

# Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

## FEDERAL DEPOSIT INSURANCE CORPORATION

### 12 CFR Part 327

RIN 3064-AD92

#### Assessments, Large Bank Pricing

**AGENCY:** Federal Deposit Insurance Corporation (FDIC).

**ACTION:** Notice of proposed rulemaking and request for comment.

**SUMMARY:** The FDIC proposes to amend its regulations to revise some of the definitions used to determine assessment rates for large and highly complex insured depository institutions. The FDIC believes these proposed amendments will result in more consistent reporting, better reflect risk to the FDIC, significantly reduce reporting burden, and satisfy many concerns voiced by the banking industry.

**DATES:** Comments must be received on or before May 29, 2012.

**ADDRESSES:** You may submit comments on the notice of proposed rulemaking, identified by RIN number and the words "Assessments, Large Bank Pricing Definition Revisions Notice of Proposed Rulemaking," by any of the following methods:

- *Agency Web Site:* <http://www.FDIC.gov/regulations/laws/federal/propose.html>. Follow the instructions for submitting comments on the Agency Web Site.
- *Email:* [Comments@FDIC.gov](mailto:Comments@FDIC.gov). Include the RIN number in the subject line of the message.
- *Mail:* Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429.
- *Hand Delivery:* Guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m.

**Instructions:** All submissions received must include the agency name and RIN for this rulemaking. Comments will be posted to the extent practicable and, in

some instances, the FDIC may post summaries of categories of comments, with the comments themselves available in the FDIC's reading room. Comments will be posted at: <http://www.fdic.gov/regulations/laws/federal/propose.html>, including any personal information provided with the comment.

#### FOR FURTHER INFORMATION CONTACT:

Patrick Mitchell, Chief, Large Bank Pricing Section, Division of Insurance and Research, (202) 898-3943; Brenda Bruno, Senior Financial Analyst, Division of Insurance and Research, (630) 241-0359 x 8312; Christopher Bellotto, Counsel, Legal Division, (202) 898-3801; Sheikha Kapoor, Counsel, Legal Division, (202) 898-3960.

#### SUPPLEMENTARY INFORMATION:

##### I. Background

###### *Legal Authority*

The Federal Deposit Insurance Act (the FDI Act) requires that the deposit insurance assessment system be risk-based.<sup>1</sup> It defines a risk-based system as one based on an institution's probability of causing a loss to the Deposit Insurance Fund (the DIF), taking into account the composition and concentration of the institution's assets and liabilities and any other factors that the FDIC determines are relevant, the likely amount of any such loss, and the revenue needs of the DIF. The FDI Act allows the FDIC to "establish separate risk-based assessment systems for large and small members of the Deposit Insurance Fund."<sup>2</sup>

###### *Large Bank Pricing Rule*

On February 7, 2011, the FDIC 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 rule).<sup>3</sup> The February rule

<sup>1</sup> Section 7(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(1)).

<sup>2</sup> Section 7(b)(1)(D) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(1)(D)).

<sup>3</sup> Assessments, Large Bank Pricing, 76 FR 10672 (February 25, 2011) (to be codified at 12 CFR 327.9).

<sup>4</sup> A large institution is defined as an insured depository institution: (1) That had assets of \$10 billion or more as of December 31, 2006 (unless, by reporting assets of less than \$10 billion for four consecutive quarters since then, it has become a small institution); or (2) that had assets of less than \$10 billion as of December 31, 2006, but has since had \$10 billion or more in total assets for at least four consecutive quarters, whether or not the

eliminated risk categories for large institutions and combined CAMELS ratings and certain forward-looking financial ratios into one of two scorecards, one for highly-complex institutions and another for all other large institutions. The scorecards calculate a total score for each institution.<sup>5</sup> The total score is then converted to the institution's initial base assessment rate, which, after certain adjustments, results in the institution's total assessment rate.<sup>6</sup> To calculate the amount of the institution's quarterly assessment, the total base assessment rate is multiplied by the institution's assessment base and the result divided by four.

One of the financial ratios used in the scorecards is the ratio of higher-risk assets to Tier 1 capital and reserves.<sup>7</sup> Higher-risk assets are defined as the sum of construction and land development (C&D) loans, leveraged loans, subprime loans, and nontraditional mortgage loans. The February rule used existing interagency

institution is new. A "highly complex institution" is defined as: (1) An insured depository institution (excluding a credit card bank) that has had \$50 billion or more in total assets for at least four consecutive quarters and that either is controlled by a U.S. parent holding company that has had \$500 billion or more in total assets for four consecutive quarters, or is controlled by one or more intermediate U.S. parent holding companies that are controlled by a U.S. holding company that has had \$500 billion or more in assets for four consecutive quarters, and (2) a processing bank or trust company. A processing bank or trust company is an insured depository institution whose last three years' non-lending interest income, fiduciary revenues, and investment banking fees, combined, exceed 50 percent of total revenues (and its last three years fiduciary revenues are non-zero), whose total fiduciary assets total \$500 billion or more and whose total assets for at least four consecutive quarters have been \$10 billion or more.

<sup>5</sup> A large or highly-complex institution's total score may also be adjusted by the large bank adjustment. 76 FR 10672, 10714 (February 25, 2011) (to be codified at 12 CFR 327.9(b)(3)).

<sup>6</sup> An institution's initial base assessment rate can be adjusted by the unsecured debt adjustment, the depository institution debt adjustment, and the brokered deposit adjustment. 76 FR 10672, 10715 (February 25, 2011) (to be codified at 12 CFR 327.9(d)).

<sup>7</sup> Higher-risk assets are used to calculate the concentration score, which is part of both the large bank scorecard and the highly complex institution scorecard. For large institutions, the concentration score is defined as the higher of: (a) The higher-risk assets to Tier 1 capital and reserves score or (b) the growth-adjusted portfolio concentrations score. For highly complex institutions, it is defined as the higher of: (a) The higher-risk assets to Tier 1 capital and reserves score or (b) the largest or top 20 counterparty exposures to Tier 1 capital and reserves score.

guidance to define leveraged loans, nontraditional mortgage loans, and subprime loans but refined the definitions to minimize reporting discrepancies. 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 rule.<sup>8</sup>

While institutions already reported C&D loan data in their quarterly reports of condition and income (the Call Reports and the Thrift Financial Reports or TFRs), they did not report the needed data for the other loans, thus requiring new line items in these reports. Therefore, on March 16, 2011, the Office of the Comptroller of the Currency, the Board of the Federal Reserve System, the Office of Thrift Supervision, the Treasury, and the FDIC (collectively, the agencies) published a Paperwork Reduction Act of 1995 (PRA) notice under normal PRA clearance procedures requesting comment on proposed revisions to the Call Reports, the TFRs, and the Federal Financial Institutions Examination Council (FFIEC) 002/002S reports that would provide the data needed by the FDIC to implement the February 2011 rule beginning with the June 30, 2011, report date (March PRA notice).<sup>9</sup>

The agencies received 19 comments in response to the March PRA notice. Of these 19 comments, 17 addressed the new items for subprime and leveraged loans added to Call Reports and TFRs. The commenters stated that institutions generally do not maintain data on these loans consistent with the definitions used in the February rule and would be unable to report the required data by the June 30, 2011, report date. These data availability concerns had not been raised during the rulemaking process leading up to the February rule.<sup>10</sup>

<sup>8</sup> 75 FR 23516 (May 3, 2010); 75 FR 72612 (November 24, 2010).

<sup>9</sup> 76 FR 14460 (March 16, 2011).

<sup>10</sup> In response to the November 2010 NPR on the revised large institution assessment system, the FDIC received a number of comments recommending changes to the definitions of subprime and leveraged loans, which the FDIC addressed in its February rule amending its assessment regulations. For example, several commenters to the November 2010 NPR stated that regular (quarterly) updating of data to evaluate loans for subprime or leveraged status would be burdensome and costly and, for certain types of retail loans, would not be possible because existing loan agreements do not require borrowers to routinely provide updated financial information. In response to these comments, the FDIC's February rule stated that large institutions should evaluate loans for subprime or leveraged status upon origination, refinancing, or renewal. However, no comments were received on the November 2010 NPR indicating that large institutions would be unable to identify and report subprime or leveraged

As a consequence of this unexpected difficulty, the agencies applied to the Office of Management and Budget (OMB) under emergency clearance procedures to allow institutions to identify and report subprime and leveraged loans and securitizations originated or purchased prior to October 1, 2011, using either their existing internal methodologies or the definitions contained in existing supervisory guidance. The reporting options are referred to as "transition guidance" and are outlined in the General Instructions for Schedule RC-O of the Reports of Condition and Income, Memorandum Items 6 through 15 for leveraged loans and subprime loans. Because the assessment-related reporting revisions needed to remain in effect beyond the limited approval period associated with an emergency clearance request, the agencies, under the auspices of the FFIEC, submitted the reporting revisions under normal PRA clearance procedures and requested public comment on July 27, 2011 (July PRA notice).<sup>11</sup>

The agencies collectively received four comments in response to the July PRA notice before the comment period closed on September 26, 2011. The commenters recommended extending the transition guidance for reporting subprime and leveraged loans until more workable and accurate definitions were developed. The commenters requested that the definitions of subprime and leveraged loans be revised because they do not effectively measure the risk that the FDIC intended to capture. Rather, commenters maintained that the definitions would capture loans that are not subprime or leveraged (i.e., are not higher-risk assets) and require burdensome reporting that could result in inconsistencies among banks. A joint comment letter from three industry trade groups also recommended that the definition of nontraditional mortgage loans be revised.

On September 28, 2011, the FDIC informed large and highly complex institutions via email (followed by changes to Call Report instructions) that the deadline for the transition guidance would be extended to April 1, 2012, and that 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 risk

loans in accordance with the final rule's definitions in their Call Reports and TFRs beginning as of June 30, 2011. The data availability concerns were first expressed in comments on the PRA notice.

<sup>11</sup> 76 FR 44987 (July 27, 2011).

determination for deposit insurance pricing purposes.

As part of its review, the FDIC considered all comments related to the higher-risk asset definitions that were submitted in response to the March and July PRA notices. The FDIC also engaged in extensive discussions with the industry and industry trade groups over the last few months to better understand their concerns and to solicit potential solutions to these concerns.

## II. Assessment System for Large and Highly Complex Institutions

The FDIC proposes amendments to the assessment system for large and highly complex institutions that would: (1) Revise the definitions of certain higher risk assets, specifically leveraged loans, which would be renamed "higher-risk C&I loans and securities," and subprime consumer loans, which would be renamed "higher-risk consumer loans and securities"; (2) clarify the timing of classifying an asset as higher risk; (3) clarify the way securitizations (including those that meet the definition of nontraditional mortgage loans) are to be identified; and (4) further define terms that are used in the large bank pricing rule. The names of the categories of assets included in the higher-risk assets to Tier 1 capital and reserves ratio have been changed to avoid confusion between the definitions used in the deposit insurance assessment regulations and the terms that generally are used within the industry and in other regulatory guidance. The definitions of C&D loans would not be amended under the NPR and these loans would continue to be defined as in the February rule. Nontraditional mortgage loans would continue to be defined as in the February rule, but the NPR clarifies how securitizations of nontraditional mortgage loans would be identified under the definition. The FDIC believes that the proposed amendments would result in more consistent reporting, better reflect risk to the FDIC, significantly reduce reporting burden, and satisfy many of the concerns voiced by the industry after adoption of the February 2011 rule.

The proposed amendments would be effective on October 1, 2012, predicated on changes to the Call Report. The effective date is discussed in detail in Section F below.

### A. Higher-Risk Assets

The FDIC uses the amount of an institution's higher-risk assets to calculate the institution's concentration score and total score. The concentration measure captures the institution's

lending (and securities owned) in higher-risk areas; concentrations in these higher-risk assets contributed to the failure of some institutions during the recent financial crisis and economic downturn.

#### Higher-Risk C&I Loans and Securities

Under the proposal, higher-risk commercial and industrial (C&I) loans and securities would include:

- Any commercial loan (funded or unfunded, including irrevocable and revocable commitments) owed by a borrower to the evaluating depository institution with an original amount greater than \$5 million if the conditions specified in (a) or (b) below are met as of origination, or, if the loan has been refinanced, as of refinance, and the loan does not meet the asset based lending (ABL) exclusion or the floor plan line of credit exclusion (discussed in Appendix C).

(a)(i) The purpose of any of the borrower's debt (whether owed to the evaluating insured depository institution or another lender) that was incurred within the previous seven years was to finance a buyout, acquisition or capital distribution and such debt was material;<sup>12 13</sup> and

(ii) The ratio of the borrower's total debt to trailing twelve-month EBITDA (*i.e.*, operating leverage ratio) is greater than 4 or the ratio of the borrower's senior debt to trailing twelve-month EBITDA (*i.e.*, operating leverage ratio) is greater than 3;<sup>14</sup> or

(b) Any of the borrower's debt (whether owed to the evaluating institution or another lender) is

<sup>12</sup> For purposes of this definition, the "purpose of the borrower's debt" is determined at the time the debt was incurred by the borrower. An institution would be required to determine if the borrower has incurred any debt in the last seven years that meets the purpose test.

<sup>13</sup> Following are definitions of some of the terms used under the proposed rule:

1. Acquisition means the purchase by the borrower of any equity interest in another company or the purchase of any of the assets and liabilities of another company.

