October 4, 2012

MEMORANDUM TO: The Board of Directors

FROM: Arthur J. Murton
Director
Division of Insurance and Research

SUBJECT: Final Rule on Assessments, Large Bank Pricing

SUMMARY OF RECOMMENDATIONS

Staff recommends that the FDIC Board of Directors (the FDIC or the Board) adopt the attached final rule relating to the large bank pricing system. The final rule, if adopted by the Board, (1) revises the definitions of certain higher-risk assets, specifically leveraged loans, which are renamed "higher-risk C&I loans and securities," and subprime consumer loans, which are renamed "higher-risk consumer loans"; (2) clarifies when an asset must be classified as higher risk; (3) clarifies the way securitizations are identified as higher risk; and (4) further defines terms that are used in the large bank pricing rule.

The FDIC uses the amount of a large or highly complex institution's higher-risk assets to calculate the institution's higher-risk concentration measure, concentration score, total score, and assessment rate. As noted in the February 2011 rule, the higher-risk concentration measure captures the risk associated with concentrated lending in higher-risk areas. This type of lending contributed to the failure of, or significant problems in, a number of large banks during the recent financial crisis and economic downturn.

If adopted, the final rule will become effective on April 1, 2013. The final rule provides that, until then, large and highly complex institutions will continue to report higher-risk assets using existing guidance.

I. Background

On February 7, 2011, the Board adopted a final rule that amended its assessment regulations, by, among other things, establishing a new methodology for determining assessment rates for large and highly complex institutions (the February 2011 rule). The rule uses a scorecard method to determine a large or highly complex institution's

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assessment rate. One of the financial ratios used in the scorecard is the ratio of higher-risk assets to Tier 1 capital and reserves. Higher-risk assets were defined as the sum of construction and land development (C&D) loans, leveraged loans, subprime loans, and nontraditional mortgage loans. In developing the definition of higher-risk assets, the FDIC used existing interagency guidance to define leveraged loans, nontraditional mortgage loans, and subprime loans, but refined the definitions to ensure consistency in reporting. In arriving at these definitions, the FDIC took into account comments that were received in response to the two notices of proposed rulemaking that led to adoption of the February 2011 rule.

While institutions already reported C&D loan data in their quarterly reports of condition and income (the Call Reports), they did not report the data for the other loans, thus requiring new line items in these reports. Therefore, the February 2011 rule required a Paperwork Reduction Act of 1995 (PRA) notice requesting comment on proposed revisions to the reports that would provide the data needed by the FDIC to implement the rule beginning with the June 30, 2011 report date (the March 2011 PRA notice).

Commenters on the March 2011 PRA notice raised concerns about their ability to report subprime and leveraged loan data consistent with the definitions used in the February 2011 rule. They also stated that they would be unable to report the required data by the June 30, 2011 report date. These data concerns had not been raised during the rulemaking process leading up to the February 2011 rule.

As a consequence of this unexpected difficulty, the FDIC issued guidance to large and highly complex institutions instructing them to identify and report subprime and leveraged loans and securitizations using either their existing internal methodologies or the definitions in existing supervisory guidance for a transition period. During the transition period, the FDIC would review the definitions of subprime and leveraged loans to determine whether changes to the definitions would alleviate commenters' concerns without sacrificing accuracy in determining risk for deposit insurance pricing purposes.

As part of the review, staff considered all comments related to the higher-risk asset definitions submitted in response to the March 2011 PRA notice and a later July 2011 PRA notice. Staff also engaged in extensive discussions with bankers and industry trade groups to better understand their concerns and to solicit potential solutions to these concerns. As a result, the Board issued a notice of proposed rulemaking on March 20, 2012 (the NPR) on which this final rule is based.

While the FDIC received only 14 comment letters on the NPR, some of the comments were extensive and detailed.[1] The final rule, if adopted by the Board, generally follows the proposal in the NPR, but makes some changes that reflect these comments. The goal of the final rule is to ensure that the assessment system captures the risk inherent in higher-risk assets without imposing unnecessary reporting burden.

