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FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 327

RIN 3064-AD92

Assessments, Large Bank Pricing

AGENCY: Federal Deposit Insurance Corporation (FDIC).

ACTION: Final Rule.

SUMMARY: The FDIC is amending 12 C.F.R. part 327 to revise some of the definitions used to determine assessment rates for large and highly complex insured depository institutions.

DATES: *Effective Date:* [XX]

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SUPPLEMENTARY INFORMATION:

I. Background

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 2011 rule).[1, 2] The February 2011 rule eliminated risk categories for large banks[3] and created two scorecards, one for highly complex banks and another for all other large banks, that combine CAMELS ratings and certain forward-looking financial ratios. The scorecards calculate a total score for each institution.[4] The total score is then converted to the bank's initial base assessment rate, which, after certain adjustments, results in the institution's total assessment rate.[5] To calculate the amount of the bank's quarterly assessment, the total assessment rate is multiplied by the bank's assessment base and the result is divided by four.

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[1] 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] The terms "bank" and "institution" are used interchangeably in the preamble of the final rule, unless the context suggests otherwise. Again, unless the context suggests otherwise, the terms include any insured depository institution that meets the definition of a large institution or highly complex institution as defined in 12 CFR 327.9(f) and (g).

[4] A large or highly complex institution's total score may be adjusted by the large bank adjustment. 12 CFR 327.9(b)(3).

[5] An institution's initial base assessment rate can be adjusted by the unsecured debt adjustment, the depository institution debt adjustment, and, for some institutions, the brokered deposit adjustment. 12 CFR 327.9(d).

One of the financial ratios used in the scorecards is the ratio of higher-risk assets to Tier 1 capital and reserves.[6] Higher-risk assets are defined in the February 2011 rule as the sum of construction and land development (C&D) loans, leveraged loans, subprime loans, and nontraditional mortgage loans. The FDIC used existing interagency guidance to define leveraged loans, nontraditional mortgage loans, and subprime loans but refined the definitions to ensure consistency in reporting. In arriving at these definitions, the FDIC took into account comments that were received in response to the two notices of proposed rulemaking that led to adoption of the February 2011 rule.[7]

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 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 Governors of the Federal Reserve System, the Office of Thrift Supervision, 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 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).[8]

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[6] 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 banks, 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 concentration score. For highly complex institutions, it is defined as the higher of: (a) the higher-risk assets to Tier 1 capital and reserves score, (b) the largest counterparty exposure to Tier 1 capital and reserves score, or (c) the top 20 counterparty exposure to Tier 1 capital and reserves score.

[7] 75 FR 23516 (May 3, 2010); 75 FR 72612 (November 24, 2010).

[8] 76 FR 14460 (March 16, 2011).

Commenters on the March PRA notice raised concerns about their ability to report subprime and leveraged loan data consistent with the definitions used in the February 2011 rule. They also stated that they would be unable to report the required data by the June 30, 2011 report date. These data concerns had not been raised during the rulemaking process leading up to the February 2011 rule.[9]

As a consequence of this unexpected difficulty, the FDIC applied to the Office of Management and Budget (OMB) for an emergency clearance request 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 in existing supervisory guidance. The agencies also submitted corresponding reporting revisions under normal PRA clearance procedures and requested public comment on July 27, 2011 (July PRA notice).[10]

In response to the PRA notices, commenters recommended extending the transition guidance for reporting subprime and leveraged loans until more workable and accurate definitions were developed.

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[9] 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 took into account in its February 2011 rule amending its assessment regulations. For example, several commenters on the November 2010 NPR stated that updating data to evaluate loans for subprime or leveraged status would be burdensome and costly, and for certain types of retail loans, would be impossible because existing loan agreements do not require borrowers to routinely provide updated financial information. In response to these comments, the FDIC's February 2011 rule stated that large institutions should evaluate loans for subprime or leveraged status upon origination, refinance, or renewal. No comments, however, 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 raised in comments on the March PRA notice.

[10] 76 FR 44987 (July 27, 2011).

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 determining risk for deposit insurance pricing purposes. The FDIC subsequently extended the deadline for the transition guidance to April 1, 2013.

The FDIC considered all comments related to the higher-risk asset definitions that were submitted in response to the March and July 2011 PRA notices as part of its review. The FDIC also engaged in extensive discussions with bankers and industry trade groups to better understand their concerns and to solicit potential solutions to these concerns. As a result, the FDIC issued a notice of proposed rulemaking on March 20, 2012 (NPR) to resolve the problems raised in comments on the March and July PRA notices.

II. Comments Received

The FDIC sought comments on every aspect of the proposed rule. The FDIC received a total of 14 comment letters.[11] The FDIC also conducted meetings with commenters and others. Summaries of these meetings are posted on the FDIC's website.[12]

Comments are discussed in the relevant sections that follow.

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[11] The FDIC also received a number of emails from commenters and other interested parties.

[12] http://www.fdic.gov/regulations/laws/federal/2012/2012-ad92.html.

III. The Final Rule: Assessment System for Large and Highly Complex Institutions

The FDIC has adopted this final rule to amend the assessment system for large and highly complex institutions by: (1) revising the definitions of certain higher-risk assets, specifically leveraged loans, which are renamed "higher-risk C&I loans and securities,"[13] and subprime consumer loans, which are renamed "higher-risk consumer loans"; (2) clarifying when an asset must be classified as higher risk; (3) clarifying the way securitizations are identified as higher risk; and (4) further defining terms that are used in the large bank pricing portions of 12 CFR 327.9. 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 those used within the industry and in other regulatory guidance. The FDIC has not amended the definition of C&D loans and the final rule retains the definitions used in the February 2011 rule. The FDIC also retains the definition of nontraditional mortgage loans; however, the final rule clarifies how securitizations of nontraditional mortgage loans are identified as higher risk. The final rule aggregates all securitizations that contain higher-risk assets into a newly defined category of higher-risk assets, "higher-risk securitizations." While the nomenclature is new, the NPR proposed including all assets that meet this newly defined category as higher-risk assets. The FDIC believes that the final rule will result in more consistent reporting, better reflect risk to the Deposit Insurance Fund (DIF), significantly reduce

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

reporting burden, and satisfy many of the concerns voiced by the industry after adoption of the February 2011 rule.

The final rule will be effective on April 1, 2013, predicated on changes to the Call Report instructions having been made. The effective date is discussed in Section E below.

A. Higher-Risk Assets

The FDIC uses the amount of an institution's higher-risk assets to calculate the institution's higher-risk concentration measure, concentration score and total score. As noted in the February 2011 rule, the higher-risk concentration measure captures the risk associated with concentrated lending in higher-risk areas. This type of lending contributed to the failure of a number of large banks during the recent financial crisis and economic downturn.[14]

Higher-risk C&I loans and securities

Basic definition of a higher-risk C&I loan and security

The definition of a "higher-risk C&I loan and security" in the final rule incorporates suggestions from comment letters, including a joint comment letter (the joint letter) from several industry trade groups and discussions with a trade group; the definition differs from the definition proposed in the NPR.

[14] 76 FR 10672, 10692-10693 (February 25, 2011).

The final rule introduces a new term, a "higher-risk C&I borrower," which includes a borrower that owes the reporting bank (*i.e.,* the bank filing its Call Report) on a C&I loan originally made on or after the effective date of the rule (April 1, 2013), if the following conditions are met:[15]

- The C&I loan must have an original amount (including funded amounts and the amount of unfunded commitments, whether irrevocable or unconditionally cancellable) of at least $5 million;
- The loan must meet the purpose and materiality tests described below; and
- When the loan is made, the borrower must meet the leverage test, also described below.

To ensure that the definition is equitably applied, all C&I loans that a borrower owes to the reporting bank that meet the purpose test when made and that are made within six months of each other must be aggregated to determine whether they have an original amount of at least $5 million; however, only loans in the original amount of $1 million or more need to be aggregated.[16] Thus, for example, if a bank makes a $4 million C&I loan and 5 months later makes a $2 million C&I loan, both of which meet the purpose test, the loans will have an original amount of $6 million. For a C&I loan that meets the purpose test and that is syndicated or participated among banks, the original amount of the loan (for purposes of determining whether the original amount is at least

[15] C&I 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. This definition includes purchased credit impaired loans and overdrafts.

[16] Loans made before the effective date of the rule need not be aggregated.

$5 million and for purposes of applying the materiality test) is the total original amount of the loan, not just the syndicated or participated portion held by an individual bank.

A "higher-risk C&I borrower" also includes a borrower that obtains a refinance[17] of an existing C&I loan, where the refinance occurs on or after the effective date of the rule and the refinanced loan is owed to the reporting bank, if the following conditions are met:

- The refinanced loan must be in an amount (including funded amounts and the amount of unfunded commitments, whether irrevocable or unconditionally cancellable) of at least $5 million;
- The C&I loan being refinanced must have met the purpose and materiality tests when it was originally made;
- The original loan must have been made no more than five years before the refinanced loan (the look-back period); and
- When the loan is refinanced, the borrower must meet the leverage test.

Again, to ensure that the definition is equitably applied, when a C&I loan is refinanced through more than one loan and the loans are made within six months of each other, they must be aggregated to determine whether they have an amount of at least $5

[17] The definition of refinance is discussed in Appendix C. Two commenters had suggested that the definition proposed in the NPR was too broad and inconsistent with Regulation Z, Section 226.20. While the definition in the final rule differs from the Regulation Z definition, the two definitions serve different purposes. Regulation Z states that a refinancing occurs when an existing obligation is satisfied and replaced with a new obligation, and this new transaction requires new disclosures to the consumer. The purpose of Regulation Z is to determine when new disclosures should be required to be given to consumers. The purpose of the definition in the final rule is to determine when an institution should re-evaluate a loan for higher-risk status. Prior to proposing its definition of refinance in the NPR, the FDIC discussed it at length with the industry and other interested parties.

million. Thus, for example, an $8 million C&I refinancing loan that is split into two $4 million loans, where both are made within six months of each other, will still have an amount of $8 million.

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

Under the final rule, "higher-risk C&I loans or securities" include all C&I loans owed to the reporting bank by a higher-risk C&I borrower, except loans subject to an exclusion described below, and all securities issued by the higher-risk C&I borrower that are owned by the reporting bank, except securities classified as trading book, without regard to when the loans were made or the securities purchased.[18]

Purpose test

A loan or refinance meets the purpose test if it is to finance a buyout, acquisition or capital distribution. Under the final rule, an "acquisition" is the purchase by the borrower of any equity interest in another company or the purchase of all or a substantial

[18] The amount of a higher-risk C&I loan or security to be reported on the Call Report as of the end of a quarter is the amount of C&I loans, and unfunded C&I loan commitments, owed to the reporting bank by a higher-risk C&I borrower and the amount of securities issued by a higher-risk C&I borrower that are owned by the reporting bank.

portion of the assets of another company; a "buyout" is the purchase or repurchase by the borrower of the borrower's outstanding equity (a buyout includes, but is not limited to, an equity buyout or funding of an Employee Stock Ownership Plan (ESOP)); and a "capital distribution" is a dividend payment or other transaction designed to enhance shareholder value, such as repurchase of stock.[19]

The purpose test will help identify risk and reflect the method used internally by most banks to identify higher-risk loans. The test identifies those borrowers with certain higher-risk characteristics, such as a heavy reliance on either enterprise value or improvement in the borrower's profitability.[20]

Materiality test

A loan or refinance meets the materiality test if the amount of the original loan (including funded amounts and the amount of unfunded commitments, whether irrevocable or unconditionally cancellable) equals or exceeds 20 percent of the total funded debt of the borrower. Total funded debt of the borrower is to be determined as of the date of the original loan and does not include the loan to which the materiality test is being applied.[21] A loan also meets the materiality test if, before the loan was made, the borrower had no funded debt.