2. Buyout for purposes of calculating higher-risk C&I assets means the issuance of debt to finance the purchase or repurchase by the borrower of the borrower's outstanding equity. A buyout could include, but is not limited to, an equity buyout or funding of an Employee Stock Ownership Plan (ESOP).

3. Capital distribution means that the borrower incurs debt to finance a dividend payment or to finance other transactions designed to enhance shareholder value, such as repurchase of stock.

4. Material means resulting in a 20 percent or greater increase anytime within 12 months in the total funded debt of the borrower (including all funded debt assumed, created, or refinanced). Debt is also material if, before the debt was incurred, the borrower had no funded debt.

<sup>14</sup> EBITDA is defined as earnings before interest, taxes, depreciation, and amortization.

designated as a highly leveraged transaction (HLT) by a syndication agent.

- All securities held by the evaluating institution that are issued by a commercial borrower, if the conditions specified in (a) or (b) above are met, except securities classified as trading book; and

- All securitizations held by the evaluating institution that are more than 50 percent collateralized by commercial loans or securities that would meet the higher-risk C&I loans and securities definition if directly held by the evaluating institution, except securities classified as trading book.

The definition of a higher-risk C&I loan and security would exclude the maximum amount that is recoverable from the U.S. government, its agencies, or government-sponsored agencies under guarantee or insurance provisions, and loans that are fully secured by cash collateral.<sup>15</sup>

An institution would be required to use information reasonably available to a sophisticated investor in reasonably determining whether a securitization meets the 50 percent threshold.<sup>16</sup> Information reasonably available to a sophisticated investor should include, but is not limited to, offering memorandums, indentures, trustee reports, and requests for information from servicers, collateral managers, issuers, trustees, or similar third parties. When determining whether a revolving trust or similar securitization would meet the threshold, an institution could use established criteria, model portfolios, or limitations published in the offering memorandum, indenture, trustee report or similar documents.

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. In such a case, the institution may exercise its judgment in making the determination.

<sup>15</sup> In order to exclude a loan based on cash collateral, the cash would be required to be in the form of a savings or time deposit held by the insured depository institution. The insured depository institution would be required to have in place a signed collateral assignment of the deposit account, which is irrevocable for the remaining term of the loan or commitment, and the insured depository institution would be required to place a hold on the deposit account that alerts the institution's employees to an attempted withdrawal. For the exclusion to apply to a revolving line of credit, the cash collateral would be required to be equal to or greater than the amount of the total loan commitment (the aggregate funded and unfunded balance of the loan).

<sup>16</sup> A securitization would be as defined in Appendix A, Section II(B)(16) of Part 325 of the FDIC's Rules and Regulations, as it may be amended from time to time.

Nevertheless, the FDIC would retain the right to review and audit for compliance with the rule any determination that a securitization does not meet the 50 percent threshold.

In cases where a securitization is required to be consolidated on the balance sheet as a result of SFAS 166 and SFAS 167, and a large institution or highly complex institution has access to the necessary information, an institution may evaluate individual loans in the securitization on a loan-by-loan basis. Any loan within the securitization that meets the definition of a higher-risk asset would be reported as a higher-risk asset and any loan within the securitization that does not meet the definition of a higher-risk asset would not be reported as such. When making this evaluation, the institution would have to follow the transition guidance described in Appendix C, Section C. Once an institution evaluated a securitization for higher-risk asset designation on a loan-by-loan basis, it would have to continue to evaluate all securitizations for which it has the required information in a similar manner (*i.e.*, on a loan-by-loan basis). For securitizations for which the institution does not have access to information on a loan-by-loan basis, the institution would be required to determine whether the securitization meets the 50 percent threshold as described previously for other securitizations.

When an institution acquires a C&I loan or security, it would have to determine whether the loan or security meets the definition of a higher-risk C&I loan or security using the origination criteria and analysis performed by the original lender. If this information were unavailable, however, the institution would have to obtain recent, refreshed data from the borrower or other appropriate third-party.<sup>17</sup>

Appendix C provides detailed definitions of many of the terms used in the foregoing definition.

In arriving at its proposal, the FDIC carefully reviewed the comments submitted in response to the March and July PRA notices on the leveraged loan definition contained in the February rule. Of the 19 respondents commenting on the March PRA notice, 17 raised concerns over the leveraged loan definition; 6 of the 8 respondents to the July PRA notice raised such concerns. Further, as the FDIC noted in the public comment file for the July PRA notice,

<sup>17</sup> Somewhat more stringent requirements would apply when an institution acquires loans or securities from another entity on a recurring or programmatic basis.

the FDIC met with representatives of four industry trade groups and twice with large and highly complex institutions prior to the close of the comment period on the PRA notice.

Three industry trade groups commented on the July PRA notice that the minimum size for leveraged loans included in the February rule (\$1 million or higher) is too low since it would capture a large number of small business loans that are not normally considered leveraged. These trade groups commented that the \$1 million level overstates leveraged exposures and creates a significant reporting burden, since banks do not generally gather the data required to make a leveraged loan determination for these smaller loans. The commenters further noted that loans under \$5 million are typically characterized by additional risk-reducing requirements, such as borrower's guarantees and additional collateral. When these risk-reducing mitigants are prevalent, relying solely on the debt-to-EBITDA test could be a less accurate measure of the risk of these borrowers.

The proposal would increase the threshold level to \$5 million. The increased threshold would result in better identification of higher-risk C&I loans and would also reduce the reporting burden.

In response to the July PRA Notice, three banking industry trade groups in a joint letter to the FDIC stated that the definition of leveraged loans used in the February rule does not capture risk as intended and is not a reliable measure of a leveraged loan. They maintained that an institution's debt-to-EBITDA ratio is not, by itself, a reliable indicator of risk, particularly if the loans are asset based or are to companies or industries that traditionally have higher leverage levels. They added that the definition of leveraged loans in the February rule captures such a large portion of an institution's loan portfolio that it does not provide a meaningful differentiation of risk among institutions and creates a reporting burden. The trade groups suggested that considering the purpose of the loan in conjunction with the borrower's operating leverage ratio would result in more accurate identification of risk.<sup>18</sup>

The proposed definition would combine a test of the borrower's operating leverage ratio with a purpose test, namely, that if the purpose of any of the borrower's debt (whether owed to the evaluating insured depository

institution or another lender) was to finance a buyout, acquisition, or capital distribution, and that debt was material, a C&I loan or security to that borrower would be classified as higher risk. The purpose of the debt would help identify risk to the FDIC and reflect the method used internally by most banks to identify higher-risk loans. The purpose test would identify those borrowers with certain higher-risk characteristics, such as a heavy reliance on either enterprise value or improvement in the borrower's operating efficiencies.<sup>19</sup>

The industry suggested in a comment letter to the July PRA Notice and in subsequent discussions that banks should look back to the original purpose of debt only if the debt was originally incurred during the previous five years. Under the proposal, however, banks would have to look back to the original purpose of any of the borrower's debt incurred during the previous seven years. During the most recent buyout boom of the mid to late 2000s, a seven-year maturity was often the longest dated maturity for loans that facilitated a leveraged buyout. Under the proposal, where the purpose test is met, loans originated in 2007 (near the end of the leveraged buyout boom) to a borrower that remains above the proposed debt-to-EBITDA ratio thresholds would continue to be classified as higher-risk assets, even when they are refinanced; loans that are refinanced from the same time period but where the borrower has de-levered through either EBITDA growth or debt repayment would not be defined as higher-risk under the proposal.

Under the proposal, debt to finance a buyout, acquisition, or capital distribution would also have to be material. Such debt would be material if it resulted in a 20 percent or greater increase anytime within 12 months in the total funded debt of the borrower.<sup>20</sup> During discussions with the industry, bankers have suggested that total funded debt should have to increase by 50 percent or more to be considered a material buyout, acquisition, or capital distribution. Under the proposal, only a 20 percent increase is required. A 20 percent increase would be high enough to ensure that the FDIC does not capture transactions that do not materially increase the risk profile of the borrower, but low enough to capture transactions such as capital distributions that benefit the borrower's shareholders while

increasing the risk to the lending institutions.

The joint comment letter to the July PRA Notice also noted that collateral was not appropriately considered in the leveraged loan definition included in the February rule. The commenters stated that loans would be classified as leveraged even though they had strong collateral backing them, which should result in significantly lower loss rates than loans that are dependent primarily on the enterprise value of a highly-leveraged company. Examples of the loans commenters thought should be excluded from the leveraged loan definition were asset-based loans and dealer floor plan loans.

After considering the comments, the proposed rule would exclude certain well-collateralized asset-based loans and floor plan loans from the definition of higher-risk C&I loans and securities. Because these loans carry significant operational risk, the exclusions would apply only to loans that are well secured by self-liquidating collateral (i.e., accounts receivable and inventory) and only when the institution can demonstrate that it has a history of strong risk management and internal controls over these loans. Excluding loans under these conditions should result in better differentiation of credit risk among institutions and should reduce reporting burden.

Under the February rule, higher-risk assets included securitizations where more than 50 percent of the assets backing the securitization meet the criteria for leveraged loans. In their joint comment letter, three industry trade groups stated that the reporting criteria for securitizations in the February rule is problematic given the challenges in evaluating individual loans in the securitization given the lack of standardized disclosure requirements that align with the FDIC's definition of higher-risk assets.

Under the proposal, higher-risk C&I loans and securities would continue to include securitizations where more than 50 percent of the assets backing the securitization meet the criteria for higher-risk C&I loans or securities. Concentrations in higher-risk assets, whether they are in the form of a whole loan or a securitization, increase the risk of loss to the FDIC during times of prolonged periods of economic stress. 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 described above when they purchase interests in these securitizations.

<sup>18</sup> The operating leverage ratio is the borrower's total or senior debt to trailing twelve-month EBITDA.

<sup>19</sup> Enterprise value is a measure of the borrower's value as a going concern.

<sup>20</sup> This debt would also be material if, before the debt was incurred, the borrower had no funded debt.

Trade groups also commented that categorizing securitizations as higher-risk assets based solely on the underlying collateral ignores important risk mitigants such as credit enhancements. The performance of a securitization, however, is highly correlated with the performance of the underlying assets, even when the securitization contains terms or conditions intended to reduce risk. As stated in an interagency NPR issued in December 2011, "during the crisis, a number of highly rated senior securitization positions were subject to significant downgrades and suffered substantial losses."<sup>21</sup> Even where losses have not yet been realized (as in many collateralized loan obligations), 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.

#### Higher-Risk Consumer Loans and Securities

Under the proposal, higher-risk consumer loans and securities would be defined as:

(a) All consumer loans 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) was greater than 20 percent, excluding those consumer loans that meet the definition of a nontraditional mortgage loan;<sup>22</sup> and

(b) Securitizations that are more than 50 percent collateralized by consumer loans meeting the criteria in (a), except those classified as trading book.<sup>23</sup>

An institution would be required to use the information that is or would be reasonably available to a sophisticated investor in reasonably determining whether a securitization meets the 50 percent threshold. Information reasonably available to a sophisticated investor should include, but is not limited to, offering memorandums, indentures, trustee reports, and requests for information from servicers, collateral managers, issuers, trustees, or similar

third parties. When determining whether a revolving trust or similar securitization would meet the threshold, an institution could use established criteria, model portfolios, or limitations published in the offering memorandum, indenture, trustee report or similar documents.

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. In such a case, the institution may exercise its judgment in making the determination. Nevertheless, the FDIC would retain the right to review and audit for compliance with the rule any determination that a securitization does not meet the 50 percent threshold.

In cases where a securitization is required to be consolidated on the balance sheet as a result of SFAS 166 and SFAS 167, and a large institution or highly complex institution has access to the necessary information, an institution may evaluate individual loans in the securitization on a loan-by-loan basis. Any loan within the securitization that meets the definition of a higher-risk asset would be reported as a higher-risk asset and any loan within the securitization that does not meet the definition of a higher-risk asset would not be reported as such. When making this evaluation, the institution would have to follow the transition guidance described in Appendix C, Section C. Once an institution evaluated a securitization for higher-risk asset designation on a loan-by-loan basis, it would have to continue to evaluate all securitizations for which it has the required information in a similar manner (i.e., on a loan-by-loan basis). For securitizations for which the institution does not have access to information on a loan-by-loan basis, the institution would be required to determine whether the securitization meets the 50 percent threshold as described previously for other securitizations.

Institutions would have to determine the PD of a consumer loan as of origination, or, if the loan has been refinanced, as of refinance. When an institution acquires a consumer loan or security, it would have to determine whether the loan or security meets the definition of a higher-risk consumer loan or security using the origination criteria and analysis performed by the original lender. If this information is unavailable, however, the institution would have to obtain recent, refreshed

data from the borrower or other appropriate third-party.<sup>24</sup>

In arriving at its proposal, the FDIC carefully reviewed the comments submitted in response to the March and July PRA notices on the subprime loan definition contained in the February rule. Of the 19 respondents commenting on the March PRA notice, 17 raised concerns over the subprime loan definition; 6 of the 8 respondents to the July PRA notice raised such concerns. Further, as the FDIC noted in the public comment file for the July PRA notice, the FDIC met with representatives of four industry trade groups and twice with large and highly complex institutions prior to the close of the comment period on the PRA notice.

