FDIC
Federal Deposit Insurance Corporation
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Division of Insurance and Research

March 6, 2012

MEMORANDUM TO: The Board of Directors

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

SUBJECT: Notice of Proposed Rulemaking on Assessments, Large Bank Pricing

Staff recommends that the FDIC Board of Directors (FDIC or Board) authorize publication of the attached Notice of Proposed Rulemaking on Assessments for Large Bank Pricing (NPR or proposal) with a 60 day comment period. The NPR would amend the assessment regulations for large bank pricing that were adopted in February 2011.

Specifically, the proposed rule would:

- revise the definition of 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";
- provide clarification on the timing of identifying an asset as higher risk;
- provide clarification on the way securitizations (including those that meet the definition of nontraditional mortgage loans) are to be identified; and
- further define terms that are used in the large bank pricing rule.

Leveraged loans would be renamed "higher-risk C&I loans and securities" and subprime consumer loans would be renamed "higher-risk consumer loans and securities" 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 construction and development loans and nontraditional mortgage loans would remain the same, although the proposal would clarify how securitizations of nontraditional mortgage loans would be identified under the current definition.

Staff 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.

Concur: Michael H. Krimminger 3-6-12
Michael Krimminger
General Counsel

I. Background

On February 7, 2011, the FDIC Board adopted a final rule that amended its assessment regulation, by, among other things, establishing a new methodology for determining assessment rates for large and highly complex institutions (the February rule).[1,2] The rule 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, which is converted to the institution's initial base assessment rate and, after certain adjustments, results in the institution's total assessment rate. [3, 4] 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. The February rule defined higher-risk assets 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 guidance to define leveraged loans, subprime loans, and nontraditional mortgage 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.[5]

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[1] Assessments, Large Bank Pricing, 76 FR 10672 (February 25, 2011) (to be codified at 12 CFR 327.9).

[2] 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 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.

[3] A large or highly-complex institution's total score may be adjusted by a large bank adjustment. 76 FR 10672, 10714 (February 25, 2011) (to be codified at 12 CFR 327.9(b)(3)).

[4] 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)).

[5] 75 FR 23516 (May 3, 2010); 75 FR 72612 (November 24, 2010).

While large and highly-complex 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 data for the other loans; thus, new line items were required in the Call Reports and TFRs. Therefore, on March 16, 2011, the Office of the Comptroller of the Currency, the Federal Reserve System, the Office of Thrift Supervision and the FDIC (the federal banking 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 rule beginning with the June 30, 2011, report date (March PRA notice).[6]

The federal banking 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 the 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 adoption of the February rule.[7]

As a consequence of this unexpected difficulty, the FDIC applied to the Office of Management and Budget under emergency clearance procedures to allow large and highly-complex 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. 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).[8]

The FDIC received four comments in response to the July PRA notice before the comment period closed on September 26, 2011. The commenters suggested that the transition

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[6] 76 FR 14460 (March 16, 2011).

[7] 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. 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 February rule stated that large institutions should evaluate loans for subprime or leveraged status upon origination, refinance, or renewal. No comments were received on the November 2010 NPR indicating that large institutions would be unable to identify and report subprime or leveraged 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 March PRA notice.

[8] 76 FR 44987 (July 27, 2011).

guidance for reporting subprime and leveraged loans should be extended 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. Commenters maintained that the definitions were too broad and 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, FDIC staff 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 could alleviate commenters' concerns without sacrificing accuracy in risk determination for deposit insurance pricing purposes.

In drafting the attached NPR, staff reviewed and considered all comments related to the higher-risk asset definitions that were submitted in response to the March and July PRA notices. Staff 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. Higher-Risk Assets

The scorecard that was adopted under the February rule contains a concentration score that measures the amount of an 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.

A. 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;[9] 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 higher-risk C&I loans and securities definition if directly held by the evaluating institution, except securities classified as trading book.

The definition 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.[10]

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. 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.[11,12]

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[9] 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.

[10] 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).

[11] Information reasonably available to a sophisticated investor would include, but would not be 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 could use established criteria, model portfolios, or limitations published in the offering memorandum, indenture, trustee report or similar documents.

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.[13]

Rationale

In arriving at this proposal, staff 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, 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 after the February rule was adopted that $1 million, which was the minimum level for a C&I loan to be classified as a higher-risk asset under the February rule, was too low since it would capture a large number of small business loans that are not normally considered leveraged or higher risk. These trade groups further 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 noted that loans under $5 million are typically characterized by additional risk-reducing requirements, such as borrower's guarantees and additional collateral. Staff agrees with the commenters and believes that increasing the threshold level to $5 million for commercial loans to be classified as a higher-risk C&I loan and security would result in better identification of higher-risk assets and would reduce the reporting burden.

In response to the July PRA notice, the 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 the FDIC 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.[14] They added that the definition of leveraged loans used 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

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[12] 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.