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[19] The NPR proposed to include as an acquisition "any of the assets and liabilities of another company." The final rule narrows and clarifies this definition.

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

[21] When multiple loans must be aggregated to determine whether they total at least $5 million, the materiality test is to be applied as of the date of the last loan.

At the time of refinance, whether the original loan met the purpose or materiality tests may not be easily determined by a new lender. In such a case, the new lender must use its best efforts and reasonable due diligence to determine whether the original loan met these tests.

Leverage test

A borrower meets the leverage test if the ratio of the borrower's total debt to trailing twelve-month EBITDA (commonly known as the operating leverage ratio) is greater than 4, or the ratio of the borrower's senior debt to trailing twelve-month EBITDA (also commonly known as the operating leverage ratio) is greater than 3.[22]

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

Comments on the proposed definition

In the joint letter, commenters took issue with several parts of the NPR's proposed definitions related to higher-risk C&I loans.[23] The NPR proposed that a C&I

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

[23] The NPR proposed the following definition of a "higher-risk C&I loan and security":

• 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; and
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> (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

loan of any size that was made within the past seven years and that met the purpose and materiality tests, whether made by the reporting bank or another institution, would make all C&I loans to a leveraged borrower higher risk if the borrower had a total of at least $5 million in C&I loans owed to the reporting bank. The commenters suggested that a $5 million threshold should be part of the purpose test, on the grounds that a loan of less than $5 million at origination or refinance would not be sufficiently material to be "higher risk" even if it financed an acquisition, buyout or capital distribution, and that requiring a lender to consider loans under $5 million to a borrower would be expensive and time consuming. The commenters further suggested that the look back at the purpose and materiality of debt should apply only when currently outstanding debt is *refinanced*, on the grounds that the definition of higher-risk is intended to identify risk when it is created. Finally, the commenters recommended that the look-back period should be, at most, five years rather than the seven years proposed in the NPR, on the grounds that most large banks track the past borrowing history of a borrower only three years back through a review of their financial statements and that the purpose of debt becomes murkier as it grows older and as new debt is added.

(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.

Under the proposed definition, multiple loans to one borrower were to be aggregated to determine whether the outstanding amount exceeded $5 million to the extent that the institution's loan data systems could do so without undue cost. If the cost was excessive, the institution could treat multiple loans to one borrower as separate loans.

The final rule adopts these suggestions with some modifications primarily intended either to simplify the rule or to ensure that the intent of the definitions cannot be easily circumvented.

In the joint letter and a subsequent email, commenters suggested that debt incurred to fund ordinary business actions such as dividends to make tax payments should be excluded from the definition of a capital distribution in the purpose test. The final rule does not adopt this suggestion because the materiality test should be sufficient to exclude most loans made in the ordinary course of business.

Several industry trade groups and one bank commented that a material increase in debt should be defined as a 50 percent increase in funded debt within one year rather than the proposed 20 percent increase, arguing that 20 percent would include loans made to firms for routine acquisitions in the normal course of business. According to the commenters, such loans might include financing for a modest stock redemption or basic dividend program. Commenters also suggested that the materiality test should apply only to debt that meets the purpose test, rather than all debt. The final rule adopts the suggestion to consider only purpose loans in the materiality test.

Because the materiality test will measure only the increase in total funded debt that results from loans that meet the purpose test, rather than the total increase in funded debt from any source, the final rule continues to define a material increase as at least 20 percent. Increasing the threshold above 20 percent could exclude borrowers that were highly leveraged before obtaining a loan that meets the purpose test, even if the loan was large. Furthermore, the final rule already adopts a narrower definition of higher-risk C&I

loans than existing and proposed regulatory guidelines on leveraged lending, which do not contain any materiality test.[24] The final rule also simplifies the materiality test by requiring that a loan that meets the purpose test must be at least 20 percent of total funded debt as of the date of origination, rather than as of one year earlier.

The FDIC received no comments on the definition of the leverage test proposed in the NPR.

Exclusions from the definition of higher-risk C&I loan and security

As proposed in the NPR, the definition of a higher-risk C&I loan and security in the final rule excludes the maximum amount that is recoverable from the U.S. government or its agencies under guarantee or insurance provisions, as well as loans (including syndicated or participated loans) that are fully secured by cash collateral.[25,26]

In the joint letter, commenters recommended excluding loans that are collateralized by securities issued by the U.S. government, its agencies, or government-

[24] OCC's February 2008 Comptroller's Handbook on Leverage Lending (pages 2 and 3) and the (interagency) Proposed Guidelines on Leveraged Lending, 77 FR 19417 (March 30, 2012).

[25] To exclude a loan based on cash collateral, the cash must be in the form of a savings or time deposit held by an insured depository institution. The insured depository institution (or lead institution or agent bank in the case of a participation or syndication) must have a perfected first priority security interest, a security agreement, and a collateral assignment of the deposit account that is irrevocable for the remaining term of the loan or commitment. In addition, the institution must place a hold on the deposit account that alerts the institution's employees to an attempted withdrawal. If the cash collateral is held at another institution or at multiple institutions, a security agreement must be in place and each institution must have in place an account control agreement (as defined in Appendix C). For the exclusion to apply to 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).

[26] The NPR proposed excluding from the definition of a higher-risk C&I loan and security "the maximum amount that is recoverable from ... [GSEs] under guarantee or insurance provisions," but the final rule omits this language because no GSE guarantees or insures C&I loans or securities issued by a C&I borrower.

sponsored enterprises (GSEs). The final rule, however, does not exclude loans so collateralized because the collateral is subject to interest rate risk and collateral arrangements are subject to operational risk. Commenters also recommended excluding loans that are fully secured by brokerage account collateral (securities-based loans). The final rule does not exclude these loans because the value of the collateral is subject to several sources of risk, including operational, credit and market risk.

A bank suggested that the definition of higher-risk C&I loans exclude loans acquired at a discount or marked to fair value. Another commenter suggested that the definition exclude modified loans. The final rule does not adopt these suggestions. The higher-risk concentration ratio is a forward looking financial measure aimed at capturing the risk of concentrations in higher-risk assets, irrespective of how the assets are valued on the balance sheet or whether they are modified. These loans have the characteristics of higher-risk loans, despite being recorded at a discount or at fair value at the date of acquisition or having been modified from the original terms. The future performance of these assets remains uncertain; the institution still faces the risk of additional losses on these assets.

In the joint letter, commenters recommended that unplanned overdrafts not be included as higher-risk C&I loans, arguing that they create exposures that are incidental and cured within a few days, if not overnight. The final rule, however, defines C&I loans consistent with the Call Report definition of such loans, which includes unplanned overdrafts. An overdraft alone is unlikely to cause a borrower to be considered higher risk, however; it is only likely to be included as higher-risk to the extent that other loans cause a C&I borrower to be considered higher risk.

Exclusions for asset-based lending and floor plan lending

The definition of higher-risk C&I loans and securities excludes certain well-collateralized asset-based loans and floor plan loans.[27] Excluding these loans should result in better differentiation of risk among banks and will reduce reporting burden. Because these loans carry significant operational risk, the exclusions 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. The final rule provides that, if a bank's primary federal regulator (PFR) has criticized (that is, included in Matters Requiring Attention or MRA) the bank's controls or administration of its asset-based or floor plan loan portfolios, the exclusion will not apply.

The final rule details the conditions that institutions must meet to be eligible for the asset-based and floor plan lending exclusions. The differences between the final rule and the NPR are generally the result of recommendations from commenters. The final rule requires that a new borrowing base certificate be obtained within 30 days before or after each draw or advance on a loan, as opposed to requiring a new borrowing base certificate at each draw or advance, as proposed in the NPR.[28] A bank is required to validate the borrowing base, but is not required to do so at each draw, as was proposed in the NPR.[29] In their joint letter, commenters stated that it is not standard practice for

[27] The proposal included asset-based lending guidance. The final rule, however, incorporates this guidance into the asset-based lending exclusion conditions in Appendix C.

[28] A "borrowing base certificate" is defined in Appendix C.

[29] The requirements of the validation process are discussed further in Appendix C.

lenders to obtain a new borrowing base certificate at each advance or draw on a loan, and noted that it is not unusual for draws to occur on a daily basis. The commenters further stated that requiring lenders to obtain a new borrowing base certificate at each advance or draw would impose a major administrative burden on banks and their borrowers. In the joint letter, commenters recommended that a new borrowing base certificate be required within 60 days of each draw or advance. The final rule adopts a 30-day requirement on the grounds that 60 days does not provide sufficient assurance that the loan is fully secured.

The final rule permits a bank to exclude an asset-based loan from higher-risk C&I loans owed by a higher-risk C&I borrower, provided that the advance rate on the accounts receivables that serve as collateral for the loan does not exceed 85 percent. This is a change from the NPR, which proposed that advance rates on accounts receivable should *generally* not exceed 75 percent to 85 percent of eligible receivables. One commenter noted that the term "generally" gave institutions the option to allow advance rates of greater than 85 percent of eligible accounts receivable when appropriate. Because advance rates in excess of 85 percent expose the lender to the risk of loss from a relatively small default rate on accounts receivable, however, the final rule requires that advance rates never exceed 85 percent for the exclusion to apply.

In response to comments, the final rule also provides that:

- The borrowing base may include other assets, but a loan must be fully secured by the portion of the borrowing base that is composed of accounts receivable and inventory.

- Appraisals will not be required for accounts receivable collateral. In addition, when there is a readily available and determinable market price for inventory from a recognized exchange or third-party industry source, inventory may be valued using these sources in lieu of an appraisal.

- An institution need not have the unconditional ability to take control of a borrower's deposit accounts to be eligible for the asset-based lending exclusion; rather, it is sufficient if the lending institution has the legally enforceable ability to take dominion over the borrower's deposit accounts without further consent by the borrower (or any other party). In all cases, the lending bank must have a perfected first priority security interest in the deposit account, a security agreement must be in place and, if the account is held at an institution other than the lending institution, an account control agreement must also be in place. [30]

- The lending bank must have the ability to withhold funding of a draw or loan advance if the outstanding balance on the loan is not within the collateral formula prescribed by the loan agreement.