The representatives stated that institutions generally do not maintain the data necessary to identify consumer loans as higher-risk under the February rule, and would not be able to collect such data prior to filing their Call Reports for the June 30, 2011, report date. Commenters also stated that adapting current reporting systems to capture such loans automatically would, in some cases, be impossible and would require ongoing manual intervention, which is costly and burdensome.<sup>25</sup>

A group representing the industry also asserted that the definition of subprime loans does not correlate with more sophisticated risk-grading systems generally used by banks internally. While these systems consider the factors included in the subprime definition, they consider these jointly rather than individually, and incorporate other information such as the size and type of delinquency and other measures of the borrower's debt capacity. As a consequence, the group believed that using the definition contained in the February rule would greatly overstate institutions' exposure to subprime loans and relative risk. In the group's view, this overstatement of exposure and relative risk could reduce credit or increase its cost for some types of consumers, such as students, since an institution factors the cost of assessments into its credit and pricing decisions.

The proposed definition would better capture and differentiate higher-risk consumer loans and securities among banks compared to the current

<sup>24</sup> Somewhat more stringent requirements would apply when an institution acquires loans or securities from another entity on a recurring or programmatic basis.

<sup>25</sup> These data availability concerns, particularly as they relate to institutions' existing loan portfolios, had not been raised as an issue during the rulemaking process on large bank pricing that culminated in the February rule.

<sup>21</sup> Risk-Based Capital Guidelines: Market Risk: Alternatives to Credit Ratings for Debt and Securitization Positions 76 FR 79380, 79395 (December 21, 2011).

<sup>22</sup> 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. However, if the loan later ceases to meet the definition of nontraditional mortgage loan but continues to still qualify as a higher-risk consumer loan, it would then be reported as a higher-risk consumer loan.

<sup>23</sup> A securitization would be as defined in Appendix A, Section II(B)(16) of Part 325 of the FDIC's Rules and Regulations as it may be amended from time to time.

definition. In addition, the proposal should be easier for institutions to adopt and implement as it more closely aligns with how they currently measure risk.

This same industry group proposed an alternative definition of subprime consumer loans based on PD within one year from origination. Under the proposal, institutions would report the outstanding balance of consumer loans in their retail portfolios stratified by a specified number of products and PD bands. The FDIC has engaged in extensive discussions with industry representatives regarding this proposal and incorporated many of the proposal's major elements into the NPR.

The FDIC chose to propose a two-year, instead of a one-year, PD in order to more closely align with the time horizon used by recognized third party vendors that produce standard validation charts. These charts include observed default rates over a specified two-year period by credit score and product type. If these charts were modified to conform to the PD estimation guidelines in Appendix C, institutions could use them to classify consumer loans under the proposed definition.

A PD estimated according to the guidelines should reflect the average two-year, stress period performance of loans across a range of remaining maturities, as opposed to the performance of loans within the first two years of origination. The FDIC is

concerned with potential default risk throughout the life of the loan and not just over the first two years following origination. By considering different origination time periods and various remaining maturities, the proposed approach should better represent the default risk throughout the life of the loan. Different product types tend to have different default profiles over time, with some products resulting in peak default rates sooner after origination than other products. An approach that considers various remaining maturities should mitigate the default timing bias between products following origination of a loan.

The FDIC intends to collect two-year PD information on various types of consumer loans from large and highly complex institutions. However, the types of information collected and the format of the information collected on the Call Report would be subject to a PRA notice, providing an opportunity for comment, published in the **Federal Register**. The following table is an example of how the FDIC may collect the consumer loan information. Once the definition of higher-risk consumer loans is adopted in a final rule, the FDIC anticipates that appropriate changes to the Call Reports would be made and that institutions would report consumer loans according to the definition in the final rule. As suggested in the example table below and in Appendix 1, institutions would report the

outstanding amount of all consumer loans, including those with a PD below the subprime threshold, stratified by the 10 product types and 12 two-year PD bands.<sup>26</sup> In addition, for each product type, institutions would indicate whether the PDs were derived using scores and default rate mappings provided by a third party vendor or an internal approach.<sup>27</sup> Institutions would report the value of all securitizations that are more than 50 percent collateralized by higher-risk consumer loans (other than trading book) as a separate item.

<sup>26</sup> All reported amounts would exclude the maximum amounts recoverable from the U.S. government, its agencies, or government-sponsored agencies under guarantee or insurance provisions, as well as loans that are fully secured by cash collateral. In order to exclude a loan based on cash collateral, the cash would be required to be in the form of a savings or time deposit held by the insured depository institution, the insured depository institution would be required to have a signed collateral assignment of the deposit account, which is irrevocable for the remaining term of the loan or commitment, and the insured depository institution would be required to place a hold on the deposit account, which alerts the institution's employees to an attempted withdrawal. In the case of a revolving line of credit, the cash collateral would have to be equal to or greater than the amount of the total loan commitment (the aggregate funded and unfunded balance of the loan) for the exclusion to apply.

<sup>27</sup> An internal approach would include the use of an institution's own default experience with a particular product and credit score, whether that score was provided by a third party or was internally derived.

## Outstanding Balance of Consumer Loans by Two-Year Probability of Default

Product	Two-year Probability of Default											
	≤ 1%	1-4%	4-7%	7-10%	10-14%	14-16%	16-18%	18-20%	20-22%	22-26%	26-30%	>30%
All nontraditional residential mortgages <sup>1</sup>												
Closed end loans secured by first liens on 1-4 family residential properties <sup>2</sup>												
Closed end loans secured by junior liens on 1-4 family residential properties <sup>3</sup>												
Revolving, open-end first liens and credit lines secured by 1-4 family residential properties <sup>4</sup>												
Revolving, open-end junior liens and credit lines secured by 1-4 family residential properties <sup>5</sup>												
Credit cards <sup>6</sup>												
Automobile loans <sup>7</sup>												
Student loans <sup>8</sup>												
Other consumer loans (including single payment and installment) and revolving credit plans other than credit cards <sup>9</sup>												
Consumer leases <sup>10</sup>												
Totals												

Note: All reported amounts would exclude the amounts recoverable from the U.S. government, its agencies, or government-sponsored agencies under guarantee or insurance provisions, as well as loans that are fully secured by cash collateral.

<sup>1</sup> As defined in the Large Bank Pricing rule.

<sup>2</sup> Schedule RC-C item 1(c)(2)(a), excluding loans reported as nontraditional residential mortgages.

<sup>3</sup> Schedule RC-C item 1(c)(2)(b), excluding loans reported as nontraditional residential mortgages.

<sup>4</sup> Part of Schedule RC-C item 1(c)(1), "Revolving, open-end loans secured by 1-4 family residential properties and extended under lines of credit."

<sup>5</sup> The portion of Schedule RC-C item 1(c)(1) not reported as revolving, open-end senior liens.

<sup>6</sup> Schedule RC-C item 6(a)

<sup>7</sup> Schedule RC-C item 6(c)

<sup>8</sup> Part of Schedule RC-C item 6(d) "Other consumer loans".

<sup>9</sup> The portion of Schedule RC-C item 6(d) not reported as student loans, plus item 6(b) "Other revolving credit plans."

<sup>10</sup> Schedule RC-C item 10(a)

The proposed 20 percent PD threshold was determined based on an evaluation of performance data provided by a couple of large third party vendors of consumer credit scores. Specifically, for each vendor, this data contained observed, two-year default rates and the proportion of consumer accounts captured by credit score and product type. Default rates were calculated in a manner similar to the guidelines in Appendix C. The FDIC considered the proportion of consumer accounts and range of scores that would be deemed higher-risk under different PD thresholds, overall and by product type, and how those results compare to score-based definitions of subprime commonly used by the industry. The FDIC would use the information that would be included in the Call Report to

determine whether the PD threshold should be changed in the future.<sup>28</sup>

The FDIC anticipates that it may receive additional or updated information from third party vendors prior to the Board adopting a final rule. The FDIC would consider any additional information received before it proposes that a particular PD threshold be adopted in the final rule. In reviewing the PD threshold, the FDIC would use a methodology similar to the methodology described above. The methodology used would include consideration of the proportion of consumer accounts and range of scores that would be deemed higher risk under different PD thresholds and how those compare to score-based definitions of

subprime commonly used in the industry.

During discussions with the industry, a few institutions suggested that the FDIC have the flexibility to modify the time periods used for PD estimation without further notice-and-comment rulemaking. The institutions suggested that the FDIC could either change the time period considered or add additional time periods to the existing time period. The FDIC agrees that having the flexibility to modify the time periods, as part of the risk-based assessment system, would allow the FDIC to better differentiate risk among institutions. For example, a material change in consumer behavior or the development of new consumer products or default data might suggest changes to what should be considered a higher-risk consumer loan. Under these

<sup>28</sup> See 76 FR 10672, 10700 (February 25, 2011) (H. Updating the Scorecard).

circumstances, incorporating new or additional time periods might better capture either the changes in consumer behavior or new potentially higher-risk consumer products so that FDIC can better identify and measure emerging risks. The FDIC would also have, as part of the risk-based assessment system, the flexibility to increase or decrease the PD threshold of 20 for identifying higher-risk consumer loans to reflect the updated consumer default data from the different time periods selected without the necessity of further notice-and-comment rulemaking. Before making changes to the established PD threshold, the FDIC would analyze resulting potential changes in the distribution of the higher-risk consumer loans and would consider the resulting effect on total deposit insurance assessments and risk differentiation among institutions. The FDIC would provide institutions with at least one quarter advance notice of any changes to the PD estimation time periods or the PD threshold.<sup>29</sup>

#### Nontraditional Mortgage Loans

The proposal does not make changes to the definition of a nontraditional mortgage loan; however, it does clarify how securitizations of nontraditional mortgage loans would be identified under the current definition.<sup>30</sup>

In a comment letter in response to the March and July PRA notices, three industry trade groups stated that the criteria outlined for identifying nontraditional mortgage loans in the February rule do not fully differentiate risk among banks or among nontraditional mortgage loans. The commenters maintained that not all nontraditional mortgage loans contain the same level of risk. The industry suggested that banks identify and report nontraditional mortgage loans by the PD within one year from origination as determined as of origination by a credit scoring system, similar to their recommendation for reporting subprime consumer loans.

After reviewing the merits of the industry's suggestions, the FDIC has concluded that identifying a mortgage loan using a one-year PD would be inappropriate given the unique risks of nontraditional mortgage loans. Unlike leveraged loans and subprime loans, institutions have not indicated any difficulty complying with the existing

definition of nontraditional mortgage loans and the FDIC believes that changes to the definition would not result in better risk determination for deposit insurance pricing purposes. The FDIC will monitor future rulemakings regarding Qualified Residential Mortgages and the capital treatment of nontraditional mortgage loans to determine whether any changes to the definition should be considered.

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 described above when they purchase interests in these securitizations. The proposal clarifies that an institution would be required to use information reasonably available to a sophisticated investor in reasonably determining whether a securitization meets the 50 percent threshold of the assets backing a securitization contain nontraditional mortgage loans.

Information reasonably available to a sophisticated investor should include, but is not limited to, offering memorandums, indentures, trustee reports, and requests for information from servicers, collateral managers, issuers, trustees, or similar third parties. When determining whether a revolving trust or similar securitization would meet the threshold, an institution could use established criteria, model portfolios, or limitations published in the offering memorandum, indenture, trustee report or similar documents.

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. In such a case, the institution may exercise its judgment in making the determination. Nevertheless, the FDIC would retain the right to review and audit for compliance with the rule any determination that a securitization does not meet the 50 percent threshold.

In cases where a securitization is required to be consolidated on the balance sheet as a result of SFAS 166 and SFAS 167, and a large institution or highly complex institution has access to the necessary information, an institution may evaluate individual loans in the securitization on a loan-by-loan basis. Any loan within the securitization that meets the definition of a higher-risk asset would be reported as a higher-risk asset and any loan within the securitization that does not meet the definition of a higher-risk asset would not be reported as such. When making this evaluation, the institution would have to follow the transition guidance

described in Appendix C, Section C. Once an institution evaluated a securitization for higher-risk asset designation on a loan-by-loan basis, it would have to continue to evaluate all securitizations for which it has the required information in a similar manner (i.e., on a loan-by-loan basis). For a securitizations for which the institution does not have access to information on a loan-by-loan basis, the institution would be required to determine whether the securitization meets the 50 percent threshold as described previously for other securitizations.

Under the proposal, institutions would also have to determine whether residential loans and securities meet the definition of a nontraditional mortgage loan as of origination, or, if the loan has been refinanced, as of refinance, subject to requirements similar to those proposed for higher-risk consumer loans.

When an institution acquires a residential loan or security, it would have to determine whether the loan or security meets the definition of a nontraditional mortgage loan using the origination criteria and analysis performed by the original lender. If this information were unavailable, however, the institution would have to obtain recent, refreshed data from the borrower or other appropriate third-party.<sup>31</sup>

#### B. Evaluation of Higher-Risk Assets

The FDIC proposes that institutions evaluate C&I and consumer loans as of origination and refinance to determine whether they meet the criteria for higher-risk assets. A loan that is determined to be both a higher-risk consumer and a nontraditional mortgage loan should be reported only as a nontraditional mortgage loan, not both.

#### C. Large Bank Adjustment Process

The FDIC currently has the ability to adjust a large or highly complex institution's total score (which is used to determine its deposit insurance assessment rate) by a maximum of 15 points (the large bank adjustment).<sup>32</sup> Because the proposed definitions should result in better risk identification and consistent application across the industry, the FDIC anticipates that there would be limited circumstances where the FDIC would consider a large bank adjustment as a result of perceived mitigants to an institution's higher-risk

<sup>29</sup> Reporting all consumer loans by product and PD bands was part of the industry's proposal to strengthen identification of higher-risk consumer loans.