[1] The FDIC also received a number of emails from and conducted meetings with commenters and other interested parties.

II. Higher-Risk C&I Loans

Definition

The proposed definition of a higher-risk C&I loan and security in the NPR, which was intended to replace the definition of a leveraged loan in the February 2011 rule, was informed by an approach recommended by commenters on the March 2011 PRA notice.[2] According to these commenters, the definition of a leveraged loan in the February 2011 rule was overly broad and included loans that were not higher risk. Commenters argued that many industries routinely operate with high leverage and are not necessarily higher risk. Heightened risk arises, according to the commenters, when a business increases its leverage for the purpose of financing a buyout, acquisition or capital distribution, because loans for these purposes typically change the way the business operates. For example, a buyout loan for the purpose of a merger can lead to new lines of business and new management. Thus, bankers themselves view loans of this type, rather than any loan to any leveraged borrower, as higher risk. This difference in view regarding what constitutes a higher-risk loan to a commercial borrower contributed to the difficulty the industry had in complying with and reporting under the definition in the February 2011 rule.

In response, the definition of a higher-risk C&I loan and security in the NPR included a "purpose test" to focus more narrowly on commercial loans that presented higher risk. Under the proposed definition, a leveraged commercial borrower would have been treated as a higher-risk borrower if the borrower had obtained a loan intended to finance a buyout, acquisition or capital distribution (that is, if the loan met a "purpose" test) within the previous seven years (the seven-year "look-back period"). Under the proposed definition, the "purpose" loan could have been made by any lender. The "purpose" loan could have been for any amount, but would have had to result in at least a 20 percent increase over 12 months in the total funded debt of the borrower (the "materiality" test) to make the borrower higher risk. The NPR proposed that, if C&I loans to a higher-risk borrower totaled at least $5 million, then all C&I loans to that borrower would be considered higher risk.

In a joint letter filed by a coalition of trade groups (the joint letter) and in discussions, commenters argued that the NPR definition still covered too many loans that were not actually higher risk, and that complying with and reporting under the definition would remain difficult and expensive. The joint letter suggested that a $5 million threshold should be part of the purpose test, on the grounds that a loan of less than $5 million at origination or refinance would not be sufficiently material to be higher risk even if it financed an acquisition, buyout or capital distribution, and that requiring a lender to consider loans under $5 million to a borrower would be expensive and time consuming. The joint letter also suggested that the look back at the purpose and materiality of debt should apply only when currently outstanding debt is refinanced, on the grounds that the definition of higher risk is intended to identify risk when it is created.

[2] "C&I" is an abbreviation for "commercial and industrial."

Finally, the commenters recommended that the look-back period should be, at most, five years rather than seven years as proposed in the NPR, on the grounds that most large banks track the past borrowing history of a borrower only three years back through a review of their financial statements, and that the purpose of debt becomes murkier as it grows older and as new debt is added.

The final rule, if adopted by the Board, implements these suggestions with some modifications primarily intended either to simplify the rule or to ensure that the intent of the definitions cannot be easily circumvented.

The final rule introduces a new term, a "higher-risk C&I borrower," which includes a borrower that owes the reporting bank (*i.e.,* the bank filing its Call Report) on a C&I loan originally made on or after April 1, 2013, if the following conditions are met:

- The C&I loan must have an original amount (including funded amounts and the amount of unfunded commitments, whether irrevocable or unconditionally cancellable) of at least $5 million;

- The loan must meet the purpose and materiality tests described below; and

- When the loan is made, the borrower must meet the leverage test, also described below.

To ensure that the definition is equitably applied, all C&I loans that a borrower owes to the reporting bank that meet the purpose test when made, and that are made within six months of each other, must be aggregated to determine whether they have an original amount of at least $5 million; however, only loans in the amount of $1 million or more need to be aggregated.[3] Thus, for example, if a bank makes a $4 million C&I loan and five months later makes a $2 million C&I loan, both of which meet the purpose test, the loans will have an original amount of $6 million.

