11. Commitments, Contingent Liabilities and Guarantees The Bancorp, in the normal course of business, enters into financial instruments and various agreements to meet the financing needs of its customers. The Bancorp also enters into certain transactions and agreements to manage its interest rate and prepayment risks, provide funding, equipment and locations for its operations and invest in its communities. These instruments and agreements involve, to varying degrees, elements of credit risk, counterparty risk and market risk in excess of the amounts recognized in the Bancorp’s Condensed Consolidated Balance Sheets. Creditworthiness for all instruments and agreements is evaluated on a case-by-case basis in accordance with the Bancorp’s credit policies. The Bancorp’s significant commitments, contingent liabilities and guarantees in excess of the amounts recognized in the Condensed Consolidated Balance Sheets are summarized as follows: Commitments The Bancorp has certain commitments to make future payments under contracts. The following table reflects a summary of significant commitments: ($ in millions) September 30, 2009 December 31, 2008 September 31, 2008 Commitments to extend credit $ 42,250 49,391 50,230 Letters of credit (including standby letters of credit) 7,691 8,951 8,899 Forward contracts to sell mortgage loans 4,156 3,235 1,695 Noncancelable lease obligations 910 937 910 Capital commitments for private equity investments 83 79 71 Purchase obligations 60 81 87 Capital expenditures 37 68 83 Commitments to extend credit Commitments to extend credit are agreements to lend, typically having fixed expiration dates or other termination clauses that may require payment of a fee. Since many of the commitments to extend credit may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash flow requirements. The Bancorp is exposed to credit risk in the event of nonperformance for the amount of the contract. Fixed-rate commitments are also subject to market risk resulting from fluctuations in interest rates and the Bancorp’s exposure is limited to the replacement value of those commitments. As of September 30, 2009, December 31, 2008 and September 30, 2008, the Bancorp had a reserve for unfunded commitments totaling $243 million, $195 million and $132 million, respectively, included in other liabilities in the Condensed Consolidated Balance Sheets. Letters of credit Standby and commercial letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. At September 30, 2009, approximately $2.7 billion of letters of credit expire within one year (including $44 million issued on behalf of commercial customers to facilitate trade payments in dollars and foreign currencies), $4.7 billion expire between one and five years and $317 million expire thereafter. Standby letters of credit are considered guarantees in accordance with U.S. GAAP. At September 30, 2009, December 31, 2008 and September 30, 2008, the reserve related to these standby letters of credit was $6 million, $3 million and $2 million, respectively. Approximately 60%, 66% and 69% of the total standby letters of credit were secured as of September 30, 2009, December 31, 2008 and September 30, 2008, respectively. In the event of nonperformance by the customers, the Bancorp has rights to the underlying collateral, which can include commercial real estate, physical plant and property, inventory, receivables, cash and marketable securities. The Bancorp monitors the credit risk associated with the standby letters of credit using the same dual risk rating system utilized for estimating probabilities of default within its loan and lease portfolio. Under this risk rating as of September 30, 2009, approximately $5.9 billion of the standby letters of credit were classified as average or better; approximately $1.4 billion were classified as watch-list or special mention; and approximately $345 million were classified as either substandard or doubtful. At September 30, 2009, the Bancorp had outstanding letters of credit that were supporting certain securities issued as VRDNs. The Bancorp facilitates financing for its commercial customers, which consist of companies and municipalities, by marketing the VRDNs to investors. The VRDNs pay interest to holders at a rate of interest that fluctuates based upon market demand. The VRDNs generally have long-term maturity dates, but can be tendered by the holder for purchase at par value upon proper advance notice. When the VRDNs are tendered, a remarketing agent generally finds another investor to purchase the VRDNs to keep the securities outstanding in the market. As of September 30, 2009, Fifth Third Securities, Inc. (FTS) acted as the remarketing agent to issuers on approximately $3.6 billion of VRDNs. As remarketing agent, FTS is responsible for finding purchasers for VRDNs that are put by investors. The