<sup>30</sup> A securitization would be as defined in Appendix A, Section II(B)(16) of Part 325 of the FDIC's Rules and Regulations, as it may be amended from time to time.

<sup>31</sup> Somewhat more stringent requirements would apply when an institution acquires loans or securities from another entity on a recurring or programmatic basis.

<sup>32</sup> 76 FR 10714 (February 25, 2011) to be codified at 12 CFR 327.9(b)(3).



concentration measure. The proposed revised definitions, which include specific exceptions for well-collateralized loans, should result in generally equal treatment of similar loans at different institutions.

#### D. Audit

Several of the proposed changes could require periodic auditing to ensure consistent reporting across the industry. For example, the PD calculation, whether through credit score mapping or through an internal approach, if not properly monitored, could potentially result in inconsistent application. Also, institutions would need to carefully evaluate their controls for asset-based and floor plan lending to determine whether they can exclude these loans from their higher-risk C&I loans and securities totals. The FDIC expects institutions will have appropriate systems in place for the proper identification and reporting of higher-risk assets. Enhanced review procedures for higher-risk asset reporting should be part of these systems. Institutions' higher-risk identification and reporting programs should include applicable policies, procedures, reviews, and validation (through internal or external audits). The results of any internal reviews or external audits of higher-risk assets reporting should be made available to the FDIC upon request. The FDIC may review and audit for compliance all determinations made by insured institutions for assessment purposes. The FDIC may also review specific details of an institution's reporting, including loans that are excluded from higher-risk assets. Any weakness identified in the reporting of higher-risk assets may be considered when forming supervisory strategies or in the application of adjustments to an institution's total score as outlined in the Guidelines.

#### E. Updating the Scorecard

As set forth in the February rule, the FDIC has the flexibility to update the minimum and maximum cutoff values used in each scorecard annually without further rulemaking as long as the method of selecting cut-off values remains unchanged.<sup>33</sup> The FDIC can add new data for subsequent years to its analysis and can, from time to time, exclude some earlier years from its analysis. Updating the minimum and maximum cutoff values and weights allows the FDIC to use the most recent

data, thereby improving the accuracy of the scorecard method.<sup>34</sup>

The new definitions would allow the FDIC to better measure the risk present in large and highly-complex institutions, but they do not change that risk. Unless the FDIC re-calibrates cutoff values for the higher-risk assets to Tier 1 capital and reserves ratio, however, the proposed changes to the definitions of higher-risk assets could result in significant increases or decreases in the amount of total deposit insurance assessments collected from large and highly complex banks. Each scorecard measure, including the higher-risk assets to Tier 1 capital and reserves ratio, is converted to a score between 0 and 100 based upon minimum and maximum cutoff values for the measure (where the minimum and maximum cutoff values get converted to a score of 0 or 100). Most of the minimum and maximum cutoff values represent the 10th and 90th percentile values for each measure, which are derived using data on large institutions over a ten-year period beginning with the first quarter of 2000 through the fourth quarter of 2009. Since the cutoff values for the higher-risk assets to Tier 1 capital and reserves ratio were calibrated using higher-risk assets data reported in accordance with an institution's existing methodology for identifying leveraged or subprime loans and securities, changing the definitions of these higher-risk assets may result in significant differences in the volume of higher-risk assets reported by institutions, and differences in the amount of deposit insurance assessments collected by the FDIC.

The FDIC does not intend for the proposed changes in definitions to result in the FDIC collecting higher or lower deposit insurance assessment revenue from large and highly complex institutions as a whole (although it may result in individual institutions paying higher or lower deposit insurance assessments). Consequently, the FDIC anticipates that it may need to use its flexibility to update cutoff values to update the minimum and maximum cutoff values for the higher-risk assets to Tier 1 capital and reserves ratio.<sup>35</sup> Changes in the distribution of the higher-risk assets to Tier 1 capital and

reserves ratio scores and the resulting effect on total assessments and risk differentiation between institutions would be taken into account in determining changes to the cutoffs. In addition, because the FDIC has not collected any data under the proposed definitions, changes to cutoff values for the higher-risk assets to Tier 1 capital and reserves ratio could be made more frequently than annually. This review would ensure proper risk differentiation between institutions.<sup>36</sup>

#### F. Implementation and Effective Date

To allow time for institutions to implement systems to comply with the revised definitions, predicated on Call Report changes, the proposed amendments would become effective October 1, 2012. Because the FDIC is proposing no amendments to the definitions of construction and land development loans and nontraditional mortgage loans (other than to clarify how securitizations that meet the definition of a nontraditional mortgage loan are to be identified), the FDIC proposes that institutions continue to define and report these higher-risk assets as they have been doing under the February rule.

#### Transition Guidance Until Effective Date

Prior to October 1, 2012, large institutions and highly complex institutions will continue to use the transition guidance for leveraged loans and subprime loans as outlined in the General Instructions (Instructions) for Schedule RC-O of the Consolidated Reports of Condition and Income, Memorandum items 6 through 15. The Instructions will be updated as of March 31, 2012 to reflect October 1, 2012 (formerly April 1, 2012) as the date to begin identifying newly originated loans and securities according to the proposed definitions of these two higher-risk asset categories.

This transition guidance provides that, for loans or securities originated or purchased before October 1, 2012, an institution may use either the definition in the February rule or continue to use its existing internal methodology for identifying loans and securities as leveraged or subprime for Schedule RC-O assessment reporting purposes. Institutions that do not have an existing methodology in place to identify loans and securities as leveraged or subprime

<sup>36</sup> The FDIC would provide large and highly-complex institutions with at least one quarter advance notice in their quarterly deposit insurance invoice of changes in the cutoff values to ensure that the industry can determine the effect that any changes may have on its assessments.

<sup>33</sup> 76 FR 10672, 10700 (February 25, 2011) (H. Updating the Scorecard).

<sup>34</sup> If, as a result of its review and analysis, the FDIC concludes that different measures should be used to determine risk-based assessments, that the method of additional or alternative selecting cutoff values should be revised, that the weights assigned to the scorecard measures should be recalibrated, or that a new method should be used to differentiate risk among large institutions or highly complex institutions, changes would be made through a future rulemaking.

<sup>35</sup> 76 FR 10672, 10700 (February 25, 2011).

(because they are not required to report these exposures to their primary federal regulator for examination or other supervisory purposes or do not measure and monitor loans and securities with these characteristics for internal risk management purposes) may continue to apply existing guidance provided by their primary federal regulator, by the agencies' 2001 Expanded Guidance for Subprime Lending Programs, (for consumer loans and securities) or by the February 2008 Comptroller's Handbook on Leveraged Lending (for C&I loans and securities).

#### Rules in Effect on the Effective Date and Thereafter

Effective October 1, 2012, the proposed definitions described above would apply to:

- (1) All C&I loans and securities originated or purchased on or after October 1, 2012;
- (2) All consumer loans and securities, except securitizations of consumer loans and securities, whenever originated or purchased;
- (3) All residential real estate loans and securities, except securitizations of residential real estate loans, whenever originated or purchased; and
- (4) All securitizations of C&I, consumer, and residential real estate loans originated or purchased on or after October 1, 2012.

For consumer and residential real estate loans and securities (other than securitizations) originated or purchased prior to October 1, 2012, an institution would have to determine whether the loan or security met the definition of a higher-risk consumer loan or security no later than December 31, 2012, using information as of the date of the origination of the loan or security if the institution had that information.<sup>37</sup> If the institution did not have that information, it would have to use refreshed data to determine whether a loan or security met the definition. Refreshed data would be defined as the most recent data available as if the loan or security were being originated in the fourth quarter of 2012. In all instances, the refreshed data used would have to be as of July 1, 2012 or later.

For C&I loans and securities originated or purchased before October 1, 2012, and all securitizations originated or purchased before October 1, 2012, institutions would be required

<sup>37</sup> Institutions had to determine whether loans and securities originated or purchased prior to October 1, 2012, met the definition of a construction and land development loan or a nontraditional mortgage loan in time to file accurate reports of condition as of June 30, 2012, and September 30, 2012.

to either continue to use their existing internal methodology or existing guidance provided by their primary federal regulator or use the proposed definitions to determine whether to include the loan, security or securitization as a concentration in a risk area for purposes of the higher-risk assets to Tier 1 capital and reserves ratio.

#### III. Request for Comments

The FDIC seeks comment on every aspect of this proposed rule. In particular, the FDIC seeks comment on the questions set out below. The FDIC asks commenters to include specific reasons for their positions.

##### 1. Deposit Insurance Pricing Definitions

- a. Is the collateral test in the higher-risk C&I loans and securities definition appropriately specified?
- b. Is the purpose test in the higher-risk C&I loans and securities definition appropriately specified?
- c. Can institutions identify and report C&I loans as higher-risk?
- d. Is the definition of material appropriate?
- e. Should other risk measures, besides PD, be considered to define higher-risk consumer loans and securities?
- f. Can institutions report all of their consumer loans into the proposed products and PD bands?
- g. Is the proposed PD level of 20 appropriate to identify higher-risk consumer loans?
- h. Is the definition of refinance appropriate?
- i. Are all definitions clear and are institutions able to implement the definitions as proposed?

##### 2. Regulatory Matters

- a. What are the costs and what is the extent of regulatory burden of the proposal compared to the February rule?
- b. Will the new effective date for the transition guidance (October 1, 2012) allow institutions sufficient time to update systems to accurately identify and report higher-risk assets as defined in the proposed definitions? If not, what date should the transition guidance be extended to?
- c. Are the requirements in the proposed regulation clearly stated? If not, how could the regulation be more clearly stated?
- d. Does the proposed regulation contain language that is not clear? If so, which language requires clarification?
- e. Large institutions and highly-complex institutions would be required to define their higher-risk assets as outlined in Appendix C. Is the direction and language used in Appendix C clear?

#### IV. Regulatory Analysis and Procedure

##### A. Solicitation of Comments on Use of Plain Language

Section 722 of the Gramm-Leach-Bliley Act, Public Law 106-102, 113 Stat. 1338, 1471 (Nov. 12, 1999), requires the federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The FDIC invites your comments on how to make this proposal easier to understand. For example:

- Are the requirements in the proposed regulation clearly stated? If not, how could the regulation be more clearly stated?
- Does the proposed regulation contain language or jargon that is not clear? If so, which language requires clarification?
- Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes to the format would make the regulation easier to understand?
- What else could the FDIC do to make the regulation easier to understand?

##### B. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) requires that each federal agency either certify that a proposed rule would not, if adopted in final form, have a significant economic impact on a substantial number of small entities or prepare an initial regulatory flexibility analysis of the rule and publish the analysis for comment.<sup>38</sup> For RFA purposes a small institution is defined as one with \$175 million or less in assets.

As of September 30, 2011, of the 7,436 insured commercial banks and savings associations, there were 3,989 small insured depository institutions, as that term is defined for purposes of the RFA. The proposed rule, however, would apply only to institutions with \$10 billion or greater in total assets. Consequently, small institutions for purposes of the RFA will experience no significant economic impact should the FDIC implement the proposal in a final rule.

##### C. Paperwork Reduction Act

No collections of information pursuant to the Paperwork Reduction Act of 1995, 44 U.S.C. 3501-3521 (PRA), are contained in the proposed rule.

<sup>38</sup> See 5 U.S.C. 603, 604 and 605.

*D. The Treasury and General Government Appropriations Act, 1999—Assessment of Federal Regulations and Policies on Families*

The FDIC has determined that the proposed rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, enacted as part of the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1999 (Pub. L. 105–277, 112 Stat. 2681).

**List of Subjects in 12 CFR Part 327**

Bank deposit insurance, Banks, Savings associations.

For the reasons set forth above, the FDIC proposes to amend 12 CFR part 327 as follows:

**PART 327—ASSESSMENTS**

1. The authority citation for part 327 continues to read as follows:

**Authority:** 12 U.S.C. 1441, 1813, 1815, 1817–19, 1821.

2. Revise appendix C to subpart A of part 327 to read as follows:

**Appendix C to Subpart A to Part 327—Concentration Measures**

The concentration score for large institutions is the higher of the higher-risk

assets to Tier 1 capital and reserves score or the growth-adjusted portfolio concentrations score. The concentration score for highly complex institutions is the highest of the higher-risk assets to Tier 1 capital and reserves score, the Top 20 counterparty exposure to Tier 1 capital and reserves score, or the largest counterparty to Tier 1 capital and reserves score. The higher-risk assets to Tier 1 capital and reserves ratio and the growth-adjusted portfolio concentration measure are described below.

**A. Higher-Risk Assets/Tier 1 Capital and Reserves**

The higher-risk assets to Tier 1 capital and reserves ratio is the sum of the concentrations in each of four risk areas described below and is calculated as:

$$H_i = \sum_{k=1}^4 \left( \frac{\text{Amount of Exposure}_{i,k}}{\text{Tier 1 Capital} + \text{Reserves}_i} \right)$$

Where:

$H_i$  is institution  $i$ 's higher-risk concentration measure and  $k$  is a risk area.<sup>1</sup> The four risk areas ( $k$ ) are construction and land development loans, higher-risk commercial and industrial (C&I) loans and securities, higher-risk consumer loans and securities, and nontraditional mortgage loans.

1. Construction and land development loans include construction and land development loans outstanding and unfunded commitments to fund construction and land development loans, whether revocable or irrevocable.<sup>2</sup>

2. Higher-risk commercial and industrial (C&I) loans and securities include:

- Any commercial loan (funded or unfunded, including irrevocable and revocable commitments) owed by a borrower to the evaluating depository institution with an original amount greater than \$5 million if the conditions specified in (a) or (b) below are met as of origination, or, if the loan has been refinanced, as of refinance, and the loan does not meet the asset based lending (ABL)

<sup>1</sup> The higher-risk concentration ratio is rounded to two decimal points.