A "higher-risk C&I borrower" also includes a borrower that obtains a refinance of an existing C&I loan, where the refinance occurs on or after the effective date of the rule and the refinanced loan is owed to the reporting bank, if the following conditions are met:

- The refinanced loan must be in an amount (including funded amounts and the amount of unfunded commitments, whether irrevocable or unconditionally cancellable) of at least $5 million;

- The C&I loan being refinanced must have met the purpose and materiality tests when it was originally made;

[3] Loans made before the effective date of the rule need not be aggregated. For a C&I loan that meets the purpose test and that is syndicated or participated among banks, the original amount of the loan (for purposes of determining whether the original amount is at least $5 million) is the total original amount of the loan, not just the syndicated or participated portion held by an individual bank.

- The original loan must have been made no more than five years before the refinanced loan (the look-back period); and

- When the loan is refinanced, the borrower must meet the leverage test.

Again, to ensure that the definition is equitably applied, when a C&I loan is refinanced through more than one loan and the loans are made within six months of each other, they must be aggregated to determine whether they have an amount of at least $5 million. Thus, for example, an $8 million C&I refinancing loan that is split into two $4 million loans, where both are made within six months of each other, will still have an amount of $8 million.

A borrower ceases to be a "higher-risk C&I borrower" if: (1) the borrower no longer has any C&I loans owed to the reporting bank that, when originally made, met the purpose and materiality tests; (2) any such loans outstanding owed by the borrower to the reporting bank have all been refinanced more than five years after originally being made; or (3) the reporting bank makes a new C&I loan or refinances an existing C&I loan and the borrower no longer meets the leverage test. A borrower cannot cease to be a higher-risk borrower except as provided above.

Under the final rule, a "higher-risk C&I loan or security" includes all C&I loans owed to the reporting bank by a higher-risk C&I borrower, except loans subject to an exclusion described below, and all securities issued by the higher-risk C&I borrower that are owned by the reporting bank, except securities classified as trading book, without regard to when the loans were made or the securities purchased.

Purpose test

A loan or refinance meets the purpose test if it is to finance a buyout, acquisition or capital distribution.[4] The purpose test will help identify risk and reflect the method used internally by most banks to identify higher-risk loans. The test identifies those borrowers with certain higher-risk characteristics, such as a heavy reliance on either enterprise value or improvement in the borrower's profitability.[5]

Materiality test

A loan or refinance meets the materiality test if the amount of the original loan (including funded amounts and the amount of unfunded commitments, whether irrevocable or unconditionally cancellable) equals or exceeds 20 percent of the total funded debt of the borrower. Total funded debt of the borrower is to be determined as of

[4] Under the final rule, an "acquisition" is the purchase by the borrower of any equity interest in another company or the purchase of all or a substantial portion of the assets of another company; a "buyout" is the purchase or repurchase by the borrower of the borrower's outstanding equity (a buyout includes, but is not limited to, an equity buyout or funding of an Employee Stock Ownership Plan (ESOP)); and a "capital distribution" is a dividend payment or other transaction designed to enhance shareholder value, such as repurchase of stock.

[5] Enterprise value is a measure of the borrower's value as a going concern.

the date of the original loan and does not include the loan to which the materiality test is being applied.[6] A loan also meets the materiality test if, before the loan was made, the borrower had no funded debt.

Leverage test

A borrower meets the leverage test if the ratio of the borrower's total debt to trailing twelve-month EBITDA (commonly known as the operating leverage ratio) is greater than 4, or the ratio of the borrower's senior debt to trailing twelve-month EBITDA (also commonly known as the operating leverage ratio) is greater than 3.[7]

Other changes and comments

The NPR proposed excluding from the definition of a higher-risk C&I loan (1) asset-based lending and floor plan lending, (2) the maximum amount recoverable from the U.S. government or its agencies under guarantee or insurance provisions, and (3) loans fully secured by cash collateral. The final rule retains these exclusions but, in response to comments, makes minor changes regarding collateral control requirements for the asset-based lending exclusion.[8] These changes are described in detail in the preamble to the final rule.