- A bank's lending policies or procedures must address the maintenance of an inventory loan agreement with the borrower, consistent with the requirements for an accounts receivable loan agreement.

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[30] For the purposes of this rule, an account control agreement means a written agreement between the lending bank (the secured party), the borrower, and the institution that holds the deposit account serving as collateral (the depository bank), that the depository bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the borrower (or any other party).

- Banks are required to obtain financial statements from dealer floor plan borrowers, but the statements need not be audited. Original Equipment Manufacturers (OEM) financial statements, otherwise known as dealer statements, will be sufficient.

Higher-Risk Consumer Loans

"Higher-risk consumer loans" are defined as 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) is greater than 20 percent, excluding those consumer loans that meet the definition of a nontraditional mortgage loan.[31,32]

Higher-risk PD threshold

As noted by commenters, the FDIC may need to adjust the higher-risk PD threshold after reviewing data for the first reporting period, since the 20 percent threshold in the definition was determined based on preliminary score-to-default rate mappings received from a few credit score providers.

The NPR proposed that the FDIC could change the PD threshold without further notice-and-comment rulemaking. Several trade groups commented that the higher-risk

[31] For the purposes of this rule, consumer loans consist of all loans secured by 1-4 family residential properties as well as loans and leases made to individuals for household, family, and other personal expenditures, as defined in the instructions to the Reports of Condition and Income, Schedule RC-C, as the instructions may be amended from time to time.

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

PD threshold, after a potential adjustment following the first reporting period, should remain invariant and not be changed without notice-and-comment rulemaking.

The final rule is generally consistent with these comments.[33] Under the final rule, the FDIC retains the flexibility to change the 20 percent threshold without further notice-and-comment rulemaking, but only as the result of reviewing data for up to the first two reporting periods. The FDIC will give banks at least one quarter advance notice of any change through a Financial Institution Letter. Any subsequent changes to the threshold will be made through notice-and-comment rulemaking.

A threshold of 20 percent was found to be generally consistent with score-based definitions of subprime commonly used by the industry, capturing the riskiest 10 to 20 percent of consumer loans on a national basis. If, once the final rule is in effect, the overall proportion of consumer loans reported as higher-risk among large institutions differs materially from this preliminary estimate of 10 to 20 percent of consumer loans, the FDIC may decide to adjust the 20 percent threshold. The final rule, like the proposed rule, gives the FDIC the flexibility to make this change without further notice-and-comment rulemaking (as a result of reviewing data reported for the first one or two reporting periods) so that a re-calibration of the measure can be accomplished quickly to prevent banks from being unfairly assessed. Before making any such change, the FDIC

[33] Several commenters also suggested that, if the FDIC were to adjust the PD threshold, the new threshold should only apply to loans originated or refinanced after the effective date of the change, and the determination that a loan is or is not higher risk will be based on the previous threshold. In the commenters' view, this suggestion would allow institutions to adjust their pricing policies prospectively to account for the cost of making a new loan that meets the revised threshold. Because the final rule requires notice-and-comment rulemaking before changing the PD threshold (except for a potential change after the first or second reporting period under the final rule), this issue would be addressed in any such future rulemaking.

will analyze the potential effect of changing the PD threshold on the distribution of higher-risk consumer loans among institutions and the resulting effect on assessments collected from the industry.

One bank commented that the higher-risk PD threshold should vary by product type, and that volatility in default rates is more relevant than the average level of default rates. As an example, the bank noted that, although credit card default rates were higher than default rates on some other products during the recent crisis, the default rates on credit cards rose less than the default rates on other products. In particular, the default rates on mortgages rose significantly and unexpectedly, causing losses that threatened institutions and the financial system. The bank also commented that other risk factors, such as historic default rates, yields, and resilience to stress, should be taken into account.

While the factors that the commenter mentioned are relevant, taking them into account in the definition of a higher-risk consumer loan would introduce excessive complexity with uncertain improvements in risk differentiation. Under the final rule, as proposed in the NPR, institutions must estimate the two-year PD for a consumer loan based on how loans with similar risk characteristics performed during the recent crisis. The FDIC chose to use the recent stress period for PD estimation, as opposed to a longer history, to capture the consumer behavior that generated significant unexpected losses. The PDs estimated using the specified time periods are not intended to reflect long-run mean default rates or capture product-by-product differences in more favorable periods.

Methodology for estimating PDs

Time period. Under the final rule, and as proposed in the NPR, an institution must estimate the two-year PD for a consumer loan based on the observed stress period default rate (defined below) for loans of a similar product type made to consumers with credit risk comparable to the borrower being evaluated, all as detailed in the estimation guidelines in Appendix C. To capture the default behavior of consumers during a period of economic stress, the default rate is to be calculated as the average of the two, 24-month default rates from July 2007 to June 2009, and July 2009 to June 2011.[34]

Several trade groups and two institutions commented that the time periods used for PD estimation should be updated bi-annually. These commenters suggested that the average default rates could be calculated on a rolling basis, using the two most recent consecutive 24-month periods, or on a cumulative basis using all consecutive 24-month periods from July 2007 forward. They noted that it is standard industry practice to recalibrate credit models at least once a year, and that model parameters more than two years old are generally considered unreliable. Furthermore, the commenters stated that specifying a regular interval for updating the time periods would make the process more predictable and give institutions an opportunity to adjust their credit policies and pricing in advance of any changes, thus promoting a more stable flow of credit to consumers.

Identifying higher-risk consumer loans based on PD estimates from a time of economic stress is consistent with the FDIC's objective of assessing large institutions during favorable periods based on how they are likely to perform during periods of stress,

[34] Institutions must use the formula in Appendix C to calculate the average default rate.

as explained in the February 2011 rule. If the time period were to be updated on a rolling or cumulative basis, as suggested, the resulting PD estimates would eventually not reflect the performance of loans during the recent crisis. While the updated default rates might be closer to realized two-year default rates during favorable periods, they would generally not capture the relative differences in default behavior among product types that can be expected to occur under stress conditions (and that actually did occur during the recent financial crisis). In addition, unless changes were made to the higher-risk PD threshold of 20 percent, any regular updating of the time period could introduce an undesirable level of pro-cyclicality into the higher-risk concentration measure, whereby the volume of higher-risk loans would tend to rise as credit conditions deteriorated, and fall as conditions improved. This type of volatility could occur even if the distribution of credit scores in a loan portfolio remained static over time. The final rule avoids this volatility by using a fixed historical period for measuring default rates.

Default rates calculated using the recent crisis period may not reflect future changes in macroeconomic factors, industry standards, or consumer behavior that affect the riskiness of different product types. To ensure that the PD methodology continues to accurately identify higher-risk consumer loans, the FDIC may need to update the time period used for PD estimation at some point. Under the final rule, unlike the proposed rule, a change in the time period would require further notice-and-comment rulemaking.

Default rate and definition of "active loan." The final rule requires institutions to calculate the default rate for each 24-month time period 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 24-month period). An

"active" loan is defined as any loan that was open and not in default as of the observation date, and on which a payment was made within the 12 months prior to the observation date. This definition differs from the one proposed in the NPR, which had defined an active loan as a loan that 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. The FDIC had proposed this balance-based definition to exclude accounts that, while open and available for use, were generally not being used. Including these accounts in the default rate calculation could result in PD estimates that understate the default experience of truly active accounts. The FDIC also based its proposal on indications that historical balance data were available in the credit bureau data used by third-party providers of consumer credit scores.

One credit reporting bureau, however, informed the FDIC that historical data on account balances are often either unavailable or difficult to obtain. The credit reporting bureau also suggested that the proposed approach could miss active revolving loans where the balance is completely paid off each month. As an alternative, the credit reporting bureau suggested that an active account could be defined as any loan reported by the lender in the 12 months prior to the observation date, or any loan that has a positive balance as of the observation date.

The FDIC concluded, based on discussions with the three major credit reporting bureaus, that the date of last payment is information that is generally reported and maintained historically. In addition, defining an active loan using the date of last payment should better capture active revolving accounts that pay off monthly compared to both the proposed definition and a definition that would rely on the balance only as of

the observation date. While the commenter's suggestion to include any loan reported by the lender in the 12 months prior to the observation date would also capture these revolving accounts, this definition could capture accounts that are no longer open as of the observation date or are otherwise inactive.

Additional risk factors. The final rule requires that, at a minimum, the PD estimate of a loan must be based on the product type and credit score of the borrower. In response to a comment, the final rule clarifies that institutions may consider risk factors other than product type and credit score (*e.g.*, geography) in estimating the PD of a loan, because these factors may improve PD estimates. All estimation requirements detailed in the final rule, including the minimum sample size, however, must be satisfied regardless of the number of factors used.

Mapping scores to default rates. The final rule requires partitioning the entire credit score range generated by a given scoring system into a minimum of 15 credit score bands. A PD for each credit score band and loan product type (and for any other risk factor being considered) must be estimated as the average of two particular 24-month default rates as described in Appendix C. Each 24-month default rate must be calculated using a random sample of at least 1,200 active loans. Although each score band will likely include multiple credit scores, each credit score will need to have a unique PD associated with it. Therefore, when the number of score bands is less than the number of unique credit scores (as will almost always be the case), banks must use a linear interpolation between adjacent default rates to determine the PD for a particular score. The observed default rate for each band must be assumed to correspond to the midpoint of the range for that 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 $\left(\frac{.04 - .06}{623 - 618}\right) \cdot (620 - 618) + .06 = .052$

One provider of consumer credit scores recommended an alternative to the proposed method of assigning PDs to individual score values. This commenter suggested that the FDIC permit banks to use a least-squares regression or other accepted statistical methodology to estimate the score-to-default rate relationship. The commenter noted that the relationship between the logarithm of the odds of not defaulting and the FICO score is very close to linear. The commenter argued that PDs estimated using a regression would be less dependent on the way institutions structure score bins and provide more reliable estimates of future default rates for a given score.

Depending on the nature of the data, least-squares regression and alternative methods of estimating the score-to-default rate relationship may, in fact, have certain advantages over the proposed approach. Given the minimum sample size and score band requirements, however, estimates generated using the proposed approach should be similar to those generated using alternative statistical methods. While the industry generally understands and uses linear interpolation, many banks that try to develop their own PD estimates according to the requirements may lack the expertise to apply more sophisticated fitting methods to their data. To ensure consistency among estimation methods, the final rule retains the linear interpolation approach.

Alternative methodology. Like the proposed rule, the final rule allows institutions to request to use default rates calculated using fewer observations or score bands than the

specified minimums, either in advance of, or concurrent with, actual reporting under the requested approach. The request must explain in detail how the requested approach differs from the rule specifications and include, at a minimum, a table with default rates and the 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 approach while the FDIC evaluates the request. If, after reviewing the request, the FDIC determines that the institution's approach is unacceptable, the institution may be required to amend its Call Reports and treat any loan whose PD had been estimated using the disapproved methodology as an unscorable domestic consumer loan subject to the de minimis approach described above; the institution, however, will be required to submit amended information for no more than the two most recently dated and filed Call Reports preceding the FDIC's determination.