<sup>2</sup> Construction and land development loans are as defined in the instructions to Call Report schedule RC-C Part I—Loans and Leases, as they may be amended from time to time, and include items reported on line items RC-C 1.a.1 (1–4 family residential construction loans), RC-C 1.a.2. (Other construction loans and all land development and other land loans), and RC-O M.10.a (Total unfunded commitments to fund construction, land development, and other land loans secured by real estate), and exclude RC-O M.10.b (Portion of unfunded commitments to fund construction, land development and other loans that are guaranteed or insured by the U.S. government, including the FDIC), RC-O M.13.a (Portion of funded construction, land development, and other land loans guaranteed or insured by the U.S. government, excluding FDIC loss sharing agreements), RC-M 13a.1.a.1 (1–4 family construction and land development loans covered by loss sharing agreements with the FDIC), and RC-M 13a.1.a.2 (Other construction loans and all land development loans covered by loss sharing agreements with the FDIC).

exclusion or the floor plan line of credit exclusion (defined below).<sup>3,4</sup>

(a)(i) The purpose of any of the borrower's debt<sup>5</sup> (whether owed to the evaluating insured depository institution or another lender) that was incurred within the previous seven years was to finance a buyout (e.g., to fund an equity buyout or fund an Employee Stock Ownership Plan (ESOP)), acquisition (e.g., merger or tender offer), or capital distribution (e.g., dividends, stock repurchase, or cash-out) and such debt was material as defined below; and

(ii) The ratio of the borrower's total debt to trailing twelve-month EBITDA (*i.e.*, operating leverage ratio) is greater than 4 or the ratio of the borrower's senior debt to trailing twelve-month EBITDA (*i.e.*, operating leverage ratio) is greater than 3; or

(b) Any of the borrower's debt (whether owed to the evaluating institution or another lender) is designated as a highly leveraged transaction (HLT) by a syndication agent.

- All securities held by the evaluating institution that are issued by a commercial borrower, if the conditions specified in (a) or (b) above are met, except securities classified as trading book; and
- All securitizations held by the evaluating institution that are more than 50 percent collateralized by commercial loans or securities that would meet the foregoing higher-risk C&I loans and securities

<sup>3</sup> Commercial loans are as defined as commercial and industrial loans in the instructions to Call Report Schedule RC-C Part I—Loans and Leases, as they may be amended from time to time. An overdraft is a higher-risk C&I loan or security, provided the overdraft is extended to a company and not an individual and it otherwise meets the Call Report definition of a C&I loan.

<sup>4</sup> Unfunded commitments are defined as unused commitments, as this term is defined in the instructions to Call Report Schedule RC-L, Derivatives and Off-Balance Sheet Items, as they may be amended from time to time.

<sup>5</sup> As used in this definition of higher-risk C&I loans and securities, debt includes all forms of obligation and liability, including loans and securities.

definition if directly held by the evaluating institution, except securities classified as trading book.<sup>6</sup>

Institutions must determine whether C&I loans and securities meet the definition of a higher-risk C&I loan and security as of origination, or, if the loan has been refinanced, as of refinance, as discussed in Section A of this Appendix. When an institution acquires a C&I loan or security, it must determine whether the loan or security meets the definition of a higher-risk C&I loan or security using the origination criteria and analysis performed by the original lender. If this information is unavailable, the institution must obtain refreshed data from the borrower or other appropriate third-party. Refreshed data for C&I loans and securities is defined as the most recent data available. However, the data must be as of a date that is no earlier than one year before the acquisition of the C&I loan or security. The acquiring institution must also determine whether an acquired loan or securitization is higher risk as soon as reasonably practicable, but not later than one year after acquisition.

However, when an institution acquires loans or securities from another entity on a recurring or programmatic basis, the acquiring institution may determine whether the loan or security meets the definition of a higher-risk C&I loan or security using the origination criteria and analysis performed by the original lender only if the acquiring institution verifies the information provided.<sup>7</sup> Otherwise, the acquiring institution must obtain the necessary information from the borrower or other appropriate third party to make its own

<sup>6</sup> A securitization is defined in Appendix A, Section II(B)(16) of Part 325 of the FDIC's Rules and Regulations, as it may be amended from time to time.

<sup>7</sup> Loans or securities acquired from another entity are acquired on a recurring basis if an institution has acquired other loans or securities from that entity at least once within the calendar year or the previous calendar year of the acquisition of the loans or securities in question.

determination of whether the acquired assets should be classified as a higher-risk C&I loan and security. If the financial information is not available as of the origination date or refinance, the institution must obtain refreshed data from the borrower or other appropriate third-party. Refreshed data for C&I loans or securities acquired on a recurring or programmatic basis is defined as the most recent data available, and in any case, the refreshed data used must be as of a date that is no earlier than three months before the acquisition of the C&I loan or security. The acquiring institution must also determine whether a loan or securitization acquired on a recurring or programmatic basis is higher risk as soon as is practicable, but not later than three months after the date of acquisition.

Higher-risk C&I loans and securities include purchased credit impaired loans that meet the definition of higher-risk C&I loans and exclude the following:

- Residential, commercial or farmland loans secured by real estate;
  - Loans to finance agricultural production;
  - Loans to equity REITs;
  - Lease financing receivables;
  - Loans to individuals for commercial, industrial, or professional purposes;
  - Loans to foreign governments and official institutions;
  - Obligations of states and political subdivisions of the U.S.;
  - Loans to depository and nondepository financial institutions;
  - The maximum amount of any loan that is recoverable from the U.S. government, its agencies, or government-sponsored agencies under guarantee or insurance provisions;
  - Loans that are fully secured by cash collateral, provided that the cash is in the form of a savings or time deposit held by the insured depository institution, the insured depository institution has in place a collateral assignment of the deposit account signed by the borrower, the assignment is irrevocable as long as the loan or commitment is outstanding, and a hold is placed on the deposit account that alerts the institution's employees to an attempted withdrawal; in the case of a revolving line of credit, the cash collateral must be equal to or greater than the amount of the total loan commitment (the aggregate funded and unfunded balance of the loan);
- C&I loans that are secured by liquid assets other than cash are not excluded from the higher-risk loan designation.

An institution must use the information reasonably available to a sophisticated investor in reasonably determining whether a securitization meets the 50 percent threshold. Information reasonably available to a sophisticated investor includes, but is not limited to, offering memorandums, indentures, trustee reports, and requests for information from servicers, collateral managers, issuers, trustees, or similar third parties. When determining whether a revolving trust or similar securitization meets the 50 percent threshold, an institution may use established criteria, model portfolios, or limitations published in the offering memorandum, indenture, trustee report or similar documents.

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. In such a case, the institution may exercise judgment in making its determination. Generally, the FDIC may review and audit for compliance all determinations made by insured depository institutions for assessment purposes, including a determination that a securitization does not meet the 50 percent threshold.

In cases where a securitization is required to be consolidated on the balance sheet as a result of SFAS 166 and SFAS 167, and a large institution or highly complex institution has access to the necessary information, an institution may evaluate individual loans in the securitization on a loan-by-loan basis. Any loan within the securitization that meets the definition of a higher-risk asset must be reported as a higher-risk asset and any loan within the securitization that does not meet the definition of a higher-risk asset need not be reported as such. When making this evaluation, the institution must follow the transition guidance described in Appendix C, Section C. Once an institution evaluates a securitization for higher-risk asset designation on a loan-by-loan basis, it must continue to evaluate all securitizations for which it has the required information in a similar manner (i.e., on a loan-by-loan basis). For securitizations for which the institution does not have access to information on a loan-by-loan basis, the institution must determine whether the securitization meets the 50 percent threshold.

#### **Definition of Terms Used Within the Definition of Higher-Risk C&I Loans and Securities**

An *acquisition* means the purchase by the borrower of any equity interest in another company or the purchase of any of the assets and liabilities of another company.

A *buyout* means the issuance of debt to finance the purchase or repurchase by the borrower of the borrower's outstanding equity. A buyout could include, but is not limited to, an equity buyout or funding of an ESOP.

A *capital distribution* means that the borrower incurs debt to finance a dividend payment or to finance other transactions designed to enhance shareholder value, such as repurchase of stock.

For purposes of the definition of a higher-risk C&I loan and security, a debt *is material* if it results in a 20 percent or greater increase any time within 12 months in the total funded debt of the borrower (including all funded debt assumed, created or refinanced). Debt is also material if, before the debt was incurred, the borrower had no funded debt.

When calculating either of the borrower's *operating leverage ratios*, the only permitted EBITDA adjustments are those specifically permitted for that borrower at the time of underwriting and only funded amounts of lines of credit must be considered debt.

The debt-to-EBITDA ratio must be calculated using the consolidated financial statements of the borrower unless the loan is to a subsidiary of a larger organization. In

that case, the ratio may be calculated using consolidated financial statements of the parent company provided that the parent company and all of its major operating subsidiaries have unconditionally and irrevocably guaranteed the borrower's debt to the reporting large institution or highly complex institution.

In the case of a merger of two companies or the acquisition of one or more companies or parts of companies, the pro-forma debt is to be used as well as the trailing twelve-month pro-forma EBITDA for the combined companies. When calculating the trailing pro-forma EBITDA for the combined company, no adjustments are allowed for economies of scale or projected cost savings that may be realized subsequent to the acquisition unless specifically permitted for that borrower under the loan agreement.

The *original amount* of the loan is defined as:

(1) For loans drawn down under lines of credit or loan commitments, the amount of the line of credit or loan commitment on the date of its most recent approval, extension or renewal prior to the date of the most recent Call Report. If the amount currently outstanding as of the date of the most recent Call Report exceeds this amount, then the original amount is the amount outstanding as of the Call Report date.

(2) For loan participations and syndications, the original amount of the loan participation or syndication is the total amount of the credit originated by the lead lender.

(3) For all other loans, the original amount is the total amount of the loan as of origination or the amount outstanding as of the Call Report date, whichever is larger.

Multiple loans to one borrower are to be aggregated to the extent that the institution's loan data systems can do so without undue cost. If the cost is excessive, the institution may treat multiple loans to one borrower as separate loans.

The *purpose* of the borrower's debt for purposes of meeting the definition of higher-risk C&I loans is determined at the time the debt was incurred by the borrower.

A *securitization* is as defined in Appendix A, Section II(B)(16) of Part 325 of the FDIC's Rules and Regulations, as it may be amended from time to time.

*Senior debt* includes any portion of total debt that has a priority claim on any of the borrower's assets. A priority claim is a claim that entitles the holder to priority of payment over other debt holders in bankruptcy.

*Total debt* is defined as all interest-bearing financial obligations and includes, but is not limited to, overdrafts, borrowings, repurchase agreements (repos), trust receipts, bankers acceptances, debentures, bonds, loans (including those secured by mortgages), sinking funds, capital (finance) lease obligations (including those obligations that are convertible, redeemable or retractable), mandatory redeemable preferred and trust preferred securities accounted for as liabilities in accordance with ASC Subtopic 480-10, Distinguishing Liabilities from Equity—Overall (formerly FASB Statement No. 150, "Accounting for Certain Financial Instruments with Characteristics of both

Liabilities and Equity”), and subordinated capital notes. Total debt excludes pension obligations, deferred tax liabilities and preferred equity.

#### Asset-Based Lending Exclusion

Asset-based loans that meet certain conditions are excluded from an institution’s higher-risk C&I loan totals. An excluded asset-based loan is defined as any loan, new or existing, in which all of the following conditions are present:

- The loan is managed by a lender or group of lenders with experience in asset-based lending and collateral monitoring, including, but not limited to, experience in reviewing the following: Collateral reports, borrowing base certificates,<sup>8</sup> collateral audit reports, loan to collateral values, and loan limits, using procedures common to the industry.<sup>9</sup>

- The insured depository institution has taken, or has the legally enforceable unconditional ability to take, dominion of cash through account control agreements over the borrower’s depository accounts such that proceeds of collateral are applied to the loan balance as collected.

- The insured depository institution has a perfected first priority security interest in all assets included in the borrowing base certificate.

- If the loan is a credit facility (revolving or term loan), it must be fully secured by self-liquidating assets such as accounts receivable and inventory.<sup>10</sup> Fully secured is defined as a 100 percent or lower loan-to-value ratio after applying the appropriate discounts (determined by the loan agreement) to the collateral. For purposes of calculating the ratio, a revolving loan amount is the amount of the loan if fully drawn to the maximum permitted borrowing base.

- Advance rates on accounts receivable should generally not exceed 75 percent to 85 percent of eligible receivables and 65 percent of eligible inventory and the bank’s lending policy should address maintenance of an accounts receivable and inventory loan agreement that includes the items detailed in the Accounts Receivable and Automobile Dealer Floor Plan Lending Guidance included in Section D of this Appendix.

- Assets must be valued or appraised by an independent third-party appraiser using net orderly liquidation value (NOLV), fair value, or forced sale value (*versus* a “going concern” value), whichever is appropriate, to arrive at a net realizable value. Appraisals are to be prepared in accordance with industry standards.

<sup>8</sup> Borrowing base certificates are defined in Appendix C, Section D.

<sup>9</sup> Guidelines that address acceptable industry-standard controls over asset based lending are included in Appendix C, Section D. Loans must adhere to these guidelines to be eligible for the ABL exclusion.