The final rule does not adopt some suggested changes. For example, the final rule does not adopt the industry's suggestion that the threshold in the materiality test be increased from 20 percent to 50 percent. Because the materiality test will measure only the increase in total funded debt that results from loans that meet the purpose test, rather than the total increase in funded debt from any source, the final rule continues to define a material increase as at least 20 percent. Increasing the threshold above 20 percent could exclude borrowers that were highly leveraged before obtaining a loan that meets the purpose test, even if the loan was large. Furthermore, the final rule already adopts a narrower definition of higher-risk C&I loans than existing and proposed regulatory guidelines on leveraged lending, which do not contain any materiality test.[9] The final rule also simplifies the materiality test by requiring that a loan that meets the purpose test must be at least 20 percent of total funded debt as of the date of origination, rather than as of one year earlier.

In the joint letter, commenters recommended excluding loans that are fully collateralized by securities issued by the U.S. government, its agencies, or government-sponsored enterprises (GSEs). The final rule, however, does not exclude loans so collateralized because the collateral is subject to interest rate risk and collateral

[6] When multiple loans must be aggregated to determine whether they total at least $5 million, the materiality test is to be applied as of the date of the last loan.
[7] EBITDA is defined as earnings before interest, taxes, depreciation, and amortization.
[8] The NPR also proposed excluding from the definition of a higher-risk C&I loan and security "the maximum amount that is recoverable from … [GSEs] under guarantee or insurance provisions," but the final rule omits this language because no GSE guarantees or insures C&I loans or securities.
[9] OCC's February 2008 Comptroller's Handbook on Leverage Lending (pages 2 and 3) and the (interagency) Proposed Guidelines on Leveraged Lending, 77 FR 19417 (March 30, 2012).

arrangements are subject to operational risk. Commenters also recommended excluding loans that are continuously secured by brokerage account collateral (securities-based loans). The final rule does not exclude these loans because the value of the collateral is subject to several sources of risk, including operational, credit and market risk. The final rule does not incorporate some other, more minor, suggestions, as well.

Effective date

The final rule applies to all C&I loans owed to a reporting bank by a higher-risk C&I borrower and all securities issued by a higher-risk C&I borrower that are owned by the reporting bank. To be classified as a higher-risk C&I borrower under the final rule, the borrower must have obtained a C&I loan or refinanced an existing C&I loan on or after April 1, 2013. Therefore, banks will not need to reexamine their entire existing C&I loan and security portfolios immediately to determine whether the loans and securities meet the new definition of higher-risk C&I loans and securities. Furthermore, for C&I loans and securities originated or purchased before April 1, 2013, where the loans are owed to the reporting bank by a borrower that does not meet the definition of a higher-risk C&I borrower, a bank must continue to use the transition guidance in the September 2012 Call Report instructions to determine whether to report the loan or security as a higher-risk asset for purposes of the higher-risk assets to Tier 1 capital and reserves ratio.A bank may, however, opt to apply the final rule definition of higher-risk C&I loans and securities to all of its C&I loans and securities.[10]

III. Higher-Risk Consumer Loans

If adopted by the Board, the final rule will define a "higher-risk consumer loan" substantially as proposed in the NPR. A "higher-risk consumer loan" is defined as a consumer loan where, as of origination, or, if the loan has been refinanced, as of refinance, the probability of default (PD) within two years (the two-year PD) is greater than 20 percent, excluding those consumer loans that meet the definition of a nontraditional mortgage loan.[11,12] The final rule adopts the methodology and requirements proposed in the NPR for determining a two-year PD with only minor modifications. As proposed in the NPR, the final rule allows a bank that cannot meet these requirements to submit a written request to the FDIC to use an alternative methodology. The circumstances under which a bank may do so are very limited. The

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[10] A bank that does so must also apply the final rule definition of a higher-risk C&I borrower without regard to when the loan is originally made or refinanced (that is, whether made or refinanced before or after April 1, 2013)

[11] A loan that meets both the definitions of a nontraditional mortgage loan and a higher-risk consumer loan at the time of origination should be reported as a nontraditional mortgage loan. If the loan, however, later ceases to meet the definition of nontraditional mortgage loan but continues to qualify as a higher-risk consumer loan, it must then be reported as a higher-risk consumer loan.