Bancorp issues letters of credit, as a credit enhancement, to the VRDNs remarketed by FTS, in addition to approximately $1.7 billion in VRDNs remarketed by third parties at September 30, 2009. These letters of credit are included in the total letters of credit balance provided in the previous table. At September 30, 2009, FTS held $3 million of these VRDN’s in its portfolio and classified them as trading securities. The Bancorp purchased $963 million of the VRDNs from the market, through FTS, and held them in its trading securities portfolio at September 30, 2009. For the VRDNs remarketed by third parties, in some cases, the remarketing agent has failed to remarket the securities and has instructed the indenture trustee to draw upon approximately $77 million of letters of credit issued by the Bancorp. The Bancorp recorded these draws as commercial loans in its Condensed Consolidated Balance Sheets at September 30, 2009. Forward contracts to sell mortgage loans The Bancorp enters into forward contracts to economically hedge the change in fair value of certain residential mortgage loans held for sale due to changes in interest rates. The outstanding notional amounts of these forward contracts were $4.2 billion, $3.2 billion and $1.7 billion as of September 30, 2009, December 31, 2008 and September 30, 2008, respectively. Noncancelable lease obligations The Bancorp’s subsidiaries have entered into a number of noncancelable lease agreements. The minimum rental commitments under noncancelable lease agreements are shown in the previous table. The Bancorp or its subsidiaries have also entered into a limited number of agreements for work related to banking center construction and to purchase goods or services. Contingent Liabilities Payment processing chargebacks Prior to the completion of the Processing Business Sale on June 30, 2009, the Bancorp processed VISA® and MasterCard® merchant card transactions. Pursuant to VISA® and MasterCard® rules, the Bancorp assumed certain contingent liabilities relating to these transactions which typically arose from billing disputes between the merchant and cardholder that were ultimately resolved in the cardholder’s favor. In such cases, these transactions were “charged-back” to the merchant and disputed amounts were refunded to the cardholder. If the Bancorp was unable to collect these amounts from the merchant, it would bear the loss for refunded amounts. The likelihood of incurring a contingent liability arising from chargebacks was relatively low, as most products or services were delivered when purchased and credits were issued on returned items. For the six months ended June 30, 2009, the Bancorp processed approximately $57 million of chargebacks presented by issuing banks, resulting in no material losses to the Bancorp. The Bancorp had accrued for probable losses based on historical experience and did not carry a loss reserve related to such chargebacks at September 30, 2009, December 31, 2008 and September 30, 2008. Subsequent to the Processing Business Sale, the Bancorp does not bear the risk of loss for these chargebacks. Private mortgage reinsurance For certain mortgage loans originated by the Bancorp, borrowers may be required to obtain private mortgage insurance (PMI) provided by third-party insurers. In some instances, these insurers cede a portion of the PMI premiums to the Bancorp, and the Bancorp provides reinsurance coverage within a specified range of the total PMI coverage. The Bancorp’s reinsurance coverage typically ranges from 5% to 10% of the total PMI coverage. The Bancorp’s maximum exposure in the event of nonperformance by the underlying borrowers is equivalent to the Bancorp’s total outstanding reinsurance coverage, which was $182 million at September 30, 2009. As of September 30, 2009, December 31, 2008 and September 30, 2008, the Bancorp maintained a reserve of approximately $36 million, $13 million and $1 million, respectively, related to exposures within the reinsurance portfolio. During the second quarter of 2009, the Bancorp suspended the practice of providing reinsurance of private mortgage insurance for newly originated mortgage loans. Legal claims There are legal claims pending against the Bancorp and its subsidiaries that have arisen in the normal course of business. See Note 12 for additional information regarding these proceedings. Guarantees The Bancorp has performance obligations upon the occurrence of certain events under financial guarantees provided in certain contractual arrangements. Residential mortgage loans sold with recourse The Bancorp previously sold certain residential mortgage loans in the secondary market with credit recourse. In the event of any customer default, pursuant to the credit recourse provided, the Bancorp is required to reimburse the third party. The maximum amount of credit