<sup>10</sup> An asset is self-liquidating if, in the event the borrower defaults, the asset can be easily liquidated and the proceeds of the sale of the assets would be used to pay down the loan. These assets can include machinery, heavy equipment or rental equipment if the machinery or equipment is inventory for the borrower’s primary business and the machinery or equipment is included in the borrowing base.

- The insured depository institution must maintain documentation of borrowing base certificate reviews and collateral trend analyses to demonstrate that collateral values are actively, routinely and consistently monitored. A new borrowing base certificate is required at each draw or advance on the loan. At the time of each draw the insured depository institution must validate the assets that compose the borrowing base certificate (by requesting from the borrower a listing of accounts receivable by creditor and a listing of individual pieces of inventory) and certify that the outstanding balance of the loan remains within the collateral formula prescribed by the loan agreement. Borrowing base reporting must be performed and validated (through asset-based tracking reports) at least on a monthly basis and supplemented by periodic, but no less than annual, field examinations (audits) to be performed by individuals who are independent of the credit origination or administration process. There must be a process in place to ensure that the insured depository institution is correcting audit exceptions.

The FDIC retains the authority to verify that institutions are in compliance with sound internal controls and administration practices for asset based loans, as discussed in Section D of this Appendix. Generally, the FDIC may review and audit for compliance all determinations made by insured depository institutions for assessment purposes, including the exclusion of an asset based loan from an institution’s reported higher-risk C&I loans and securities totals.

#### Floor Plan Lines of Credit Exclusion

Floor plan loans that meet certain conditions are excluded from an institution’s higher-risk loan totals. An excluded automotive dealer floor plan loan is defined as any loan, new or existing, used to finance the purchase of automobile inventory by an automotive dealer in which all of the following conditions are present:

- The loan is managed by a lender or group of lenders experienced in automobile dealer floor plan lending and monitoring collateral to ensure the borrower remains in compliance with floor plan limits and repayment requirements. Lenders should have experience in reviewing certain items, including but not limited to: Collateral reports, floor plan limits, floor plan aging reports, automobile inventory audits or inspections, and loan-to-collateral value (LTV) ratios. The insured depository institution must obtain and review audited financial statements of the borrower on an annual basis to ensure that adequate controls are in place.<sup>11</sup>

- Each loan advance is made against a specific automobile or under a borrowing base certificate held as collateral at no more than 100 percent of (i) dealer invoice plus freight charges (for new vehicles) or (ii) the cost of a used vehicle at auction or the

<sup>11</sup> Additional guidelines covering acceptable industry-standard controls over automobile dealer floor plan lending are included in Appendix C, Section D. Loans must also adhere to these guidelines to be eligible for the floor plan line of credit exclusion.

wholesale value (using the prevailing market guide, e.g., NADA, Black Book, Blue Book). Permissible advance rates depend upon the types of risk mitigation systems the insured depository institution has in place for a particular credit facility. The advance rate of 100 percent of dealer invoice plus freight charges on new vehicles and the advance rate of the cost of a used vehicle at auction or the wholesale value may only be used where there is a manufacturer repurchase agreement or an aggressive curtailment program in place that is tracked by the institution over time and subject to strict controls.

- Each loan is self liquidating (*i.e.*, if the borrower defaulted on the loan, the collateral could be easily liquidated and the proceeds of the sale of the collateral would be used to pay down the loan advance).

- Vehicle inventories and collateral values are closely monitored, including the completion of regular (at least quarterly) dealership automotive inventory audits or inspections to ensure accurate accounting for all vehicles held as collateral. Floor plan aging reports must be reviewed by the institution. Curtailment programs should be instituted where necessary and institutions must ensure that curtailment payments are made on stale automotive vehicle inventory financed under the floor plan loan.<sup>12</sup>

The FDIC retains the authority to verify that institutions are in compliance with sound internal controls and administration practices for floor plan loans, as discussed in Section D of this Appendix. Generally, the FDIC may review and audit for compliance all determinations made by insured depository institutions for assessment purposes, including the exclusion of a floor plan loan from an institution’s reported higher-risk C&I loans and securities totals.

3. Higher-risk consumer loans and securities are defined as:

(a) All consumer loans where, as of origination, or, if the loan has been refinanced, as of refinancing, the probability of default (PD) within two years (the two-year PD) was greater than 20 percent, excluding those consumer loans that meet the definition of a nontraditional mortgage loan; and

(b) all securitizations that are more than 50 percent collateralized by consumer loans meeting the criteria in (a), except those classified as trading book.<sup>13</sup>

Institutions must determine whether consumer loans meet the definition of a higher-risk consumer loan as of origination, or, if the loan has been refinanced, as of refinancing, as discussed in Section A of this Appendix. The two-year PD must be

<sup>12</sup> Curtailment programs ensure that the lender receives regular principal payments on floor plan loans in situations where the underlying collateral is not selling as quickly as expected. Under such programs, when vehicles that serve as collateral on a floor plan loan do not sell within a reasonable and specific timeframe, the borrower is required to begin repaying the lender a certain dollar amount (to be determined by the loan agreement) on a monthly or quarterly basis.

<sup>13</sup> A securitization is defined in Appendix A, Section II(B)(16) of Part 325 of the FDIC’s Rules and Regulations, as it may be amended from time to time.

estimated using an approach that conforms to the requirements detailed below. When an institution acquires a consumer loan or security, it must determine whether the loan or security meets the definition of a higher-risk consumer loan or security using the origination criteria and analysis performed by the original lender. If this information is unavailable, the institution must obtain refreshed data from the borrower or other appropriate third-party. Refreshed data for consumer loans and securities is defined as the most recent data available. However, the data must be as of a date that is no earlier than three months before the acquisition of the consumer loan or security. The acquiring institution must also determine whether an acquired loan or securitization is higher risk as soon as reasonably practicable, but not later than three months after acquisition.

However, when an institution acquires loans or securities from another entity on a recurring or programmatic basis, the acquiring institution may determine whether the loan or security meets the definition of a higher-risk consumer loan or security using the origination criteria and analysis performed by the original lender only if the acquiring institution verifies the information provided.<sup>14</sup> Otherwise, the acquiring institution must obtain the necessary information from the borrower or other appropriate third party to make its own determination of whether the purchased assets should be classified as a higher-risk consumer loan and security. If the financial information is not available as of the origination date or refinancing, the institution must obtain refreshed data from the borrower or other appropriate third-party. Refreshed data for consumer loans or securities acquired on a recurring or programmatic basis is defined as the most recent data available, and in any case, the refreshed data used must be as of a date that is no earlier than three months before the acquisition of the consumer loan or security. The acquiring institution must also determine whether a loan or securitization acquired on a recurring or programmatic basis is higher risk as soon as is practicable, but not later than three months after the date of acquisition.

Higher-risk consumer loans include purchased credit-impaired loans that meet the definition of higher-risk consumer loans and exclude the maximum amounts recoverable from the U.S. government, its agencies, or government-sponsored agencies under guarantee or insurance provisions, and loans that are fully secured by cash collateral, provided that the cash collateral is in the form of a savings or time deposit held by the insured depository institution. In the case of a revolving line of credit, the cash collateral must be equal to or greater than the amount of the total loan commitment (the aggregate funded and unfunded balance of the loan). Loans that are fully secured by savings and time deposits are not higher-risk consumer loans, provided that the insured depository

institution has in place a collateral assignment of the deposit account signed by the borrower, the assignment is irrevocable as long as the term or commitment is outstanding, and a hold is placed on the deposit account that alerts the institution's employees to an attempted withdrawal. Consumer loans that are secured by liquid assets other than cash are not excluded from the higher-risk consumer loan definition.

A loan that meets both the nontraditional mortgage loan and higher-risk consumer loan and security definitions at the time of origination, or, if the loan has been refinanced, as of refinancing, must be reported only as a nontraditional mortgage loan. However, if the loan ceases to meet the nontraditional mortgage loan definition but continues to meet the definition of a higher-risk consumer loan and security, the loan is to be reported as a higher-risk consumer loan and security.

An institution must use the information that is reasonably available to a sophisticated investor in reasonably determining whether a securitization meets the 50 percent threshold. Information reasonably available to a sophisticated investor includes, but is not limited to, offering memorandums, indentures, trustee reports, and requests for information from servicers, collateral managers, issuers, trustees, or similar third parties. When determining whether a revolving trust or similar securitization meets the threshold, an institution may use established criteria, model portfolios, or limitations published in the offering memorandum, indenture, trustee report or similar documents.

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, in such a case, the institution may exercise judgment in making its determination. Generally, the FDIC may review and audit for compliance all determinations made by insured depository institutions for assessment purposes, including a determination that a securitization does not meet the 50 percent threshold.

In cases where a securitization is required to be consolidated on the balance sheet as a result of SFAS 166 and SFAS 167, and a large institution or a highly complex institution has access to the necessary information, an institution may evaluate individual loans in the securitization on a loan-by-loan basis. Any loan within the securitization that meets the definition of a higher-risk asset must be reported as a higher-risk asset and any loan within the securitization that does not meet the definition of a higher-risk asset need not be reported as such. When making this evaluation, the institution must follow the transition guidance described in Appendix C, Section C. Once an institution evaluates a securitization for higher-risk asset designation on a loan-by-loan basis, it must continue to evaluate all securitizations for which it has the required information in a similar manner (i.e., on a loan-by-loan basis). For securitizations for which the institution does not have access to information on a loan-by-loan basis, the institution must

determine whether the securitization meets the 50 percent threshold.

#### Requirements for PD Estimation

Estimates of the two-year PD for a loan must be based on the observed, stress period default rate for loans of a similar product type made to consumers with credit risk comparable to the borrower being evaluated. The credit risk assessment must be determined using third party or internal scores derived using a scoring system that qualifies as *empirically derived, demonstrably and statistically sound* as defined in 12 CFR 202.2(p)(2011), and has been approved by the bank's model risk oversight and governance process and internal audit mechanism. In the case of a consumer loan with a co-signer or co-borrower, the PD may be determined using the most favorable individual credit score. In estimating the PD based on such scores, institutions must adhere to the following requirements:

(1) The PD must be estimated as the average of the two, 24-month default rates observed from July 2007 to June 2009, and July 2009 to June 2011, where the average is calculated according to the following formula and  $DR_t$  is the observed default rate over the 24-month period beginning in July of year  $t$ :

$$PD = 1 - \sqrt{(1 - DR_{2007})(1 - DR_{2009})}$$

(2) The default rate for each 24-month period must be calculated as the number of active loans that experienced at least one default event during the period divided by the total number of active loans as of the observation date (i.e., the beginning of the period). A loan is considered active if it was open and not in default as of the observation date and had a positive balance any time within the 12 months prior to the observation date.

(3) The default rate for each 24-month period must be calculated using a stratified random sample of loans that is sufficient in size to derive statistically meaningful results for the product type and credit score being evaluated. The product strata must be as homogenous as possible with respect to the factors that influence default, such that products with distinct risk characteristics are evaluated separately. The loans should be sampled based on the credit score as of the observation date and, for any single product and credit score group, the sample size must be no less than 1,200 loans.

Credit score strata must be determined by partitioning the score range into a minimum of 15 bands. While the width of the credit score bands may vary, the scores within each band must reflect a comparable level of credit risk. However, since performance data for scores at the upper and lower extremes of the population distribution is likely to be limited, the top and bottom bands may include a range of scores that suggest some variance in credit quality.

When the number of score bands is less than the number of credit scores represented in the population, an observed default rate for some scores will not be available. In that case, institutions must estimate the default rate for a particular score using a linear

<sup>14</sup> Loans or securities acquired from another entity are acquired on a recurring basis if an institution has acquired other loans or securities from that entity at least once within the calendar year of the acquisition of the loans or securities in question or the previous calendar year.

interpolation between adjacent, observed default rates, where the observed default rate is assumed to correspond with the score at the midpoint of the range for the band. For example, if one score band ranges from 621 to 625 and has an observed default rate of 4 percent, while the next lowest band ranges from 616 to 620 and has an observed default rate of 6 percent, a 620 score must be assigned a default rate of 5.2 percent, calculated as

$$\left( \frac{.04 - .06}{623 - 618} \right) \cdot (620 - 618) + .06 = .052$$

When evaluating scores that fall below the midpoint of the lowest score band or above the midpoint of the highest score band, the interpolation must be based on an assumed adjacent default rate of 1 or 0, respectively.

An institution may use internally derived default rates that were calculated using fewer observations or score bands than those specified above under certain conditions. The institution must submit a written request to the FDIC in advance of or concurrent with reporting under that methodology. The request must explain in detail how the proposed approach differs from the rule specifications and the institution must provide support for the statistical appropriateness of the proposed methodology. The request must include, at a minimum, a table with the default rates and number of observations used in each score and product segment. The FDIC will evaluate the proposed methodology and may request additional information from the institution, which the institution must provide. The institution may report using its proposed approach while the FDIC evaluates the methodology. If, after reviewing the request, the FDIC determines that the institution's methodology is unacceptable, the institution will be required to amend its Call Reports and resubmit higher-risk consumer loan amounts according to the FDIC's requirements for PD estimation. The institution will be required to submit corrected information for no more than the two most recently dated and filed Call Reports preceding the FDIC's determination and for any Call Reports after the determination.

