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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Accounting for Financial Instruments

In October of 2000, the Financial Accounting Standards Board ("FASB") issued an Exposure Draft, A*ccounting for Financial Instruments with Characteristics of Liabilities, Equity or Both*, which establishes standards for accounting for financial instruments. In the March 2001 edition of *Status Report,* the subjects raised in the Exposure Draft are discussed from various perspectives in an article entitled *FASB Addresses Issues Related to the Classification of Compound Financial Instruments That Have Characteristics of Liabilities and Equity.* In general, the Exposure Draft focuses on requirements to be used in determining the classification of financial instrument components as liabilities or equity. The requirements are based on a revised definition of liabilities that would result in a liability classification for certain obligations that do not establish an ownership relationship. Without the revised definition of liabilities, all financial instrument components embodying obligations that could potentially be settled by the issuance of equity securities would be classified as equity. However, the FASB concluded that obligations should not be classified as equity unless they establish an ownership relationship. For example, preferred shares that are mandatorily redeemable which embody an obligation to transfer assets to the holder to redeem the shares at a specified price and time would be classified as a liability. However, preferred shares that are mandatorily convertible into a fixed number of common shares which embody an obligation that must be settled by the issuance of a fixed number of common shares with the holder being exposed to the risk of changes in the fair value of the issuer's equity securities would be classified as equity. Copies of the article are available from our firm or, alternatively, may be accessed on the web site of the FASB at *http://accounting.rutgers.edu/raw/fasb.*

FDIC Insurance Reform Plan

The Federal Deposit Insurance Corporation ("FDIC") recently released its report entitled *Keeping the Promise: Recommendations for Deposit Insurance Reform* in which the FDIC recommends changes to address weaknesses in the system providing for deposit insurance as follows:

- Merge the Bank Insurance Fund ("BIF") and the Savings Association Insurance Fund ("SAIF"). A combined fund would be stronger and would prevent the destabilizing effects that would result if one fund required premiums while the other did not. Moreover, many banks and thrifts today have commingled BIF and SAIF insured deposits. A merger of the funds also would greatly simplify reporting and accounting responsibilities for institutions and the FDIC.

- Risk-based premiums to all institutions should be eliminated; the FDIC should charge regular premiums for risk regardless of the level of the fund. Current law restricts the FDIC from charging premiums to most banks that are well-capitalized as long as the insurance fund is above a Designated Reserve Ratio ("DRR") of 1.25 percent of insured deposits, or $1.25 for every $100 of insured deposits. 92 percent of the industry does not pay for deposit insurance, and the more than 900 banks that were chartered within the last five years have never paid any premiums. The system both underprices risk and does not adequately differentiate among banks according to risk. The FDIC should be allowed to charge risk-based insurance premiums to all institutions.

- Sharp premiums triggered by deviations from the DRR should be eliminated. If the fund falls below a target level, premiums should increase gradually. If it grows above a target level, funds should be rebated gradually.

- Rebates should be based on past contributions to the fund.

- The deposit insurance coverage levels should be indexed to maintain its real value. While it is for the Congress to decide the initial coverage level, that level should be indexed to the Consumer Price Index in order to maintain its real value. This would insure more predictable adjustments in response to inflation, as compared with the ad hoc changes that have been made in the past.

The report is available on the website of the FDIC at *http://www.fdic.gov/deposit/insurance/initiative/direcommendations.html*.

Court Decisions

Morehouse v. Behlmann, 31 S.W. 3d 55 (Mo.App. E.D. 2000) held that a used motor vehicle salesman's representations that the vehicle was "in excellent condition," "in good condition," "in tip-top shape" and would be "reliable" were statements of fact, rather than mere opinion, that were actionable when the vehicle's engine failed, where a salesman had 42 years of experience, and purchaser told the salesman that she was inexperienced and had no idea what to look for.

Luebbers v. Money Store, Inc., 344 Ark. 232 (2001) held that the Arkansas General Assembly may not avoid the constitutional prohibition against usury by merely stating that fees shall not be deemed "interest" or by stating that a transaction shall not be deemed to be a "loan", and the General Assembly does not have the power to usurp the judicial function of the courts pursuant to the separation-of-powers doctrine contained in the Arkansas Constitution. The Arkansas legislature had enacted legislation regarding fees charged by check cashers which provided that the fee would not be deemed "interest". The fees in this case calculated to an annual percentage rate of 372.4%.

Arbitration by FDIC of Disputes

The Federal Deposit Insurance Corporation ("FDIC") has issued its *Statement of Policy Regarding Binding Arbitration* which addresses the FDIC's use of arbitration for resolving disputes by offices and divisions of the FDIC in a timely and cost efficient manner. The Policy Statement was effective March 26, 2001, and applies to disputes arising with the FDIC in all of its capacities. The FDIC may use arbitration to resolve disputes in situations where it is more practical, cost-effective, or efficient than litigation. The FDIC may agree to use binding arbitration in its contracts prior to an actual dispute arising. Copies of the Policy Statement are available from our firm.