risk in the event of nonperformance by the underlying borrowers is equivalent to the total outstanding balance. In the event of nonperformance, the Bancorp has rights to the underlying collateral value securing the loan. At September 30, 2009, December 31, 2008 and September 30, 2008, the outstanding balances on these loans sold with credit recourse were approximately $1.1 billion, $1.3 billion, and $1.4 billion, respectively, and the delinquency rates were approximately 8.39%, 6.40%, and 4.98%, respectively. At September 30, 2009, December 31, 2008 and September 30, 2008, the Bancorp maintained an estimated credit loss reserve on these loans sold with credit recourse of approximately $20 million, $20 million and $13 million, respectively, recorded in other liabilities in the Condensed Consolidated Balance Sheets. To determine the credit loss reserve, the Bancorp used an approach that is consistent with its overall approach in estimating credit losses for various categories of residential mortgage loans held in its loan portfolio. In addition, conforming residential mortgage loans sold to unrelated third parties are generally sold with representation and warranty recourse provisions. Under these provisions, the Bancorp is required to repurchase any previously sold loan for which the representation or warranty of the Bancorp proves to be inaccurate, incomplete or misleading. As of September 30, 2009, December 31, 2008, and September 30, 2008, the Bancorp maintained a reserve related to these loans sold with the representation and warranty recourse provision of $10 million, $6 million, and $4 million, respectively. Liquidity support and credit enhancement provided to an unconsolidated QSPE Throughout 2008, the Bancorp had transferred at par, subject to credit recourse, certain primarily floating-rate, short-term investment grade commercial loans to an unconsolidated QSPE that is wholly owned by an independent third-party. The Bancorp did not transfer any new loans to the QSPE during the nine months ended September 30, 2009. No gains or losses were recognized on the transfers to the QSPE for the three and nine months ended September 30, 2008. Generally, the loans transferred provide a lower yield due to their investment grade nature and, therefore, transferring these loans to the QSPE allows the Bancorp to reduce its interest rate exposure to these lower yielding loan assets while maintaining the customer relationships. Under current accounting provisions, QSPEs are exempt from consolidation and, therefore, not included in the Bancorp’s Condensed Consolidated Financial Statements. The outstanding balance of these loans at September 30, 2009, December 31, 2008 and September 30, 2008 was $964 million, $1.9 billion and $2.5 billion, respectively. As of September 30, 2009, the loans transferred had a weighted average life of 2.0 years. These loans may be transferred back to the Bancorp upon the occurrence of certain specified events. These events include borrower default on the loans transferred, ineligible loans transferred by the Bancorp to the QSPE, the inability of the QSPE to issue commercial paper and in certain circumstances bankruptcy preferences initiated against underlying borrowers. The maximum amount of credit risk in the event of nonperformance by the underlying borrowers is approximately equivalent to the total outstanding balance. During the nine months ended September 30, 2009 and 2008, the QSPE did not transfer any loans back to the Bancorp as a result of a credit event. The Bancorp monitors the credit risk associated with the underlying borrowers through the same risk grading system currently utilized for establishing loss reserves in its loan and lease portfolio. Under this risk rating system as of September 30, 2009, approximately $861 million of the loans in the QSPE were classified average or better; approximately $27 million were classified as watch-list or special mention; approximately $47 million were classified as substandard; and approximately $28 million were classified as doubtful. At September 30, 2009, December 31, 2008 and September 30, 2008, the Bancorp’s loss reserve related to the credit enhancement provided to the QSPE was $58 million, $37 million and $27 million, respectively, and was recorded in other liabilities in the Condensed Consolidated Balance Sheets. To determine the credit loss reserve, the Bancorp used an approach that is consistent with its overall approach in estimating credit losses for various categories of commercial loans held in its loan portfolio. The QSPE issues commercial paper and uses the proceeds to fund the acquisition of commercial loans transferred to it by the Bancorp. The ability of the QSPE to issue commercial paper is a function of general market conditions and the credit rating of the liquidity provider. In the event