[13] Somewhat more stringent requirements would apply when an institution acquires loans or securities from another entity on a programmatic or recurring basis.

[14] EBITDA is defined as earnings before interest, taxes, depreciation, and amortization.

considering the purpose of the loan in conjunction with the borrower's operating leverage ratio would result in more accurate identification of risk.[15]

Staff proposes that a test of the borrower's operating leverage ratio be combined 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 the increase in the debt was material, a C&I loan to that borrower would be classified as higher risk. Staff believes that including the purpose of the debt helps identify risk to the FDIC and reflects the method used internally by most banks to identify higher-risk loans. The purpose test identifies those borrowers with certain higher-risk characteristics, such as a heavy reliance on either enterprise value or improvement in the borrower's operating efficiencies.[16] The purpose test would target the riskiest borrowers with high absolute leverage levels that are the result of a material transaction that altered the risk profile of the borrower.

For purposes of reporting a loan or security as a higher-risk C&I loan or security, the industry suggested in a comment letter to the July PRA notice and in subsequent discussions with FDIC staff that banks should look back to the purpose of the debt only if the debt was incurred during the previous five years. Staff believes, however, that banks should have to look back to the 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 proposed rule, 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. This debt would be material if it resulted in a 20 percent or greater increase within 12 months in the total funded debt of the borrower.[17] During discussions between staff and 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. Staff believes that only a 20 percent increase in total funded debt would be appropriate when determining whether the loan meets the purpose test for a higher-risk C&I loan or security. 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.

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[15] The operating leverage ratio is the borrower's total or senor debt to trailing twelve-month EBITDA.

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

[17] This debt would also be material if, before the debt was incurred, the borrower had no funded debt.

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. A strong collateral backing should result in significantly lower loss rates to the FDIC in contrast to 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, staff proposes that certain well-collateralized loans be excluded from the definition of higher-risk C&I loans and securities; excluding well-collateralized asset-based loans and floor plan loans should result in better differentiation of credit risk among institutions and reduce reporting burden. 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 would only apply 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 risk 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 to the July PRA notice, 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 without standardized disclosure requirements that align with the FDIC's definition of higher-risk assets.

Concentrations in higher-risk assets, whether they are in the form of a whole loan or a securitization can increase the risk of loss to the FDIC during times of prolonged periods of economic stress. Staff believes that the proposal would result in consistent reporting for securitizations of higher-risk assets for deposit insurance pricing purposes.

The 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."[18] 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.

[18] Risk-Based Capital Guidelines: Market Risk: Alternatives to Credit Ratings for Debt and Securitization Positions 76 FR 79380, 79395 (December 21, 2011).

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;[19] and

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

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. Guidelines for identifying a securitization as higher-risk are set forth in footnotes 12 and 13.

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 was unavailable, however, the institution would have to obtain recent, refreshed data from the borrower or other appropriate third-party.[20]

<u>Rationale</u>

In arriving at its proposal, staff 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 Report for June 30, 2011. Commenters also stated that

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[19] A loan that met both the definitions of a nontraditional mortgage loan and a higher-risk consumer loan at the time of origination would be reported as a nontraditional mortgage loan. However, if the loan later ceased to meet the definition of nontraditional mortgage loan but continued to still qualify as a higher-risk consumer loan, it would then be reported as a higher-risk consumer loan.

[20] Somewhat more stringent requirements would apply when an institution acquires loans or securities from another entity on a recurring or programmatic basis.

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.[21]

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.

Staff believes that the definition for higher-risk consumer loans and securities contained in the NPR would better capture and differentiate higher-risk consumer loans and securities among banks compared to the definition in the February rule. In addition, the proposal should be easier for institutions to adopt and implement as it more closely aligns with how they currently measure risk.

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

Staff chose to use 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. Staff 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

[21] 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.

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.

Under the proposal, the FDIC would collect two-year PD information on various types of consumer loans from large and highly complex institutions.[22] The following table is an example of how the FDIC might collect the consumer loan information. Once the definition of higher-risk consumer loans is adopted in a final rule, staff anticipates that appropriate changes to the Call Report would be made and that large and highly-complex institutions would report 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.[23] 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.[24] 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.

[22] The types of information collected and the format of the information collected would be subject to a comment request published in the Federal Register.

[23] 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 was 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.

[24] 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

	Two-year Probability of Default											
Product	≤ 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[1]												
Closed end loans secured by first liens on 1-4 family residential properties[2]												
Closed end loans secured by junior liens on 1-4 family residential properties[3]												
Revolving, open-end first liens and credit lines secured by 1-4 family residential properties[4]												
Revolving, open-end junior liens and credit lines secured by 1-4 family residential properties[5]												
Credit cards[6]												
Automobile loans[7]												
Student loans[8]												
single payment and installment) and revolving credit plans other than credit cards[9]												
Consumer leases[10]												
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.