(4) The credit scores represented in the historical sample must have been produced by the same entity, using the same or substantially similar methodology as the methodology used to derive the credit scores to which the default rates will be applied. For example, the default rate for a particular vendor score cannot be evaluated based on the score-to-default rate relationship for a different vendor, even if the range of scores under both systems is the same. On the other hand, if the current and historical scores were produced by the same vendor using slightly different versions of the same scoring system and equivalent scores represent a similar likelihood of default, then the historical experience could be applied.

(5) A loan is considered to be in default when it is 90+ days past due, charged-off, or the consumer enters bankruptcy during the 24-month performance window.

The FDIC has the flexibility, as part of its risk-based assessment system, to modify the

time periods used for PD estimation without further notice-and-comment rulemaking. The FDIC also has the authority, as part of the risk-based assessment system, to increase or decrease the PD threshold of 20 percent, for identifying higher-risk consumer loans to reflect the updated consumer default data from the different time periods selected without further notice-and-comment rulemaking. Before changing the PD threshold, the FDIC will analyze resulting potential changes in the distribution of higher-risk consumer loans and the resulting effect on total deposit insurance assessments and risk differentiation among institutions. The FDIC will provide institutions with at least one quarter advance notice with their quarterly deposit insurance invoice of any changes to the PD estimation time periods or the PD threshold.

4. Nontraditional mortgage loans include all residential loan products that allow the borrower to defer repayment of principal or interest and include all interest-only products, teaser rate mortgages, and negative amortizing mortgages, with the exception of home equity lines of credit (HELOCs) or reverse mortgages.<sup>15 16 17</sup>

For purposes of the higher-risk assets to Tier 1 capital and reserves ratio, nontraditional mortgage loans include securitizations where more than 50 percent of the assets backing the securitization meet the preceding definition of a nontraditional mortgage loan, with the exception of those securities classified as trading book.<sup>18</sup>

Institutions must determine whether residential loans and securities meet the definition of a nontraditional mortgage loan as of origination, or, if the loan has been refinanced, as of refinancing, as discussed in Section A of this Appendix. When an institution acquires a residential loan or security, it must determine whether the loan or security meets the definition of a nontraditional mortgage loan using the origination criteria and analysis performed by the original lender. If this information is unavailable, the institution must obtain refreshed data from the borrower or other appropriate third-party. Refreshed data for residential loans and securities is defined as the most recent data available. However, the data must be as of a date that is no earlier than three months before the acquisition of the residential loan or security. The acquiring institution must also determine whether an acquired loan or securitization is higher-risk not later than three months after acquisition.

However, when an institution acquires loans or securities from another entity on a

<sup>15</sup> A teaser-rate mortgage loan is defined as a mortgage with a discounted initial rate where the lender offers a lower rate and lower payments for part of the mortgage term.

<sup>16</sup> <http://www.fdic.gov/regulations/laws/federal/2006/06noticeFINAL.html>.

<sup>17</sup> A mortgage loan is no longer considered a nontraditional mortgage loan once the teaser rate has expired. An interest only loan is no longer considered a nontraditional mortgage loan once the loan begins to amortize.

<sup>18</sup> A securitization is defined in Appendix A, Section II(B)(16) of Part 325 of the FDIC's Rules and Regulations, as it may be amended from time to time.

recurring or programmatic basis, the acquiring institution may determine whether the loan or security meets the definition of a nontraditional mortgage loan using the origination criteria and analysis performed by the original lender only if the acquiring institution verifies the information provided.<sup>19</sup> Otherwise, the acquiring institution must obtain the necessary information from the borrower or other appropriate third party to make its own determination of whether the acquired assets should be classified as a nontraditional mortgage loan. If the financial information is not available as of the origination date or refinancing, the institution must obtain refreshed data from the borrower or other appropriate third-party. Refreshed data for residential loans or securities acquired on a recurring or programmatic basis is defined as the most recent data available, and in any case, the refreshed data used must be as of a date that is no earlier than three months before the acquisition of the residential loan or security. The acquiring institution must also determine whether a loan or securitization acquired on a recurring or programmatic basis is higher-risk not later than three months after the date of acquisition.

An institution is required to use the information that is reasonably available to a sophisticated investor in reasonably determining whether a securitization meets the 50 percent threshold. Information reasonably available to a sophisticated investor includes, but is not limited to, offering memorandums, indentures, trustee reports, and requests for information from servicers, collateral managers, issuers, trustees, or similar third parties. When determining whether a revolving trust or similar securitization meets the threshold, an institution may use established criteria, model portfolios, or limitations published in the offering memorandum, indenture, trustee report or similar documents.

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. In such a case, the institution may exercise judgment in making its determination. Generally, the FDIC may review and audit for compliance all determinations made by insured depository institutions for assessment purposes, including a determination that a securitization does not meet the 50 percent threshold.

In cases where a securitization is required to be consolidated on the balance sheet as a result of SFAS 166 and SFAS 167, and a large institution or highly complex institution has access to the necessary information, an institution may evaluate individual loans in the securitization on a loan-by-loan basis. Any loan within the securitization that meets the definition of a higher-risk asset must be reported as a higher-risk asset and any loan

<sup>19</sup> Loans or securities acquired from another entity are acquired on a recurring basis if an institution has acquired other loans or securities from that entity at least once within the calendar year or the previous calendar year of the acquisition of the loans or securities in question.



within the securitization that does not meet the definition of a higher-risk asset would not be reported as such. When making this evaluation, the institution must follow the transition guidance described in Appendix C, Section C. Once an institution evaluates a securitization for higher-risk asset designation on a loan-by-loan basis, it must continue to evaluate all securitizations for which it has the required information in a similar manner (*i.e.*, on a loan-by-loan basis). For securitizations for which the institution does not have access to information on a loan-by-loan basis, the institution must determine whether the securitization meets the 50 percent threshold.

### Definition of Refinance/Timing of Classification as a Higher-Risk Asset

#### 1. "Refinance" Definition for Consumer Loans

For all consumer loans and securities (including nontraditional mortgage loans), an institution must determine whether the loan or security meets the definition of a higher-risk consumer loan or a nontraditional mortgage loan and must do so as of origination, or, if the loan has been refinanced, as of refinance.

A refinance for this purpose is an extension of new credit or additional funds on an existing loan or the replacement of an existing loan by a new or modified obligation. A refinance includes the consolidation of multiple existing obligations, disbursement of additional funds to the borrower, an increase or decrease in the interest rate, or rescheduling of principal or interest payments to create or increase a balloon payment or extend the legal maturity date of the loan by more than six months. Additional funds include a material disbursement of additional funds or, with respect to a line of credit, a material increase in the amount of the line of credit, but not a disbursement, draw, or the writing of convenience checks within the original limits of the line of credit. Except as noted below for credit cards, a material increase in the amount of the line of credit is defined as a 10 percent or greater increase in the quarter-end line of credit limit.

Modifications to a loan that would otherwise meet this definition of refinance, but result in the classification of a loan as a troubled debt restructuring (TDR), do not constitute a refinance.<sup>20</sup> Any modification made to a consumer loan pursuant to a government program, for example the Home Affordable Modification Program or the Home Affordable Refinance Program, is also not considered a refinance.

An extension of the maturity date of a loan is not, *per se*, a refinance. A contractual deferral of payments that is consistent with the terms of the original loan agreement (for example, as allowed in some student loans), is not a refinance. For an open-end or revolving line of credit, an advance of funds consistent with the terms of the loan agreement is not a refinance. Deferrals under

the Servicemembers Civil Relief Act do not constitute a refinance. Except as provided above, a modification or series of modifications to a closed-end consumer loan do not constitute a refinance.

For credit card loans, replacing an existing card because the original is expiring, for security reasons, or because of a new technology or a new system does not constitute a refinance. Reissuing a credit card that has been temporarily suspended (as opposed to closed) is not a refinance. A non-temporary credit card credit line increase that is not a result of, or related to, a loss mitigation strategy is a refinance.

#### 2. "Refinance" Definition for Commercial Loans

For all commercial loans and securities, an institution must determine whether the loan or security meets the definition of a higher-risk C&I loan and security and must do so as of origination or, if the loan has been refinanced, as of refinance.

A refinance occurs when the original obligation has been replaced by a new or modified obligation or loan agreement. A refinance includes an increase in the master commitment of the line of credit (not including adjustments to sub-limits under the master commitment), disbursement of additional money other than amounts already committed to the borrower, extension of the legal maturity date, rescheduling of principal or interest payments to create or increase a balloon payment, substantial release of collateral, consolidation of multiple existing obligations, or an increase or decrease in the interest rate. A modification or series of modifications to a commercial loan other than as described in this paragraph does not constitute a refinance.

Modifications to a commercial loan that would otherwise meet this definition of a loan as a TDR, do not constitute a refinance. Any modification made to a consumer loan pursuant to a government program, for example the "Home Affordable Modification Program or the Home Affordable Refinance Program, will not be considered a refinance for these purposes.

### B. Updating Scorecard

The FDIC retains the flexibility, as part of the risk-based assessment system, without the necessity of additional notice-and-comment rulemaking, to update the minimum and maximum cutoff values for all measures used in the scorecard. The FDIC may update the minimum and maximum cutoff values for the higher-risk assets to Tier 1 capital and reserves ratio in order to maintain an approximately similar distribution of higher-risk assets to Tier 1 capital and reserves ratio scores as reported prior to the implementation of the proposed amendments or to avoid changing the overall amount of assessment revenue collected.<sup>21</sup> The FDIC will review changes in the distribution of the higher-risk assets to Tier 1 capital and reserves ratio scores and the resulting effect on total assessments and risk differentiation between institutions when

determining changes to the cutoffs. The FDIC may update changes to the higher-risk assets to Tier 1 capital and reserves ratio cutoffs more frequently than annually. The FDIC will provide institutions with a minimum one quarter advance notice of changes in the cutoff values for the higher-risk assets to Tier 1 capital and reserves ratio with their quarterly deposit insurance invoice.

### C. Application and Transition Guidance

Sections A through C of this Appendix C apply to:

- (1) All construction and land development loans, whenever originated or purchased;
- (2) All C&I loans and securities originated or purchased on or after October 1, 2012;
- (3) All consumer loans and securities, except securitizations of consumer loans and securities, whenever originated or purchased;
- (4) All residential real estate loans and securities, except securitizations of residential real estate loans, whenever originated or purchased; and
- (5) All securitizations of C&I loans, consumer, or residential loans originated or purchased on or after October 1, 2012.

For consumer and residential real estate loans and securities (other than securitizations) originated or purchased prior to October 1, 2012, an institution must determine whether the loan or security meets the definition of a higher-risk consumer loan and security no later than December 31, 2012, using information as of the date of the origination of the loan or security if the institution has that information.<sup>22</sup> If the institution does not have that information, it must use refreshed data to determine whether a loan or security meets the definition. Refreshed data is defined as the most recent data available as if the loan or security were being originated in the fourth quarter of 2012. In all instances, the refreshed data used must be as of July 1, 2012 or later.

For C&I loans and securities originated or purchased before October 1, 2012, and all securitizations originated or purchased before October 1, 2012, institutions must either continue to use their existing internal methodology or existing guidance provided by their primary federal regulator, or use the definitions detailed in the February rule to determine whether to include the loan, security, or securitization as a concentration in a risk area for purposes of the higher-risk assets to Tier 1 capital and reserves ratio.<sup>23</sup>

### D. Accounts Receivable and Automobile Dealer Floor Plan Lending Guidance

#### 1. Accounts Receivable

Loans secured by accounts receivable should be made with advance rates at or below 75 percent to 85 percent of eligible receivables, based on the receivable quality, concentration level of account debtors, and performance of receivables as related to the

<sup>22</sup> Institutions had to determine whether loans and securities originated or purchased prior to October 1, 2012, met the definition of a construction and land development loan or a nontraditional mortgage loan in time to file accurate reports of condition as of June 30, 2012, and September 30, 2012.

<sup>23</sup> 76 FR 10672 (February 25, 2011).

<sup>20</sup> Troubled debt restructuring (TDR) is defined as this term is defined in the glossary of the Call Report instructions, as it may be amended from time to time.

<sup>21</sup> 76 FR 10672, 10700 (February 25, 2011).



terms of sale.<sup>24</sup> An institution's lending policy should address the maintenance of an accounts receivable loan agreement with the borrower. This loan agreement should establish a percentage advance against acceptable receivables, include a maximum dollar amount due from any one account debtor, address the financial strength of debtor accounts, and define acceptable receivables. The definition of acceptable receivables should consider the turnover and dilution rates of receivables pledged, the aging of accounts receivable, and the concentrations of debtor accounts.<sup>25</sup>

Ineligibles must be established for any debtor account where there is concern that the debtor may not pay according to terms. Examples of ineligibles include:

- Accounts receivable balances over 90 days beyond invoice date or 60 days past due, depending upon custom with respect to a particular industry with appropriate adjustments made for dated billings;
- Entire account balances where over 50 percent of the account is over 60 days past due or 90 days past invoice date;
- Accounts arising from other than trade (e.g., royalties, rebates);
- Consignment or guaranteed sales;
- Notes receivable;
- Progress billings;
- Account balances in excess of limits appropriate to account debtor's credit worthiness or unduly concentrated by industry, location or customer; and
- Affiliate and intercompany accounts.

## 2. Inventory

Loans against inventory should normally be made with advance rates no more than 65 percent of eligible inventory (at the lower of cost valued on a FIFO basis or market) based on an analysis of realizable value. When an appraisal is obtained, up to 85 percent of the NOLV of the inventory may be financed.