the QSPE is unable to issue commercial paper, the Bancorp has agreed to provide liquidity support to the QSPE in the form of a line of credit to the QSPE and the repurchase of assets from the QSPE. As of September 30, 2009, December 31, 2008 and September 30, 2008, the liquidity asset purchase agreement was $2.4 billion, $2.8 billion and $3.0 billion, respectively. In addition to the liquidity support options discussed above, the Bancorp has also purchased commercial paper issued by the QSPE. Beginning in 2008 and continuing through the third quarter of 2009, dislocation in the short-term funding market caused the QSPE difficulty in obtaining sufficient funding through the issuance of commercial paper. As a result, the Bancorp purchased commercial paper throughout 2008 and 2009. As of September 30, 2009, December 31, 2008 and September 30, 2008, the Bancorp held approximately $841 million, $143 million and $1.0 billion, respectively, of asset-backed commercial paper issued by the QSPE, representing 74%, 7% and 39%, respectively, of the total commercial paper issued by the QSPE. As of September 30, 2009, December 31, 2008 and September 30, 2008, there were no outstanding balances on the line of credit from the Bancorp to the QSPE. The Bancorp’s loss reserve related to the liquidity support and credit enhancement provided to the QSPE was $58 million, $37 million and $27 million at September 30, 2009, December 31, 2008 and September 30, 2008, respectively, and was recorded in other liabilities in the Condensed Consolidated Balance Sheets. To determine the credit loss reserve, the Bancorp used an approach that is consistent with its overall approach in estimating credit losses for various categories of commercial loans held in its loan portfolio. Margin accounts FTS, a subsidiary of the Bancorp, guarantees the collection of all margin account balances held by its brokerage clearing agent for the benefit of FTS customers. FTS is responsible for payment to its brokerage clearing agent for any loss, liability, damage, cost or expense incurred as a result of customers failing to comply with margin or margin maintenance calls on all margin accounts. The margin account balance held by the brokerage clearing agent as of September 30, 2009 was $7 million compared to $10 million and $17 million as of December 31, 2008 and September 30, 2008, respectively. In the event of any customer default, FTS has rights to the underlying collateral provided. Given the existence of the underlying collateral provided and negligible historical credit losses, the Bancorp does not maintain a loss reserve related to the margin accounts. Long-term borrowing obligations The Bancorp had fully and unconditionally guaranteed certain long-term borrowing obligations issued by wholly-owned issuing trust entities of $2.8 billion as of September 30, 2009, December 31, 2008 and September 30, 2008. Visa litigation The Bancorp, as a member bank of Visa prior to Visa’s completion of their IPO on March 19, 2008, had certain indemnification obligations pursuant to Visa’s certificate of incorporation and bylaws and in accordance with their membership agreements. In accordance with Visa’s by-laws prior to the IPO, the Bancorp could have been required to indemnify Visa for the Bancorp’s proportional share of losses based on the pre-IPO membership interests. In contemplation of the IPO, Visa announced that it had completed restructuring transactions during the fourth quarter of 2007. As part of this restructuring, the Bancorp’s indemnification obligation was modified to include only certain known litigation as of the date of the restructuring. This modification triggered a requirement to recognize a $3 million liability in 2007 equal to the fair value of the indemnification obligation. Additionally during 2007, the Bancorp recorded $169 million for its share of litigation formally settled by Visa and for probable future litigation settlements, and during 2008, the Bancorp recorded additional reserves of $71 million for probable future litigation settlements. In connection with the IPO in 2008, Visa retained a portion of the proceeds to fund an escrow account in order to resolve existing litigation settlements as well as fund potential future litigation settlements. During the third quarter of 2009, Visa announced it had deposited an additional $700 million into the litigation escrow account. As a result of this funding, the Bancorp recorded its proportional share of $29 million of these additional funds as a reduction to its net Visa litigation reserve liability and a reduction to noninterest expense. Later in the third quarter, the Bancorp completed the sale of its Visa, Inc. Class B shares for proceeds of $300 million. As part of this transaction the Bancorp entered into a total return swap in which the Bancorp will make or