[1] As defined in the Large Bank Pricing rule.
[2] Schedule RC-C item 1(c)(2)(a), excluding loans reported as nontraditional residential mortgages.
[3] Schedule RC-C item 1(c)(2)(b), excluding loans reported as nontraditional residential mortgages.
[4] 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."
[5] The portion of Schedule RC-C item 1(c)(1) not reported as revolving, open-end senior liens.
[6] Schedule RC-C item 6(a)
[7] Schedule RC-C item 6(c)
[8] Part of Schedule RC-C item 6(d) "Other consumer loans".
[9] The portion of Schedule RC-C item 6(d) not reported as student loans, plus item 6(b) "Other revolving credit plans."
[10] 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. Staff 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. Staff would use the information that would be included in the Call Report to determine whether the PD threshold should be changed in the future.[25]

[25] See 76 FR 10672, 10700 (February 25, 2011) (H. Updating the Scorecard).

Staff anticipates that it may receive additional or updated information from third party vendors prior to the Board adopting a final rule. Staff would consider any additional information received before it proposes a particular PD threshold be adopted in the final rule. In reviewing the PD threshold, staff 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. Staff agrees that having the flexibility to modify the time periods 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 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 retain the right 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, staff would analyze 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. Institutions would receive at least one quarter advance notice of any changes to the PD estimation time periods or the PD threshold.[26]

Nontraditional Mortgage Loans

Nontraditional mortgage loans would continue to be defined as under the February rule; however, the proposal would clarify how securitizations of nontraditional mortgage loans are identified. 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, staff has concluded that identifying a nontraditional mortgage loan using a one-year PD would be inappropriate. Unlike

[26] Reporting all consumer loans by product and PD bands was part of the industry's proposal to strengthen identification of higher-risk consumer loans.

leveraged loans and subprime loans, institutions have not indicated any difficulty complying with the existing definition of nontraditional mortgage loans and staff believes that any changes to the definition would not result in better risk determination for deposit insurance pricing purposes. The proposal, therefore, retains the definition of nontraditional mortgage loans that was used in the February rule. Staff would monitor future rulemakings regarding Qualified Residential Mortgages and the capital treatment of nontraditional mortgage loans to determine whether the any future changes to definition of nontraditional mortgage loans should be considered.

Although the proposal would not make changes to the definition of a nontraditional mortgage loan, it does clarify that an institution would be required to use information reasonably available to a sophisticated investor in reasonably determining whether more than 50 percent of the assets backing a securitization contain nontraditional mortgage loans (similar to the proposed requirement for securitizations that may contain higher-risk C&I loans or securities or higher-risk consumer loans). Guidelines for identifying a securitization as higher-risk are set forth in footnotes 12 and 13.

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 is unavailable, however, the institution would have to obtain recent, refreshed data from the borrower or other appropriate third-party.[27]

III. 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 notice-and comment rulemaking as long as the method of selecting cut-off values remains unchanged. 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.[28]

[27] Somewhat more stringent requirements would apply when an institution acquires loans or securities from another entity on a recurring or programmatic basis.

[28] If, as a result of its review and analysis, the FDIC concludes that new 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 will be made through a future rulemaking.

Unless the FDIC re-calibrates the way the higher-risk assets to Tier 1 capital and reserves ratio is scored, 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. Most of the minimum and maximum cutoff values represent the 10^{th} and 90^{th} 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 and scores 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.

Staff 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, staff anticipates that the FDIC 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.[29] 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 scores could be made more frequently than annually under the proposal. This review would ensure proper risk differentiation between institutions.[30]

IV. Implementation and Effective Date

To allow time for institutions to implement systems to comply with the revised definitions, predicated on Call Report changes, the proposal would become effective October 1, 2012. Because no amendments to the definitions of C&D and nontraditional mortgage loans are being proposed, other than clarifying how securitizations are identified, institutions would continue to define and report these higher-risk assets as they have been doing under the February rule.

[29] 76 FR 10672, 10700 (February 25, 2011).

[30] The FDIC would provide large and highly-complex institutions with a minimum one quarter advance notice of changes in the cutoff values with their quarterly deposit insurance invoice to ensure that the industry has an opportunity to consider the impact that any changes may have on its assessments.

Transition Guidance until Effective Date

Prior to October 1, 2012, large institutions and highly complex institutions will continue to use the transition guidance included in the instructions to the Call Report as updated as of March 31, 2012. 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. Institutions that do not have an existing methodology in place to identify loans and securities as leveraged or subprime (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 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 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 had that information.[31] 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.

[31] 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.

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 have to either continue to use their existing internal methodology or existing guidance provided by their primary federal regulator or use the amended 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.[32]

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[32] 76 FR 10672 (February 25, 2011).