[12] The final rule definition of a higher-risk consumer loan excludes the maximum amount that is recoverable from the U.S. government or its agencies under guarantee or insurance provisions. The NPR proposed excluding from the definition of a higher-risk consumer loan "the maximum amount that is recoverable from … [GSEs] under guarantee or insurance provisions," but the final rule omits this language because no GSE guarantees or insures individual consumer loans.

final rule allows the bank to use the alternative methodology while the FDIC evaluates it. The final rule includes a PRA notice that solicits comments on this collection of information as well as another described below for foreign consumer loans. If the FDIC disapproves the alternative methodology, the bank may be required to amend up to two prior Call Reports.

In response to comments, the final rule describes how to treat unscorable consumer loans (that is, where the available information is insufficient to determine a credit score) and foreign consumer loans. The NPR was silent on the treatment of these loans. Under the final rule, if the total outstanding balance of unscorable consumer loans of a particular product type exceeds 5 percent of the total outstanding balance for that product type, including both foreign and domestic loans, the excess amount is treated as higher risk (the de minimis approach). The final rule directs banks to review unscorable loans at least once a year and reevaluate them once a credit score becomes available.

Under the final rule, PDs for foreign consumer loans are to be calculated in the same manner as required for domestic consumer loans unless doing so would be unduly complex or unduly burdensome (for example, if a bank had to develop separate PD mappings for many different countries). Otherwise, subject to specific requirements, a bank that is required to calculate PDs for foreign consumer loans under the requirements of the Basel II capital framework may: (1) use a statistical analysis to translate one-year PDs calculated under the Basel II framework to two-year PDs that meet the final rule specifications; [13] (2) submit a written request to the FDIC to use an alternate methodology, but may not use the methodology until approved by the FDIC; or (3) treat the loan as an unscorable consumer loan subject to the de minimis approach described above. A bank that is not subject to the requirements of Basel II may follow either of the last two options available to Basel II banks – submit a written request to the FDIC to use an alternate methodology or treat the loan as an unscorable consumer loan subject to the de minimis approach described above.

While reserving the FDIC's flexibility to change the 20 percent threshold without further notice-and-comment rulemaking, the final rule, unlike the NPR, only allows for one such change in the threshold and only as the result of reviewing data for up to the first two reporting periods.

Banks will need to start reporting the amount of higher-risk consumer loans for the quarter ending June 30, 2013, without regard to when the loans were originated or purchased.

IV. Higher-Risk Securitizations

If adopted by the Board, the final rule will require securitizations (except securitizations classified as trading book) to be reported as higher-risk where, in

[13] Use of this method does not imply that a bank's PFR has approved use of the PDs for the Basel II capital framework. If a bank's PFR requires it to revise its Basel II PD methodology, the bank must use revised Basel II PDs to calculate (or recalculate if necessary) corresponding PDs under this Basel II approach.

aggregate, more than 50 percent of the assets backing the securitization meet either the criteria for higher-risk C&I loans or securities, higher-risk consumer loans, or nontraditional mortgage loans.[14] The final rule makes no substantive changes from the NPR regarding securitization.[15]

In the joint letter, commenters asserted that the proposed means of identifying securitizations as higher risk is unworkable and would make banks reluctant to invest in securitizations, which would impede the flow of credit to consumers and businesses and would further impair a market that is struggling to recover. In this same letter, commenters noted that securitizers have developed standards for the type and quantity of information that they provide investors, but this information may not be adequate for banks to make a higher-risk asset determination. Further, the commenters noted that securitizations could be issued by non-bank finance companies that are not subject to deposit insurance pricing rules or definitions and may not have the required data to provide to their investors. The commenters also added that institutions that invest in these securitizations cannot simply request the information needed to make a higher-risk asset determination or compel the servicer or originator to make that determination.