One trade group commented that the FDIC should publish its criteria for evaluating methodologies that deviate from the PD estimation requirements. The trade group stated that providing the criteria would help smaller institutions evaluate their options before devoting time and resources to developing an alternative methodology. Because the final rule allows institutions to request the use of PD estimates that differ from the specifications only in the two specific respects noted previously (using fewer observations or score bands than the specified minimums), institutions should not be expending resources developing an entirely different methodology. While providing more specific guidance on acceptable alternatives to the score band and sample size requirements may make the decision process easier for institutions, the range of

potentially acceptable alternatives is broad enough to preclude the final rule from providing predetermined criteria.

In the joint letter, commenters suggested that a simplified method of reporting should be permitted for banks with minimal exposure to higher-risk consumer loans. The commenters stated that the potential benefit to the FDIC would be small relative to the cost these banks would incur to comply with the new definition. The commenters suggested that if a bank's subprime loans – defined based on the 2001 interagency guidance – were less than one percent of Tier 1 capital and reserves, they should be allowed to report the amount as higher-risk if it is less costly for them to do so. One trade group suggested that if a portfolio has a default rate consistently below 10 percent and the bank maintains prudent underwriting criteria and appropriate monitoring for loans placed in that portfolio, the bank should not be required to estimate and report the PDs of loans in the portfolio. This same trade group stated that loans made before the effective date of the rule should be exempt from PD reporting, or the FDIC should provide a transitional period of at least three years.

Under the final rule, as proposed in the NPR, banks must calculate the PDs of *all* outstanding consumer loans following the effective date of the rule. Because the 2001 interagency guidance for subprime lending differs from the definition in the final rule, allowing banks to determine their level of exposure using this alternative standard could result in inconsistent treatment of loans across banks. This same inconsistency could result if alternative criteria were used, such as having a default rate consistently below 10 percent. While banks will need some time to modify systems and processes to report under the definitions in the final rule, the suggested transition period of three years could

result in the assessment system failing to identify higher-risk concentrations for too long. The effective date of April 1, 2013, should give banks sufficient time to comply with the final rule.

Unscorable consumer loans

The final rule definition, like the definition proposed in the NPR, requires institutions to estimate the two-year PD of a loan based, in part, on the credit risk of the borrower as reflected in a credit score.[35] When a consumer loan has a co-signer or co-borrower, the PD may be determined using the most favorable individual credit score. For unscorable consumer loans – where the available information is insufficient to determine a credit score – the final rule specifies the following treatment: if the total outstanding balance of unscorable consumer loans of a particular product type exceeds 5 percent of the total outstanding balance for that product type, including both foreign and domestic loans, the excess amount shall be treated as higher-risk (the de minimis approach). Otherwise, the total outstanding balance of unscorable consumer loans of a particular product type will not be considered higher-risk. The consumer product types used to determine whether the 5 percent test is satisfied shall correspond to the product types listed in the table used for reporting PD estimates. If, after the origination or refinance of the loan, an unscorable consumer loan becomes scoreable, the final rule requires institutions to reclassify the loan using the PD estimated according to the rule specifications. Based upon that PD, the loan will be determined to be either higher risk

[35] As detailed in Appendix C, the credit risk of the borrower must be determined using a third-party or internal scoring system that qualifies as empirically derived, demonstrably and statistically sound (EDDSS), as defined in 12 CFR 202.2(p), as amended from time to time, and that has been approved by the bank's model risk oversight and governance process and internal audit mechanism.

or not, and that determination will remain in effect until a refinancing occurs, at which time the loan must be re-evaluated. An unscorable loan must be reviewed at least annually to determine if a credit score has become available.

Several trade groups commented that the proposed rule did not consider how large banks are to treat consumer credits with no credit histories or scores. These groups noted that this issue is relevant for all types of consumer loans, but especially for student and credit card loans. One trade group argued that an institution should not be automatically required to classify unscorable loans as higher-risk, because doing so would cause some products, such as student loans, to become more expensive or less available. In the joint letter, commenters suggested that, to account for unscorable loans, large banks with sufficient data on the performance of such loans should be allowed to develop internal PD estimates using the same time period and sample size requirements in the rule. For large banks that do not have sufficient data to create such a mapping, the commenters stated that unscorable loans could initially be treated as higher-risk and subsequently re-evaluated according to the rule specifications once a credit score becomes available for the borrower. The commenters also noted that, although initially classifying unscorable loans as higher-risk is excessively conservative, it would be considered generally acceptable to large banks so long as a subsequent re-evaluation of these loans is permitted. For unscorable student loans, however, the commenters recommended that a PD distribution based on the bank's long-term default experience be permitted as opposed to initially classifying the loans as higher-risk.

Unscorable loans were not addressed in the proposed rule. In evaluating treatment options for purposes of the final rule, the FDIC sought information from a few

credit score providers on the performance of unscorable loans by product type as well as data from large banks on the volume of unscorable loans outstanding. Data on the historical performance of unscorable loans were generally unavailable. Further, where data were available, the performance of unscorable loans relative to their scored counterparts was found to vary significantly by product type, and product definitions were not consistent with the Call Report definitions expected to be used for reporting purposes. More importantly, because credit scoring systems may differ in their ability to score certain consumers, basing the treatment of all unscorable loans on performance data from only a few score providers would be inappropriate. For these reasons, the final rule adopts the conservative approach suggested in the joint letter – initially treating such loans as higher-risk (subject to the de minimis approach) and requiring banks to re-evaluate the loans according to the PD specifications once a credit score becomes available for the borrower.

The final rule does not permit institutions to develop PD estimates for unscorable loans based on internal data, nor does the final rule apply a separate standard for student loans as recommended in the joint letter. To permit banks with sufficient internal data to apply PD estimates to unscorable loans while requiring other banks to initially classify the loans as higher-risk (subject to the de minimis approach) could create an unfair advantage for those banks with sufficient internal data. As the commenters acknowledged, many student loans are either government guaranteed or co-signed by parents or other individuals with a credit history and can be scored; therefore, the volume of unscorable student loans that would be initially treated as higher-risk is likely to be small. Nevertheless, to avoid capturing immaterial exposures to unscorable student loans

as well as other types of unscorable loans in the higher-risk measure, the final rule classifies only the outstanding balance of unscorable loans in a portfolio that exceeds 5 percent of the total outstanding balance for the portfolio as higher-risk (the de minimis approach). If the outstanding balance of unscorable loans does not exceed 5 percent of the total, the amount will be ignored for the purpose of calculating higher-risk consumer loans.

Foreign consumer loans

The NPR did not discuss the treatment of foreign consumer loans, as pointed out in the joint letter. Under the final rule, a bank must estimate the PD of a foreign consumer loan according to the general specifications described above (and in Appendix C) unless doing so would be unduly complex or unduly burdensome (*e.g.*, if a bank had to develop separate PD mappings for many different countries). A bank may request to use the alternative methodology described above (*i.e.*, to use default rates calculated using fewer observations or score bands than the specified minimums), either in advance of or concurrent with reporting under that methodology, but must comply with the requirements detailed above for using an alternative methodology.

When estimating a PD according to the general specifications described above and in Appendix C would be unduly complex or unduly burdensome, a bank that is required to calculate PDs for foreign consumer loans under the requirements of the Basel II capital framework may: (1) use the Basel II approach discussed below, subject to the terms discussed below; (2) submit a written request to the FDIC to use an alternate

methodology, but may not use the methodology until approved by the FDIC;[36] or (3) treat the loan as an unscorable consumer loan subject to the de minimis approach described above.

When estimating a PD according to the general specifications described above and in Appendix C would be unduly complex or unduly burdensome, a bank that is not required to calculate PDs for foreign consumer loans under the requirements of the Basel II capital framework may: (1) treat the loan as an unscorable consumer loan subject to the de minimis approach described above; or (2) submit a written request to the FDIC to use an alternate methodology, but may not use the methodology until approved by the FDIC.[37]

Basel II approach. A bank that is required to calculate PDs for foreign consumer loans under the requirements of the Basel II capital framework may estimate the two-year PD of a foreign consumer loan based on the one-year PD used for Basel II capital purposes.[38] The bank 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 one-year PDs calculated under the Basel II framework are translated to two-year

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[36] The FDIC may request additional information from the bank regarding the proposed methodology and the bank must provide the information. The FDIC may grant a bank tentative approval to use a methodology while the FDIC considers it in more detail. If the FDIC ultimately disapproves the methodology, the bank will be required to amend Call Reports affected by the disapproved methodology treating any loan whose PD had been estimated using the disapproved methodology as an unscorable consumer loan subject to the de minimis approach described above; however, the institution will be required to amend no more than the two most recently dated and filed Call Reports preceding the FDIC's determination.

[37] The provisions in the previous footnote also apply in this case.

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

PDs that meet the final rule specifications. While the range of acceptable approaches is potentially broad, any proposed methodology must meet the following requirements:

- The bank must use data on a sample of loans for which both the one-year Basel II PDs and two-year final rule PDs can be calculated. The sample may contain both foreign and domestic loans.
- The bank must use the sample data to demonstrate that a meaningful relationship exists between the two types of PD estimates, and the significance and nature of the relationship must be determined using accepted statistical principles and methodologies. For example, to the extent that a linear relationship exists in the sample data, the bank may use an ordinary least-squares regression to determine the best linear translation of Basel II PDs to final rule PDs. The estimated equation should fit the data reasonably well based on standard statistics such as the coefficient of determination.
- The method must account for any significant variation in the relationship between the two types of PD estimates that exists across consumer products based on the empirical analysis of the data. For example, if the bank is using a linear regression to determine the relationship between PD estimates, it should test whether the parameter estimates are significantly different by product type.

The bank may report using this approach while the FDIC evaluates the methodology. If, after reviewing the methodology, the FDIC determines that the methodology is unacceptable, the institution will be required to amend its Call Reports.

The institution will be required to submit amended information for no more than the two most recently dated and filed Call Reports preceding the FDIC's determination.

Under the NPR, banks would not have been permitted to estimate the two-year PD of a foreign consumer loan using the Basel II PD. The joint letter commenters stated that the FDIC should consider issues specific to the scoring of loans from foreign markets. These commenters indicated that, due to the diversity of national credit markets, pervasive lack of standardized industry risk scores in other countries, and difficulty in applying U.S.-specific rules to many other markets, banks should be permitted to use other information in assessing the PD for a foreign loan. The commenters stated that such information could include the Basel II PD "or other measures that the banks consider to be reasonable indications of a cyclical view adjusted for the differences in the definition of default and timing of account risk assessment." The commenters added that institutions should be allowed to exercise judgment in making their determination given that not all of the information required under the proposed definition may be reasonably available.