receive payments based on subsequent changes in the conversion rate of the Class B shares into Class A shares. The swap terminates on the later of the third anniversary of Visa’s IPO or the date on which certain pre-specified litigation is finally settled. As a result of the sale of Class B shares and entering into the swap contract, the Bancorp reversed its net Visa litigation reserve liability and recognized a free-standing derivative liability with an initial fair value of $55 million. The sale of the Class B shares, recognition of the derivative liability and reversal of the net litigation reserve liability resulted in a pre-tax benefit of $288 million ($187 million after-tax), which was recognized by the Bancorp in the third quarter of 2009. 12. Legal and Regulatory Proceedings During April 2006, the Bancorp was added as a defendant in a consolidated antitrust class action lawsuit originally filed against Visa®, MasterCard® and several other major financial institutions in the United States District Court for the Eastern District of New York. The plaintiffs, merchants operating commercial businesses throughout the U.S. and trade associations, claim that the interchange fees charged by card-issuing banks are unreasonable and seek injunctive relief and unspecified damages. In addition to being a named defendant, the Bancorp is also subject to a possible indemnification obligation of Visa as discussed in Note 11. Accordingly, prior to the sale of its Class B shares in the third quarter of 2009, the Bancorp had recorded a litigation reserve of $243 million to account for its potential exposure in this and related litigation. Additionally, the Bancorp had also recorded its proportional share of $199 million of the Visa escrow account funded with proceeds from the Visa IPO along with several subsequent fundings. Upon the Bancorp’s sale of its Visa, Inc. Class B shares during the third quarter of 2009, and the recognition of the total return swap that transfers conversion risk of the Class B shares back to the Bancorp, the Bancorp reversed the remaining net litigation reserve. Refer to Note 11 for further information regarding the Bancorp’s net litigation reserve and ownership interest in Visa. This antitrust litigation is still in the pre-trial phase. In September 2007, Ronald A. Katz Technology Licensing, L.P. (Katz) filed a suit in the United States District Court for the Southern District of Ohio against the Bancorp and it’s Ohio banking subsidiary. In the suit, Katz alleges that the Bancorp and its Ohio bank are infringing on Katz’s patents for interactive call processing technology by offering certain automated telephone banking and other services. This lawsuit is one of many related patent infringement suits brought by Katz in various courts against numerous other defendants. Katz is seeking unspecified monetary damages and penalties as well as injunctive relief in the suit. Management believes there are substantial defenses to these claims and intends to defend them vigorously. The impact of the final disposition of this lawsuit cannot be assessed at this time. In 2008, five putative securities class action complaints were filed against the Bancorp and its Chief Executive Officer, among other parties. The five cases have been consolidated, and are currently pending in the United States District Court for the Southern District of Ohio. The lawsuits allege violations of federal securities laws related to disclosures made by the Bancorp in press releases and filings with the SEC regarding its quality and sufficiency of capital, credit losses and related matters, and seeking unquantified damages on behalf of putative classes of persons who either purchased the Bancorp’s securities, or acquired the Bancorp’s securities pursuant to the First Charter Corporation Acquisition. In addition to the foregoing, two cases were filed in the United States District Court for the Southern District of Ohio against the Bancorp and certain officers alleging violations of ERISA based on allegations similar to those set forth in the securities class action cases filed during the same period of time. The two cases alleging violations of ERISA have also been consolidated. These cases remain in the early stages of litigation. The impact of the final disposition of these lawsuits cannot be assessed at this time. The Bancorp and its subsidiaries are not parties to any other material litigation. However, there are other litigation matters that arise in the normal course of business. While it is impossible to ascertain the ultimate resolution or range of financial liability with respect to these contingent matters, management believes any resulting liability from these other actions would not have a material effect upon the Bancorp’s consolidated financial position, results of operations or cash flows.