The final rule, however, like the proposed rule, gives banks flexibility in making higher-risk asset determinations for securitizations. The final rule allows an institution to use information reasonably available to a sophisticated investor in reasonably determining whether a securitization meets the 50 percent threshold and suggests several sources for this information. In most cases, this information should be sufficient to make the determination, because banks must conduct thorough due diligence prior to purchase. Moreover, large and highly complex institutions are sophisticated investors and can typically obtain the information needed to determine whether a securitization meets the 50 percent threshold when they purchase interests in these securitizations. The final rule, like the proposed rule, however, also acknowledges that sufficient information necessary for an institution to make a definitive determination may not, in every case, be reasonably available to the institution as a sophisticated investor, and allows an institution to exercise its judgment in making the determination.

Commenters, through the joint letter, and a bank recommended that the FDIC allow banks to consider the structure of the securitization and any credit enhancements to it and argued that, by not doing so, the FDIC is giving banks an incentive to acquire

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[14] Unscorable consumer loans (including all foreign consumer loans) that exceed 5 percent of the loans in a securitization are deemed higher risk.

[15] The definition of a higher-risk securitization in the final rule excludes the maximum amount that is recoverable from the U.S. government or its agencies under guarantee or insurance provisions. The NPR proposed also excluding from the definition of a higher-risk C&I loan securitization "the maximum amount that is recoverable from ... [GSEs] under guarantee or insurance provisions," but the final rule omits this language because no GSE guarantees or insures securitizations containing C&I loans. The NPR also proposed a similar exclusion with regard to the proposed definition of a higher-risk consumer loan securitization, and the final rule again omits this language. No GSE currently guarantees or insures securitizations where more than 50 percent of the assets backing the securitization consist of higher-risk consumer loans or nontraditional mortgages, and the definition of a higher-risk securitization in the final rule does not apply to a securitization issued before April 1, 2013.

lesser quality, subordinated interests in securitizations, because variations in quality and subordination or the lack of it will not affect deposit insurance assessment rates. Commenters suggested that banks could use the proposed revised regulatory capital risk-weighting methodologies currently in development by the bank regulatory agencies (the Standardized Approach for Risk-Weighted Assets[16]) to determine if a securitization is higher risk.

Like the proposed rule, the final rule does not allow exclusions for higher-risk securitizations based upon structure or credit enhancements. As noted in the proposed rule, the performance of a securitization is highly correlated with the performance of the underlying assets, even when the securitization contains terms or conditions intended to reduce risk. During the crisis, a number of highly rated senior securitization positions were subject to significant downgrades and suffered substantial losses. Even where losses have not yet been realized (as is the case in many collateralized loans), the market value of these securitizations declined precipitously during the crisis, reflecting the decline in the market value of the underlying assets and the increased risk of loss. This decline in value contributed to the liquidity crisis of 2008, which forced the government to provide unprecedented support to financial institutions and liquidity markets. Furthermore, the Standardized Approach for Risk-Weighted Assets is still in development and has not yet been finalized. The proposed implementation date is more than two years away (January 15, 2015, although it may be implemented earlier); banks must have a method in place to identify higher-risk securitizations for deposit insurance pricing purposes by April 1, 2013. The final rule provides that the FDIC will monitor implementation of the Standardized Approach to determine whether all or parts of the approach should be incorporated into the risk-based pricing system for large banks and highly complex institutions.

The final rule applies to securitizations of C&I and consumer loans issued on or after April 1, 2013, including those securitizations issued on or after April 1, 2013, that are partially or fully collateralized by loans originated before April 1, 2013. For all securitizations issued before April 1, 2013, banks must either (1) continue to use the transition guidance in the September 2012 Call Report instructions or (2) apply the definitions in the final rule to all of its securitizations.[17]

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[16] 77 FR 52888 (Aug. 30, 2012).
[17] If a bank applies the definition of higher-risk C&I loans and securities in the final rule to its securitizations, it must also apply the definition of a higher-risk C&I borrower in the final rule to all C&I borrowers without regard to when the loans to those borrowers were originally made or refinanced (i.e., whether made or refinanced before or after April 1, 2013).