The final rule builds upon the suggestion of allowing banks subject to the Basel II framework to develop PD mappings for foreign consumer loans based on the Basel II PDs used for capital purposes. The final rule permits only banks subject to the Basel II framework to be able to use an alternative approach based on the Basel II PD automatically (provided that estimating a PD according to the general specifications described above and in Appendix C would be unduly complex or unduly burdensome), because the Basel II PD is well defined, subject to supervisory review and approval for banks subject to the Basel II approach, and likely to be correlated with PD estimates

developed according to the final rule requirements. In addition, those institutions that operate in many foreign markets, and for which the general methodology for determining PDs would likely be burdensome, are subject to Basel II requirements.

Missing data

Under the final rule, banks must determine the PD of a consumer loan as of the date the loan was originated, or, if the loan has been refinanced, as of the date it was refinanced. For loans originated or refinanced by a bank before April 1, 2013, and all loans acquired by a bank regardless of the date of acquisition, if information as of the date the loan was originated or refinanced is not available, then the institution must use the oldest available information to determine the PD. If no information is available, then the institution must obtain recent, refreshed data from the borrower or other appropriate third party to determine the PD. Refreshed data is defined as the most recent data available, and must be as of a date that is no earlier than three months before the acquisition of the loan. In addition, for loans acquired on or after April 1, 2013, the acquiring bank shall have six months from the date of acquisition to determine the PD.

The joint letter commenters suggested that, if data as of origination or refinance are unavailable for an acquired loan, a bank should be able to use the oldest data on file or refreshed data to determine if the loan was higher risk. The commenters further stated that a bank should not be required to go to extraordinary lengths to obtain a credit score or PD from the originating lender; the bank should be able to use the best available data at the time of acquisition. The commenters recommended that a bank be given, at most, one year from the date a loan is acquired to determine the PD of the loan, instead of the

proposed timeframe of three months. The commenters also recommended this approach – using refreshed data or the oldest data available when data as of origination or refinance are unavailable – for evaluating loans originated or purchased prior to the effective date of the rule. The commenters argued that there has been no reason in the past for large banks to maintain the data needed to determine the PDs for loans already on the books.

Under the final rule, a bank is not required to go to extraordinary lengths to obtain a credit score or PD for an existing or acquired loan; however, the bank must use the available data closest to the date of origination or refinance to minimize inconsistencies in PD estimates. While banks may need additional time to gather and evaluate the information for an acquired consumer loan, the joint letter commenters offered no reason that a full year would be needed. If data from the original lender are unavailable, banks should be able to obtain a refreshed credit score for most borrowers at reasonable cost. Further, allowing acquired loans that are truly higher risk to be treated as non-higher risk for up to one year could result in a bank's risk being under-assessed for too long. Therefore, the final rule gives banks six months to complete this determination.

Exclusions

Consistent with the definition of a higher-risk C&I loan and security, the final rule definition of a higher-risk consumer loan excludes the maximum amount that is

recoverable from the U.S. government or its agencies under guarantee or insurance provisions, as well as loans that are fully secured by cash collateral.[39,40]

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

Commenters also recommended excluding loans that are fully and continuously secured by brokerage account collateral (securities-based loans). As in the case of higher-risk C&I loans, several commenters suggested that other factors, such as loan-to-value (LTV) ratios, credit history, and borrower resources, should factor into the definition of a higher-risk consumer loan.

The final rule definition, like the definition proposed in the NPR, does account for a borrower's credit history, because the two-year PD is based, in part, on the credit score of the borrower. The final rule does not, however, adopt the other suggested exclusions. To ensure consistency, excluding loans from the higher-risk totals based upon these criteria would require the development of numerous thresholds, such as appropriate LTVs

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[39] To exclude a loan based on cash collateral, the cash must be in the form of a savings or time deposit held by a bank. The lending bank (or lead or agent bank in the case of a participation or syndication) must, in all cases, (including instances in which cash collateral is held at another bank or banks) have a perfected first priority security interest under applicable state law, a security agreement in place, and all necessary documents executed and measures taken as required to result in such perfection and priority. In addition, the lending bank must place a hold on the deposit account that alerts the bank's employees to an attempted withdrawal. For the exclusion to apply to 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).

[40] The NPR proposed excluding from the definition of a higher-risk consumer loan "the maximum amounts recoverable from … [GSEs] under guarantee or insurance provisions," but the final rule omits this language because no GSE guarantees or insures individual consumer loans.

for various asset types, frequent updating of appraisals of collateral, and frequent updating of borrower's financial statements. In addition, the final rule does not exclude loans secured by brokerage account collateral because the value of the collateral is subject to several sources of risk, including operational, credit, and market risk.

Definition of "refinance"

One large bank sought clarification on whether re-aging a loan as a loss mitigation activity would qualify as a refinancing of the loan. The FDIC believes conservative re-aging programs are a loss mitigation activity, not a refinance, provided the institution follows, at a minimum, the re-aging guidelines recommended in the interagency approved Uniform Retail Credit Classification and Account Management Policy.[41] Thus, among other things, for a loan to be considered for re-aging, the following must be true: (1) the borrower must have demonstrated a renewed willingness and ability to repay the loan; (2) the loan must have existed for at least nine months; and (3) the borrower must have made at least three consecutive minimum monthly payments or the equivalent cumulative amount.[42] In addition, for re-aging to be considered as a loss mitigation activity, and not as a refinance, the institution's program must have clearly defined policy guidelines and parameters for re-aging, as well as internal methods of ensuring the reasonableness of those guidelines and for monitoring their effectiveness. Institutions must also monitor both the number and dollar amount of re-aged accounts,

[41] 65 FR 36903 (June 13, 2000).

[42] The definition of refinance is discussed in Appendix C.

collect and analyze data to assess the performance of re-aged accounts, and determine the effect of re-aging practices on past due ratios.

In the joint letter, commenters requested that an increase in a credit card line of credit of up to 10 percent should not be considered a refinance, as proposed for all other consumer loans. In addition, the joint letter commenters requested that when a bank has internally approved a higher credit line than it has made available to the customer, providing access to this additional credit should not be considered a refinance, as the bank has not underwritten new risk. The final rule makes these changes; further, to be consistent with other types of consumer loans, a non-temporary credit card line increase of 10 percent or greater, that is not the result of a loss mitigation strategy, is a refinance under the final rule.[43]

The joint letter commenters also requested that an increase or decrease in the interest rate of a credit card loan should not be considered a refinance on the grounds that rate changes for credit card loans are commonplace (*e.g.*, formulaic adjustments tied to underlying indices, expirations of introductory rates and special rates for balance transfers, and changes mandated by law such as the Credit CARD Act). The final rule clarifies that a change to the interest rate on a credit card loan that is consistent with the terms of the loan agreement is not a refinance.

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[43] Under the final rule, a refinance excludes all temporary credit card line increases.

The FDIC intends to collect the outstanding balance of consumer loans, by two-year PD and product type, from large and highly complex institutions. The types of information collected and the format of the information collected on the Call Report will be subject to a PRA notice, which will be published in the Federal Register with request for comment. The FDIC anticipates that appropriate changes to the Call Reports will be made and that institutions will report consumer loans consistent with the definition in the final rule. Several commenters stated that any PD data reported by the banks should be kept confidential and not disclosed or used in public statements. Moreover, these commenters stated that the final rule specifications for calculating the PD, designed to provide a consistent measure across large banks, will likely not reflect banks' internal PD estimates. The FDIC agrees with these comments and affirms that any PD data reported for purposes of this rule will remain confidential.

The following table is an example of how the FDIC may collect the consumer loan information. As suggested in the example table below, institutions would report the outstanding amount of all consumer loans, including those with a PD below the high-risk threshold, stratified by the 10 product types and 12 two-year PD bands. In addition, for each product type, institutions would report the amount of unscorable loans, as defined in the final rule, and indicate whether the PDs were derived using scores and default rate mappings provided by a third-party vendor or an internal approach.[44] Although not included in this table, banks would report in their Call Reports the value of all securitizations (except those classified as trading book) of consumer loans that are more

[44] An internal approach includes 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.

than 50 percent collateralized by consumer loans that would be identified as higher-risk assets.

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

Product	Two-year Probability of Default												Unscoreable
	≤ 1%	1.01-4%	4.01-7%	7.01-10%	10.01-14%	14.01-16%	16.01-18%	18.01-20%	20.01-22%	22.01-26%	26.01-30%	>30%	
Nontraditional residential mortgages													
Closed end loans secured by first liens on 1-4 family residential properties													
Closed end loans secured by junior liens on 1-4 family residential properties													
Revolving, open-end first liens and credit lines secured by 1-4 family residential properties													
Revolving, open-end junior liens and credit lines secured by 1-4 family residential properties													
Credit cards													
Automobile loans													
Student loans													
Other consumer loans (including single payment and installment) and revolving credit plans other than credit cards													
Consumer leases													
Total													

Note: All reported amounts should exclude the amounts recoverable from the U.S. government, its agencies, or government-sponsored enterprises (GSEs) under guarantee or insurance provisions. Reported amounts should also exclude loans that are fully secured by cash, and loans fully collateralized by securities issued by the U.S. government, its agencies, or GSEs (excluding subordinated debt and equity securities of GSEs). Nontraditional residential mortgages and unscoreable loans are defined according to 12 C.F.R. Part 327 Appendix C, while other product types are defined according to the instructions for Call Report Schedule RC-C. Closed-end loans on 1-4 family residential properties should exclude loans reported previously as nontraditional residential mortgages.

Nontraditional Mortgage Loans

The final rule retains the definition of a nontraditional mortgage loan that was contained in the February 2011 rule; however, the final rule clarifies how securitizations of nontraditional mortgage loans will be identified under the definition. Securitizations are discussed in the section that follows.

Several commenters on the NPR urged the FDIC to reconsider the definition of nontraditional mortgage loans. As the FDIC stated in the NPR, it 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.

Higher-Risk Securitizations

As proposed in the NPR, the final rule requires securitizations, except securitizations classified as trading book, to be reported as higher-risk where, in aggregate, more than 50 percent of the assets backing the securitization meet the criteria for higher-risk C&I loans or securities, higher-risk consumer loans, or nontraditional mortgage loans.[45] 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 DIF during times of prolonged periods of economic stress.

The final rule treatment of securitizations differs from the proposed rule in a nonsubstantive way. In the final rule, higher-risk securitizations constitute a new classification of higher-risk assets rather than being included in higher-risk C&I loans or securities, higher-risk consumer loans, or nontraditional mortgage loans.[46]

In determining whether or not to report a securitization as higher risk, a bank is required to use information reasonably available to a sophisticated investor in reasonably

[45] Unscorable consumer loans that exceed 5 percent of the loans in a securitization are deemed higher-risk.

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

determining whether the securitization meets the 50 percent threshold.[47] Information reasonably available to a sophisticated investor includes, but is not limited to, offering memoranda, 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.