Ineligibles must be established for inventory that exhibit characteristics that make it difficult to achieve a realizable value or to obtain possession of the inventory. The following are examples of when inventory is considered ineligible as collateral:

- Slow moving, obsolete inventory and items turning materially slower than industry average;
- Inventory with value to the client only, which is generally work in process; however, it may include raw materials used solely in the client's manufacturing process;

- Consigned inventory or other inventory where a perfected lien cannot be obtained;
- Off-premise inventory subject to a mechanic's or other lien; and
- Specialized, high technology or other inventory subject to rapid obsolescence or valuation problems.

## 3. Minimum Account Management and Monitoring Standards for Asset Based and Floor Plan Lenders

Accounts receivable and floor plan lending require a rigorous level of account management compared to other forms of lending. A hands-on approach to collateral evaluation and intense financial and client monitoring must be used in order to properly manage these relationships. Clients must submit periodic detailed reports that are routinely analyzed. A staff of specially trained field auditors should visit clients on a regular basis to inspect the collateral and verify the accuracy of the reporting. Examples of detailed reports that must be routinely provided to the asset-based lender include:

**Borrowing Base Certificates:** A form prepared by the borrower that reflects the current status of the collateral. Certificates, along with supporting information, must be provided on a daily, weekly or monthly basis, depending on the terms of the loan agreement, the financial strength of the borrower and the amount of availability under the revolver. Once received by the lender, this certificate, along with the supporting information, must be reconciled with internal collateral management systems to ensure the accuracy of the collateral base, with any discrepancies reconciled with the borrower. Key information contained in the certificate must include:

- The accounts receivable balance (rolled forward from the previous certificate);
- Sales (reported as gross billings) with detailed adjustments for returns and allowances to allow for proper tracking of dilution and other reductions in collateral;
- Detailed inventory information (e.g., raw materials, work-in-process, finished goods); and
- Detail of loan activity.

**Accounts Receivable and Inventory Detail:** Monthly accounts receivable and inventory agings must be received in sufficient detail to allow the lender to compute the required ineligibles.

**Accounts Payable Detail:** Monthly accounts payable agings must be received to monitor payable performance and anticipated working capital needs.

**Covenant Compliance Certificates:** Borrowers should submit Covenant Compliance Certificates, generally on a monthly or quarterly basis (depending on the terms of the loan agreement) to monitor compliance with the covenants outlined in the loan agreement. Non-compliance with any covenants should be promptly addressed to cure any defaults, with actions taken (e.g., waiver, amendment, default pricing, blocking advance privileges) dependent on the nature of each situation.

## Definition of Terms Used in the Accounts Receivable and Automobile Dealer Floor Plan Lending Guidance

**Blocked Account:** An account that is controlled by an agreement that stipulates that all cash transferred out of the account must go to the lender. Blocked accounts are controlled by the lender. The borrower can make deposits into the blocked account, but maintains no signature authority on the account. Funds flowing into the blocked account originate from (i) direct deposit checks; (ii) lock box deposits; or (iii) wire transfers from other institutions. In the direct deposit or bulk method, the client receives checks from its customers, batches them, and deposits them in kind to the blocked account.

**Lock Box:** An agreement whereby the borrower's account debtors mail their payment checks to a specified Post Office box controlled by the lender. The lender opens the mail, processes the checks for collection, and forwards a copy or other record of the checks to the borrower. Lock box proceeds are deposited into the borrower's blocked account.

## E. Growth-Adjusted Portfolio Concentration Measure

The growth-adjusted concentration measure is the sum of the values of concentrations in each of the seven portfolios, each of the values being first adjusted for risk weights and growth. The product of the risk weight and the concentration ratio is first squared and then multiplied by the growth factor. The measure is calculated as:

$$N_i = \sum_{k=1}^7 \left[ w_k * \left( \frac{\text{Amount of exposure}_{i,k}}{\text{Tier 1 Capital} + \text{Reserves}_i} \right) \right]^2 * g_k$$

Where:

N is institution *i*'s growth-adjusted portfolio concentration measure;<sup>26</sup>

*k* is a portfolio;

<sup>24</sup> Concentration of account debtors is the percentage value of receivables associated with one or a few customers relative to the total value of receivables. Compared to a lender with numerous debtors, a lender with few debtors is exposed to a greater level of risk if one of these debtors does not pay according to its account agreement. Consequently, high levels of concentration reflect

higher risk for a lender and must cause the lender to hold higher reserves (advance a lesser percentage) all else equal.

<sup>25</sup> Turnover of receivables is the velocity at which receivables are collected. In general, faster turnover increases the advance rate imposed by the lender.

The dilution rate is the uncollectible accounts receivable as a percentage of sales. The historical

dilution rate will impact advance rates. Higher uncollectible accounts will translate into a larger reserve account and less funds advanced to the company.

<sup>26</sup> The growth-adjusted portfolio concentration measure is rounded to two decimal points.

$g$  is a growth factor for institution  $i$ 's portfolio  $k$ ; and,  
 $w$  is a risk weight for portfolio  $k$ .

The seven portfolios ( $k$ ) are defined based on the Call Report/TFR data and they are:

- Construction and land development loans;
- Other commercial real estate loans;
- First-lien residential mortgages and non-agency residential mortgage-backed securities (excludes CMOs, REMICS, CMO and REMIC residuals, and stripped MBS issued by non-U.S. Government issuers for which the collateral consists of MBS issued or guaranteed by U.S. government agencies);
- Closed-end junior liens and home equity lines of credit (HELOCs);
- Commercial and industrial loans;

- Credit card loans; and
- Other consumer loans.<sup>27 28</sup>

The growth factor,  $g$ , is based on a three-year merger-adjusted growth rate for a given portfolio;  $g$  ranges from 1 to 1.2 where a 20 percent growth rate equals a factor of 1 and an 80 percent growth rate equals a factor of 1.2.<sup>29</sup> For growth rates less than 20 percent,  $g$  is 1; for growth rates greater than 80 percent,  $g$  is 1.2. For growth rates between 20 percent and 80 percent, the growth factor is calculated as:

$$g_{i,k} = 1 + \left[ \frac{1}{3} (G_{i,k} - 0.20) \right]$$

Where:

$$G_{i,k} = \frac{V_{i,k,t}}{V_{i,k,t-12}} - 1,$$

$V$  is the portfolio amount as reported on the Call Report/TFR and it is the quarter for which the assessment is being determined.

The risk weight for each portfolio reflects relative peak loss rates for banks at the 90th percentile during the 1990–2009 period.<sup>30</sup> These loss rates were converted into equivalent risk weights as shown in Table C.1.

TABLE C.1—90TH PERCENTILE ANNUAL LOSS RATES FOR 1990–2009 PERIOD AND CORRESPONDING RISK WEIGHTS

Portfolio	Loss rates (90th percentile)	Risk weights
First-Lien Mortgages .....	2.3%	0.5
Second/Junior Lien Mortgages .....	4.6%	0.9
Commercial and Industrial (C&I) Loans .....	5.0%	1.0
Construction and Development (C&D) Loans .....	15.0%	3.0
Commercial Real Estate Loans, excluding C&D .....	4.3%	0.9
Credit Card Loans .....	11.8%	2.4
Other Consumer Loans .....	5.9%	1.2

**Note:** The following appendix will not appear in the Code of Federal Regulations.

**Appendix 1—Two-Year Probability of Default Information for Consumer Loans**

The FDIC intends to collect two-year PD information on various types of consumer loans from large and highly complex institutions. However, the types of information collected and the format of the information collected will be subject to a Paperwork Reduction Act notice (with an opportunity for comment) published in the **Federal Register**. The following table is an

example of how the FDIC may collect the consumer loan information and the kind of information that may be collected. Once the definition of higher-risk consumer loans is adopted in a final rule, appropriate changes to the Call Reports will be made and institutions will be expected to begin reporting consumer loans according to the definition in the final rule. In addition, as suggested in the example table, institutions would report the outstanding amount of all consumer loans, including those with a PD below the subprime threshold, stratified by the 10 product types and 12 two-year PD bands.<sup>31</sup> In addition, for each product type, institutions would indicate whether the PDs

were derived using scores and default rate mappings provided by a third party vendor or an internal approach.<sup>32</sup> If an internal approach was used, the institution will also have to indicate whether or not the internal approach meets the minimum number of PD bands and observations required as described in the Requirements for PD Estimation in Appendix C, Section A. Institutions would report as a separate item the value of all securitizations of consumer loans that are more than 50 percent collateralized by consumer loans that would be identified as higher-risk assets (except those classified as trading book).

<sup>27</sup> All loan concentrations should include the fair value of purchased credit impaired loans.

<sup>28</sup> Each loan concentration category should exclude the amount of loans recoverable from the U.S. government, its agencies, or government-sponsored agencies, under guarantee or insurance provisions.

<sup>29</sup> The growth factor is rounded to two decimal points.

<sup>30</sup> The risk weights are based on loss rates for each portfolio relative to the loss rate for C&I loans, which is given a risk weight of 1. The peak loss rates were derived as follows. The loss rate for each loan category for each bank with over \$5 billion in total assets was calculated for each of the last

twenty calendar years (1990–2009). The highest value of the 90th percentile of each loan category over the twenty year period was selected as the peak loss rate.

<sup>31</sup> All figures would exclude the maximum amounts recoverable from the U.S. government, its agencies, or government-sponsored agencies under guarantee or insurance provisions, as well as loans that are fully secured by cash collateral. In order to exclude a loan based on cash collateral, the cash would have to be in the form of a savings or time deposit held by the insured depository institution. The insured depository institution would also have to have a signed collateral assignment of the deposit account, which was irrevocable for the remaining

term of the loan or commitment, and the insured depository institution would have to have placed a hold on the deposit account, which alerts the institution if there are attempts to withdraw or transfer the deposit funds. In the case of a revolving line of credit, the cash collateral would have to be equal to or greater than the amount of the total loan commitment (funded and unfunded balance of the loan) for the exclusion to apply.

<sup>32</sup> An internal approach would include the use of an institution's own default experience with a particular product and credit score, whether that score was provided by a third party or was internally derived.

**TABLE 1.1 – TWO-YEAR PROBABILITY OF DEFAULT INFORMATION  
FOR CONSUMER LOANS**

**Outstanding Balance of Consumer Loans by Two-Year Probability of Default**

Product	Two-year Probability of Default											
	≤ 1%	1-4%	4-7%	7-10%	10-14%	14-16%	16-18%	18-20%	20-22%	22-26%	26-30%	>30%
All nontraditional residential mortgages <sup>1</sup>												
Closed end loans secured by first liens on 1-4 family residential properties <sup>2</sup>												
Closed end loans secured by junior liens on 1-4 family residential properties <sup>3</sup>												
Revolving, open-end first liens and credit lines secured by 1-4 family residential properties <sup>4</sup>												
Revolving, open-end junior liens and credit lines secured by 1-4 family residential properties <sup>5</sup>												
Credit cards <sup>6</sup>												
Automobile loans <sup>7</sup>												
Student loans <sup>8</sup>												
Other consumer loans (including single payment and installment) and revolving credit plans other than credit cards <sup>9</sup>												
Consumer leases <sup>10</sup>												
Totals												

Note: All reported amounts would exclude the amounts recoverable from the U.S. government, its agencies, or government-sponsored agencies under guarantee or insurance provisions, as well as loans that are fully secured by cash collateral.

<sup>1</sup> As defined in the Large Bank Pricing rule.

<sup>2</sup> Schedule RC-C item 1(c)(2)(a), excluding loans reported as nontraditional residential mortgages.

<sup>3</sup> Schedule RC-C item 1(c)(2)(b), excluding loans reported as nontraditional residential mortgages.

<sup>4</sup> Part of Schedule RC-C item 1(c)(1), "Revolving, open-end loans secured by 1-4 family residential properties and extended under lines of credit."

<sup>5</sup> The portion of Schedule RC-C item 1(c)(1) not reported as revolving, open-end senior liens.

<sup>6</sup> Schedule RC-C item 6(a)

<sup>7</sup> Schedule RC-C item 6(c)

<sup>8</sup> Part of Schedule RC-C item 6(d) "Other consumer loans".

<sup>9</sup> The portion of Schedule RC-C item 6(d) not reported as student loans, plus item 6(b) "Other revolving credit plans."

<sup>10</sup> Schedule RC-C item 10(a)

By order of the Board of Directors.

Dated at Washington, DC, this 20th day of March 2012.

Federal Deposit Insurance Corporation.

**Robert E. Feldman,**

*Executive Secretary.*

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**FEDERAL DEPOSIT INSURANCE CORPORATION**

**12 CFR Part 380**

**RIN 3064-AD94**

**Enforcement of Subsidiary and Affiliate Contracts by the FDIC as Receiver of a Covered Financial Company**

**AGENCY:** Federal Deposit Insurance Corporation (FDIC).

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** The FDIC is proposing a rule ("Proposed Rule"), with request for comments, that implements section 210(c)(16) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act"), codified at 12 U.S.C. section

5390(c)(16), which permits the Corporation, as receiver for a financial company whose failure would pose a significant risk to the financial stability of the United States (a "covered financial company"), to enforce contracts of subsidiaries or affiliates of the covered financial company despite contract clauses that purport to terminate, accelerate, or provide for other remedies based on the insolvency, financial condition or receivership of the covered financial company. As a condition to maintaining these subsidiary contracts in full force and effect, the Corporation as receiver must either: transfer any supporting obligations of the covered financial company that back the obligations of the subsidiary or affiliate under the contract (along with all assets and liabilities that