction with the reasonable belief that the account has sufficient funds and intervening transactions or the resolution of prior insufficient authorization requests from merchants cause the account to overdraft.

This proposed rule can be found at:
http://www.federalreserve.gov/newsevents/press/bcreg/20100219a.htm

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Could Your Technology Strategy Lead to Legal Action?

Every day it seems like we see a new threat facing the banking industry and chances are increasing that your technology could possibly land you in court. While economic conditions present significant challenges, computer crime is a growth industry and financial institutions represent a prime target for thieves. The combination of increasing risks, increased demand for new services and delivery channels, coupled with changing technology requires institutions to think strategically about their technology and it's governance. The need for strategic technology planning, versus technology budgets and project plans has never been more critical.

The need to critically assess your business requirements and the entire technology governance function has been accelerated by many market conditions, including increased risk from thieves.

For some of the key areas demanding a more intensive look at the strategic use of technology and examples of issues that should be considered when assessing the risks of your technology, read the full article by RSM McGladrey Managing Director Roger Peters at www.rsmmcgladrey.com/banknotes.

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