The joint letter commenters pointed out that continuously obtaining updated information on actively managed open-ended securitizations (those securitizations where the underlying assets of the securitization may change) would not only be burdensome, but unnecessary, because governing indentures require securitization managers to maintain minimum credit quality. The final rule takes this point into account and provides that a bank must determine whether a securitization is higher-risk based upon information as of the date of issuance (*i.e.*, the date the securitization is sold on a market to the public for the first time). The bank must make this determination within the time limit that would apply under Appendix C to this final rule if the bank were directly acquiring loans or securities of the type underlying the securitization. In making the determination, a bank must use one of the following methods:

- For a securitization collateralized by a static pool of loans, whose underlying collateral changes due to the sale or amortization of these loans, the 50 percent threshold is to be determined based upon the amount of higher-risk assets, as

[47] A securitization is as defined in 12 C.F.R. Part 325, Appendix A, Section II(B)(16), as it may be amended from time to time.

defined in Appendix C to this final rule, owned by the securitization on the date of issuance of the securitization.

- For a securitization collateralized by a dynamic pool of loans, whose underlying collateral may change by the purchase of additional assets, including purchases made during a ramp-up period, the 50 percent threshold is to be determined based upon the highest amount of higher-risk assets, as defined in Appendix C to this final rule, allowable under the portfolio guidelines of the securitization.

The final rule uses the term "issuance" rather than "origination," as proposed in the NPR, because the term "issuance" is commonly used and understood in the securitization industry and is less open to misinterpretation. To relieve burden on the industry, the final rule does not adopt the proposal in the NPR that a securitization be evaluated at purchase, because the most readily available information will generally be that included in offering material compiled as of the date of issuance.

In cases in which a securitization is required to be consolidated on the balance sheet as a result of SFAS 166 and SFAS 167, and where a bank has access to the necessary information, it may opt for an alternative method of evaluating the securitization to determine whether it is higher risk. The bank may evaluate individual loans in the securitization on a loan-by-loan basis and only report as higher risk those loans that meet the definition of a higher-risk asset; any loan within the securitization that does not meet the definition of a higher-risk asset need not be reported as such. Once an institution evaluates a securitization for higher-risk asset designation using this alternative evaluation method, it must continue to evaluate all securitizations that it has consolidated on the balance sheet as a result of SFAS 166 and SFAS 167, and for which

it has the required information using the alternative evaluation method. 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 in the manner previously described for other securitizations.

In the joint letter, commenters noted that some loan originators, securitizers, and servicers, including non-bank loan originators, securitizers, and servicers, may not currently collect the data needed to evaluate loans as higher-risk under the final rule. In particular, according to the trade groups, some may not collect data needed for the purpose and materiality tests of the higher-risk C&I loan definition. Some institutions that rely on loan securitization issuers or servicers to determine the credit quality of securitizations may need additional time to develop systems to collect the information necessary to make their own higher-risk asset determinations under the final rule. For these reasons, among others, the effective date of the final rule has been extended from October 1, 2012, as proposed in the NPR, to April 1, 2013. Banks will not need to review securitizations issued before April 1, 2013, to determine whether they are higher risk under the final rule. The new higher-risk definitions in the final rule will apply only to securitizations issued on or after that date, regardless of the date of origin of the underlying loans.

In the joint letter, commenters asserted that the proposed means of identifying securitizations as higher-risk is unworkable and would make banks reluctant to invest in securitizations, which would impede the flow of credit to consumers and businesses and would further impair a market that is struggling to recover. In this same letter, commenters noted that securitizers have developed standards for the type and quantity of

information that they provide investors, but this information may not be adequate for banks to make a higher-risk asset determination. Further, the commenters noted that securitizations could be issued by non-bank finance companies that are not subject to deposit insurance pricing rules or definitions and may not have the required data to provide to their investors. The commenters also added that institutions that invest in these securitizations cannot simply request the information needed to make a higher-risk asset determination or compel the servicer or originator to make that determination.

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

Commenters, through the joint letter, and a bank recommended that the FDIC allow banks to consider the structure of the securitization and any credit enhancements to it. They argued that, by not doing so, the FDIC is giving banks an incentive to acquire lesser quality, subordinated interests in securitizations, because variations in quality and subordination or the lack of it will not affect deposit insurance assessment rates.

In the joint letter, commenters noted that, while the use of external credit ratings to determine the credit quality of securitization exposures is problematic due to Section 939A of the Dodd-Frank Act, banks could use the proposed revised regulatory capital risk-weighting methodologies currently in development by the bank regulatory agencies (the Standardized Approach for Risk-Weighted Assets[48]) to determine if a securitization is higher risk. For example, the commenters suggested that securitizations with risk weights of 200 percent to 250 percent or greater could be considered below investment grade and therefore treated as higher-risk assets for deposit insurance pricing purposes.

Like the proposed rule, the final rule does not allow exclusions for higher-risk securitizations based upon structure or credit enhancements. As noted in the proposed rule, the performance of a securitization is highly correlated with the performance of the underlying assets, even when the securitization contains terms or conditions intended to reduce risk. During the crisis, a number of highly rated senior securitization positions were subject to significant downgrades and suffered substantial losses. Even where losses have not yet been realized (as is the case in many collateralized loans), the market value of these securitizations declined precipitously during the crisis, reflecting the

[48] 77 FR 52888 (Aug. 30, 2012).

decline in the market value of the underlying assets and the increased risk of loss. While commenters on the NPR noted that "based upon agency ratings, the extensive downgrades and the market value reductions of collateralized loan obligations and other securitizations in the recent financial turmoil have, for the most part, been overcome," in fact, many financial institutions suffered substantial losses due to these securitizations. This decline in value contributed to the liquidity crisis of 2008, which forced the U.S. government to provide unprecedented support to financial institutions and liquidity markets. Furthermore, the Standardized Approach for Risk-Weighted Assets is still in development and has not yet been finalized. The proposed implementation date is more than two years away (January 15, 2015, although it may be implemented earlier); banks must have a method in place to identify higher-risk securitizations for deposit insurance pricing purposes by April 1, 2013. The FDIC will monitor implementation of the Standardized Approach to determine whether all or parts of the approach should be incorporated into the risk-based pricing system for large banks and highly complex institutions.

B. Large Bank Adjustment Process

The FDIC 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).[49] Because the revised definitions should result in better risk identification and consistent application across the industry, the FDIC anticipates that there will be limited circumstances where the FDIC will consider a large

[49] 12 CFR 327.9(b)(3).

bank adjustment as a result of perceived mitigants to an institution's higher-risk concentration measure. The revised definitions, which include specific exceptions for well-collateralized loans, should result in generally equal treatment of similar loans at different institutions.

C. Audit

Several of the changes to the definitions could require periodic auditing to ensure consistent reporting across the industry. For example, the consumer loan PD calculation, whether through credit score mapping or through an internal approach, if not properly monitored, could potentially be done inconsistently. Also, institutions 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 to 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 asset identification and reporting programs include applicable policies, procedures, reviews, and validation (through internal or external audits). The results of any internal reviews or external audits of higher-risk asset reporting must be made available to the FDIC upon request. The FDIC may 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 in the application of adjustments to an institution's total

score as outlined in the Assessment Rate Adjustment Guidelines for Large and Highly Complex Institutions.[50]

D. Updating the Scorecard

The February 2011 final rule grants the FDIC 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.[51] The FDIC may add new data for subsequent years to its analysis and may, from time to time, exclude some earlier years from its analysis. Updating the minimum and maximum cutoff values and weights will allow the FDIC to use the most recent data, thereby improving the accuracy of the scorecard method.[52]

Unless the FDIC re-calibrates cutoff values for the higher-risk assets to Tier 1 capital and reserves ratio, however, the changes to the definitions of higher-risk assets may result in significant increases or decreases in the amount of total deposit insurance assessments collected from large and highly complex institutions. 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

[50] 76 FR 57992 (Sept. 19, 2011).

[51] 76 FR 10672, 10700 (Feb. 25, 2011) (H. Updating the Scorecard).

[52] 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 selecting additional or alternative 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.

percentile values for each measure, which are derived using data on large banks over a ten-year period beginning with the first quarter of 2000 through the fourth quarter of 2009. Because 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 changes in the definitions in this final rule 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.[53] 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, will be taken into account in determining changes to the cutoffs. In addition, because the FDIC has not collected any data under the revised definitions, changes to cutoff values for the higher-risk assets to Tier 1 capital and reserves ratio

[53] 76 FR 10672, 10700 (February 25, 2011).

could be made more frequently than annually. This review ensures proper risk differentiation between institutions.[54]

E. Implementation and Effective Date

The final rule makes the amended definitions effective April 1, 2013, in place of the October 1, 2012 date proposed in the NPR.

Several industry trade groups and institutions expressed concerns about their ability to report under the proposed definitions by October 1, 2012, stating that they did not have the systems in place to calculate the PD for consumer loans and were not assured that third-party providers would be able to develop PD mapping tables for institutions to use by the proposed effective date. One industry trade group noted that institutions would need time to develop internal PD mapping models, or, if the institution decided to use a third-party provider's PD mapping table, would need time to perform due diligence and negotiate contracts with third-party providers. Commenters recommended extending the effective date of the final rule from October 1, 2012, as proposed, by a range of dates, from one quarter to one year; one industry trade group recommended that either loans made before the effective date of the proposal should be exempt from PD reporting altogether or that institutions be given three years to report these loans as higher-risk.

[54] The FDIC will 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 assessments.

To allow institutions time to revise their reporting systems to be consistent with the revised definitions, the FDIC is postponing the effective date of the final rule to April 1, 2013. This new date should give institutions ample time to accurately report under the new definitions.

Because the FDIC is not amending the definitions of C&D loans and nontraditional mortgage loans (other than to clarify how securitizations that meet the definition of a nontraditional mortgage loan are to be identified), institutions should continue to define and report these higher-risk assets as they have been doing under the February 2011 rule.

Transition Guidance until Effective Date

Prior to April 1, 2013, large 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 have been updated to reflect April 1, 2013 (formerly October 1, 2012) as the effective date of this final rule.

This transition guidance provides that an institution may use either the definition in the February 2011 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. Some institutions 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 PFR for examination or other supervisory purposes or do not measure and monitor loans and securities with these characteristics for internal risk

management purposes). These institutions may continue to apply existing guidance provided by their PFR, by the agencies' 2001 Expanded Guidance for Subprime Lending Programs (for consumer loans), 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 April 1, 2013, the amended definitions described above apply to:

(1) C&I loans owed to a reporting bank by a higher-risk C&I borrower (as that term is defined in the final rule) and all securities issued by a higher-risk C&I borrower (as that term is defined in the final rule), except securitizations of C&I loans, that are owned by the reporting bank;

(2) Consumer loans (as defined in the final rule), except securitizations of consumer loans, whenever originated or purchased;

(3) Securitizations of C&I and consumer loans (as defined in the final rule) issued on or after April 1, 2013, including those securitizations issued on or after April 1, 2013, that are partially or fully collateralized by loans originated before April 1, 2013.

For C&I loans that are either originated or refinanced by a reporting bank before April 1, 2013, or purchased by a reporting bank before April 1, 2013, in cases in which the loans are owed to the reporting bank by a borrower that does not meet the definition of a higher-risk C&I borrower as that term is defined in the final rule (which requires, among other things, that the borrower have obtained a C&I loan or refinanced an existing C&I loan on or after April 1, 2013), and for securities purchased before April 1, 2013,

that are issued by an entity that does not meet the definition of a higher-risk C&I borrower, as that term is defined in the final rule, banks must continue to use the transition guidance in the September 2012 Call Report instructions to determine whether to report the loan or security as a higher-risk asset for purposes of the higher-risk assets to Tier 1 capital and reserves ratio. An institution may opt to apply the final rule definition of higher-risk C&I loans and securities to all of its C&I loans and securities, but, if it does so, it must also apply the final rule definition of a higher-risk C&I borrower without regard to when a loan is originally made or refinanced (*i.e.*, whether made or refinanced before or after April 1, 2013).

Under the final rule, banks will not need to reexamine their entire existing C&I loan and security portfolios immediately to determine whether the loans and securities meet the new definition of higher-risk C&I loans and securities (although they may opt to do so as provided in the last sentence of the preceding paragraph). Rather, they will be able to wait until a borrower seeks a new C&I loan (or refinances an existing one) on or after April 1, 2013, and meets the higher-risk C&I borrower definition before applying the new higher-risk C&I loan and security definition to all of that borrower's C&I loans and securities.

For consumer loans (other than securitizations of consumer loans) originated or purchased prior to April 1, 2013, an institution must determine whether the loan met the definition of a higher-risk consumer loan no later than June 30, 2013.

For all securitizations issued before April 1, 2013, banks must either (1) continue to use the transition guidance in the September 2012 Call Report instructions or (2) apply

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

The provisions of the final rule apply to all securitizations issued on or after April 1, 2013 (including those securitizations that are collateralized by loans originated before April 1, 2013).

III. Regulatory Analysis and Procedure

A. 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.[55] For RFA purposes a small institution is defined as one with $175 million or less in assets.

As of June 30, 2012, of the 7,246 insured commercial banks and savings institutions, there were 3,821 small insured depository institutions, as that term is defined for purposes of the RFA. The final rule, however, applies 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 from this final rule.

[55] See 5 U.S.C. 603, 604 and 605.

B. Small Business Regulatory Enforcement Fairness Act

The OMB has determined that the final rule is not a "major rule" within the meaning of the Small Business Regulatory Enforcement Act of 1996 (SBREFA) Public Law 110–28 (1996). As required by law, the FDIC will file the appropriate reports with Congress and the Government Accountability Office so that the final rule may be reviewed.

C. Paperwork Reduction Act

1. Request for Comment on Information Collection

In accordance with the Paperwork Reduction Act (44 U.S.C. 3501 et seq.) the FDIC may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The collections of information contained in this final rule are being submitted to OMB for review.

Interested parties may submit written comments to the FDIC concerning the Paperwork Reduction Act (PRA) implications of this final rule.[56] Comments should be submitted within 60 days from the publication date of this final rule in the *Federal Register*. Commenters should refer to "PRA Comments – Large Bank Definitions Modifications" in the subject line. Comments may be submitted by any of the following methods:

[56] The Notice of Proposed Rulemaking did not include a Paperwork Reduction Act notice for the Alternative Probability of Default Methodologies or the Alternative Probability of Default Methodologies for Foreign Loans; the former was inadvertently omitted; the latter was not proposed in the NPR but was added at the request of commenters on the NPR.

- Agency Web Site: http://www.fdic.gov/regulations/laws/federal/propose.html. Follow instructions for submitting comments on the Agency Web Site.

- E-mail: Comments@FDIC.gov. Include "PRA Comments – Large and Highly Complex Institutions Definitions, **3064-AD92**" in the subject line of the message.

- Mail: Gary A. Kuiper, Counsel, F-1086, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, DC 20429

- Hand Delivery/Courier: 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.

A copy of the comments may also be submitted to the OMB desk officer for the FDIC, Office of Information and Regulatory Affairs, Office of Management and Budget, New Executive Office Building, Washington, DC 20503.

Comment is solicited on:

(1) Whether the collections of information are necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;

(2) The accuracy of the agency's estimate of the burden of the collections of information, including the validity of the methodology and assumptions used;

(3) The quality, utility, and clarity of the information to be collected;

(4) Ways to minimize the burden of the collections of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology; *e.g.*, permitting electronic submission of responses; and

(5) Estimates of capital or start-up costs and costs of operation, maintenance, and purchases of services to provide information.

2. Amendment to Information Collection OMB Number: 3064-0179

(a) Alternative Probability of Default Methodologies. This final rule, amending 12 C.F.R. Part 327, to revise definitions used to determine assessment rates for large and highly complex insured depository institutions includes a provision allowing large and highly complex institutions to make a written request to the FDIC to use alternative methodologies when estimating two-year probabilities of default (PD). Under the final rule, institutions may request to use default rates calculated using fewer observations or score bands than the specified minimums, either in advance of or concurrent with reporting under that methodology. An institution's request must explain how the requested approach differs from the rule specifications and include, at a minimum, a table with default rates and the 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 approach while the FDIC evaluates the request. After reviewing the request, the FDIC may determine that the institution's approach is unacceptable; if so, the institution will be required to amend its Call Reports and report according to the

generally applicable specifications for PD estimation in the final rule; the institution will be required to submit amended information for no more than the two most recently dated and filed Call Reports preceding the FDIC's determination.

(b) Alternative Probability of Default Methodologies for Foreign Consumer Loans. The final rule also includes a provision allowing institutions to determine whether certain foreign consumer loans are higher-risk loans. One provision permits a bank that is required to calculate PDs for foreign consumer loans under the requirements of the Basel II capital framework to estimate the two-year PD of a foreign consumer loan based on the one-year PD used for capital purposes when it is unable to reasonably estimate the two-year PD according to the final rule specifications. To do this, the bank 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 one-year PDs calculated under the Basel framework are translated to two-year PDs that meet the final rule specifications. While the range of acceptable approaches is potentially broad, any proposed methodology must meet certain requirements spelled out in the final rule. The bank may report using its proposed Basel II approach while the FDIC evaluates the methodology. If, after reviewing the request, the FDIC determines that the methodology is unacceptable, the institution will be required to amend its Call Reports. The institution will be required to submit amended information for no more than the two most recently dated and filed Call Reports preceding the FDIC's determination. Another provision of the final rule permits an institution to use its own approach to determine whether certain foreign loans are higher-risk loans, provided the FDIC first approves that approach. The bank must submit its proposed approach to the FDIC and the FDIC will notify the bank

whether the approach is acceptable. The FDIC may request additional information from the bank regarding the proposed methodology and the bank must provide the information. The FDIC may grant a bank tentative approval to use a methodology while the FDIC considers it in more detail; if the FDIC ultimately disapproves the methodology, the bank will be required to amend all Call Reports affected by the disapproved methodology.

In conjunction with publication of this final rule amending 12 C.F.R. Part 327 to revise definitions used to determine assessment rates for large and highly complex insured depository institutions, the FDIC has submitted to OMB a request for clearance of the paperwork burden associated with these processes for requesting a change in methodologies. That request is pending.

(1) Title: "Large and Highly Complex Institutions Definitions – Alternative Probability of Default Methodologies."

Respondents: Large and Highly Complex insured depository institutions

Number of Responses: 0-20 per year

Frequency of Response: Occasional

Average number of hours to prepare a response: 10-40

Total Annual Burden: 0-800 hours

(2) Title: "Large and Highly Complex Institutions Definitions – Alternative Probability of Default for Foreign Loans."

Respondents: Large and Highly Complex insured depository institutions

Number of Responses: 0-20 per year

Frequency of Response: Occasional

Average number of hours to prepare a response: 10-40

Total Annual Burden: 0-800 hours

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 (Public Law 105-277, 112 Stat. 2681).

List of subjects in 12 C.F.R. Part 327

Bank deposit insurance, Banks, Savings Associations.

For the reasons set forth above, the FDIC amends chapter III of title 12 of the Code of Federal Regulations as follows:

Revise Section VI of Appendix A to subpart A of part 327 to read as follows:

Description of Scorecard Measures

Scorecard Measures[1]	Description
Tier 1 Leverage Ratio	Tier 1 capital for Prompt Corrective Action (PCA) divided by adjusted average assets based on the definition for prompt corrective action.
Concentration Measure for Large Insured depository institutions (excluding Highly Complex Institutions)	The concentration score for large institutions is the higher of the following two scores:
(1) Higher-Risk Assets/Tier 1 Capital and Reserves	Sum of construction and land development (C&D) loans (funded and unfunded), higher-risk C&I loans (funded and unfunded), nontraditional mortgages, higher-risk consumer loans, and higher-risk securitizations divided by Tier 1 capital and reserves. See Appendix C for the detailed description of the ratio.
(2) Growth-Adjusted Portfolio	The measure is calculated in the following steps:

[1] 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 April 1, 2013, or to avoid changing the overall amount of assessment revenue collected. 76 FR 10672, 10700 (February 25, 2011). 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 banks when determining changes to the cutoffs. The FDIC may update the cutoff values for the higher-risk assets to Tier 1 capital and reserves ratio more frequently than annually. The FDIC will provide banks 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.

Concentrations	(1) Concentration levels (as a ratio to Tier 1 capital and reserves) are calculated for each broad portfolio category: • C&D, • Other commercial real estate loans, • First lien residential mortgages (including non-agency residential mortgage-backed securities), • Closed-end junior liens and home equity lines of credit (HELOCs), • Commercial and industrial loans, • Credit card loans, and • Cther consumer loans. (2) Risk weights are assigned to each loan category based on historical loss rates. (3) Concentration levels are multiplied by risk weights and squared to produce a risk-adjusted concentration ratio for each portfolio. (4) Three-year merger-adjusted portfolio growth rates are then scaled to a growth factor of 1 to 1.2 where a 3-year cumulative growth rate of 20 percent or less equals a factor of 1 and a growth rate of 80 percent or greater equals a factor of 1.2. If three years of data are not available, a growth factor of 1 will be assigned. (5) The risk-adjusted concentration ratio for each portfolio is multiplied by the growth factor and resulting values are summed. See Appendix C for the detailed description of the measure.
Concentration Measure for Highly Complex Institutions (1) Higher-Risk Assets/Tier 1 Capital	Concentration score for highly complex institutions is the highest of the following three scores: Sum of C&D loans (funded and unfunded), higher-risk C&I loans (funded and unfunded),

and Reserves	nontraditional mortgages, higher-risk consumer loans, and higher-risk securitizations divided by Tier 1 capital and reserves. See Appendix C for the detailed description of the measure.
(2) Top 20 Counterparty Exposure/Tier 1 Capital and Reserves	Sum of the total exposure amount to the largest 20 counterparties (in terms of exposure amount) divided by Tier 1 capital and reserves. Counterparty exposure is equal to the sum of Exposure at Default (EAD) associated with derivatives trading and Securities Financing Transactions (SFTs) and the gross lending exposure (including all unfunded commitments) for each counterparty or borrower at the consolidated entity level.[2]
(3) Largest Counterparty Exposure/Tier 1 Capital and Reserves	The amount of exposure to the largest counterparty (in terms of exposure amount) divided by Tier 1 capital and reserves. Counterparty exposure is equal to the sum of EAD associated with derivatives trading and SFTs and the gross lending exposure (including all unfunded commitments) for each counterparty or borrower at the consolidated entity level.
Core Earnings/Average Quarter-End Total Assets	Core earnings are defined as net income less extraordinary items and tax-adjusted realized gains and losses on available-for-sale (AFS) and held-to-maturity (HTM) securities, adjusted for mergers. The ratio takes a four-quarter sum of merger-adjusted core earnings and divides it by an average of five quarter-end total assets (most recent and four prior quarters). If four quarters of data on core earnings are not available, data for quarters that are available will be added and annualized. If five quarters of data on total assets are not available, data for quarters that are available will be averaged.

[2] EAD and SFTs are defined and described in the compilation issued by the Basel Committee on Banking Supervision in its June 2006 document, "International Convergence of Capital Measurement and Capital Standards." The definitions are described in detail in Annex 4 of the document. Any updates to the Basel II capital treatment of counterparty credit risk would be implemented as they are adopted. http://www.bis.org/publ/bcbs128.pdf

Credit Quality Measure:	The credit quality score is the higher of the following two scores:
(1) Criticized and Classified Items/Tier 1 Capital and Reserves	Sum of criticized and classified items divided by the sum of Tier 1 capital and reserves. Criticized and classified items include items an institution or its primary federal regulator have graded "Special Mention" or worse and include retail items under Uniform Retail Classification Guidelines, securities, funded and unfunded loans, other real estate owned (ORE), other assets, and marked-to-market counterparty positions, less credit valuation adjustments.[3] Criticized and classified items exclude loans and securities in trading books, and the amount recoverable from the U.S. government, its agencies, or government-sponsored enterprises, under guarantee or insurance provisions.
(2) Underperforming Assets/Tier 1 Capital and Reserves	Sum of loans that are 30 days or more past due and still accruing interest, nonaccrual loans, restructured loans (including restructured 1-4 family loans), and ORE, excluding the maximum amount recoverable from the U.S. government, its agencies, or government-sponsored enterprises, under guarantee or insurance provisions, divided by a sum of Tier 1 capital and reserves.
Core Deposits/Total Liabilities	Total domestic deposits excluding brokered deposits and uninsured non-brokered time deposits divided by total liabilities.
Balance Sheet Liquidity Ratio	Sum of cash and balances due from depository institutions, federal funds sold and securities purchased under agreements to resell, and the market value of available for sale and held to maturity agency securities (excludes agency

[3] A marked-to-market counterparty position is equal to the sum of the net marked-to-market derivative exposures for each counterparty. The net marked-to-market derivative exposure equals the sum of all positive marked-to-market exposures net of legally enforceable netting provisions and net of all collateral held under a legally enforceable CSA plus any exposure where excess collateral has been posted to the counterparty. For purposes of the Criticized and Classified Items/Tier 1 Capital and Reserves definition a marked-to-market counterparty position less any credit valuation adjustment can never be less than zero.

	mortgage-backed securities but includes all other agency securities issued by the U.S. Treasury, U.S. government agencies, and U.S. government-sponsored enterprises) divided by the sum of federal funds purchased and repurchase agreements, other borrowings (including FHLB) with a remaining maturity of one year or less, 5 percent of insured domestic deposits, and 10 percent of uninsured domestic and foreign deposits.[4]
Potential Losses/Total Domestic Deposits (Loss Severity Measure)	Potential losses to the DIF in the event of failure divided by total domestic deposits. Appendix D describes the calculation of the loss severity measure in detail.
Market Risk Measure for Highly Complex Institutions	The market risk score is a weighted average of the following three scores:
(1) Trading Revenue Volatility/Tier 1 Capital	Trailing 4-quarter standard deviation of quarterly trading revenue (merger-adjusted) divided by Tier 1 capital.
(2) Market Risk Capital/Tier 1 Capital	Market risk capital divided by Tier 1 capital.[5]
(3) Level 3 Trading Assets/Tier 1 Capital	Level 3 trading assets divided by Tier 1 capital.
Average Short-term Funding/Average Total Assets	Quarterly average of federal funds purchased and repurchase agreements divided by the quarterly average of total assets as reported on Schedule RC-K of the Call Reports

Revise Appendix C to subpart A of part 327 to read as follows:

[4] Deposit runoff rates for the balance sheet liquidity ratio reflect changes issued by the Basel Committee on Banking Supervision in its December 2010 document, "Basel III: International Framework for liquidity risk measurement, standards, and monitoring," http://www.bis.org/publ/bcbs188.pdf.

[5] Market risk capital is defined in Appendix C of Part 325 of the FDIC Rules and Regulations,. http://www.fdic.gov/regulations/laws/rules/2000-4800.html#fdic2000appendixctopart325.

Appendix C to Subpart A to Part 327

I. Concentration Measures

The concentration score for large banks is the higher of the higher-risk assets to Tier 1 capital and reserves score or the growth-adjusted portfolio concentrations score.[6] 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 herein.

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 five risk areas described below and is calculated as:

$$H_i = \sum_{k=1}^{5} \left(\frac{\text{Amount of Exposure}_{i,k}}{\text{Tier 1 Capital} + \text{Reserves}_i} \right)$$

where

H_i is bank i's higher-risk concentration measure and k is a risk area.[7] The five risk areas (k) are: construction and land development (C&D) loans; higher-risk commercial and

[6] For the purposes of this Appendix, the term "bank" means insured depository institution.

[7] The higher-risk concentration ratio is rounded to two decimal points.

industrial (C&I) loans and securities; higher-risk consumer loans; nontraditional mortgage loans; and higher-risk securitizations.

1. Construction and land development loans

Construction and land development loans include construction and land development loans outstanding and unfunded commitments to fund construction and land development loans, whether irrevocable or unconditionally cancellable.[8]

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

Definitions

Higher-risk C&I loans and securities

Higher-risk C&I loans and securities are:

(a) All commercial and industrial (C&I) loans (including funded amounts and the amount of unfunded commitments, whether irrevocable or unconditionally cancellable) owed to the reporting bank (*i.e.*, the bank filing its report of condition and income, or Call Report) by a higher-risk

[8] 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).

C&I borrower, as that term is defined herein, regardless when the loans were made;[9,10] and

(b) All securities, except securities classified as trading book, issued by a higher-risk C&I borrower, as that term is defined herein, that are owned by the reporting bank, without regard to when the securities were purchased;

however, higher-risk C&I loans and securities exclude:

(a) The maximum amount that is recoverable from the U.S. government or its agencies under guarantee or insurance provisions;

(b) Loans (including syndicated or participated loans) that are fully secured by cash collateral as provided herein;

(c) Loans that are eligible for the asset-based lending exclusion, described herein, provided the bank's primary federal regulator (PFR) has not cited a criticism (included in the Matters Requiring Attention, or MRA) of the bank's controls or administration of its asset-based loan portfolio; and

(d) Loans that are eligible for the floor plan lending exclusion, described herein, provided the bank's PFR has not cited a criticism (included in the

[9] Commercial and industrial 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. This definition includes purchased credit impaired loans and overdrafts.

[10] 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.

MRA) of the bank's controls or administration of its floor plan loan portfolio.

Higher-risk C&I borrower

A "higher-risk C&I borrower" is a borrower that:

(a) owes the reporting bank on a C&I loan originally made on or after April 1, 2013, if:

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

(ii) The loan meets the purpose and materiality tests described herein; and

(iii)When the loan is made, the borrower meets the leverage test described herein; or

(b) Obtains a refinance, as that term is defined herein, of an existing C&I loan, where the refinance occurs on or after April 1, 2013, and the refinanced loan is owed to the reporting bank, if:

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

(ii) The C&I loan being refinanced met the purpose and materiality tests (described herein) when it was originally made;

(iii) The original loan was made no more than 5 years before the refinanced loan; and

(iv) When the loan is refinanced, the borrower meets the leverage test.

When a bank acquires a C&I loan originally made on or after April 1, 2013, by another lender, it must determine whether the borrower is a higher-risk borrower as a result of the loan as soon as reasonably practicable, but not later than one year after acquisition. When a bank acquires loans from another entity on a recurring or programmatic basis, however, the bank must determine whether the borrower is a higher-risk borrower as a result of the loan as soon as is practicable, but not later than three months after the date of acquisition.

A borrower ceases to be a "higher-risk C&I borrower" only if:

(a) The borrower no longer has any C&I loans owed to the reporting bank that, when originally made, met the purpose and materiality tests described herein;

(b) The borrower has such loans outstanding owed to the reporting bank, but they have all been refinanced more than 5 years after originally being made; or

(c) The reporting bank makes a new C&I loan or refinances an existing C&I loan and the borrower no longer meets the leverage test described herein.

Original amount

The original amount of a loan, including the amounts to aggregate for purposes of arriving at the original amount, as described herein, is:

(a) For C&I 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, however, the amount currently outstanding on the loan as of the date of the bank's most recent Call Report exceeds this amount, then the original amount of the loan is the amount outstanding as of the date of the bank's most recent Call Report.

(b) For syndicated or participated C&I loans, the total amount of the loan, rather than just the syndicated or participated portion held by the individual reporting bank.

(c) For all other C&I loans (whether term or non-revolver loans), the total amount of the loan as of origination or the amount outstanding as of the date of the bank's most recent Call Report, whichever is larger.

For purposes of defining original amount and a higher-risk C&I borrower:

(a) All C&I loans that a borrower owes to the reporting bank that meet the purpose test when made, and that are made within six months of each other, must be aggregated to determine the original amount of the loan; however, only loans in the original amount of $1 million or more must be

aggregated; and further provided, that loans made before the April 1, 2013, need not be aggregated.

(b) When a C&I loan is refinanced through more than one loan, and the loans are made within six months of each other, they must be aggregated to determine the original amount.

Refinance

For purposes of a C&I loan, a refinance includes:

(a) Replacing an original obligation by a new or modified obligation or loan agreement;

(b) Increasing the master commitment of the line of credit (but not adjusting sub-limits under the master commitment);

(c) Disbursing additional money other than amounts already committed to the borrower;

(d) Extending the legal maturity date;

(e) Rescheduling principal or interest payments to create or increase a balloon payment;

(f) Releasing a substantial amount of collateral;

(g) Consolidating multiple existing obligations; or

(h) Increasing or decreasing the interest rate.

A refinance of a C&I loan does not include a modification or series of modifications to a commercial loan other than as described above or modifications to a commercial loan that would otherwise meet this definition of refinance, but that result in the classification of a loan as a troubled debt restructuring (TDR), as this term is defined in the glossary of the Call Report instructions, as they may be amended from time to time.

Purpose test

A loan or refinance meets the purpose test if it is to finance:

(a) A buyout, defined as the purchase or repurchase by the borrower of the borrower's outstanding equity, including, but not limited to, an equity buyout or funding an Employee Stock Ownership Plan (ESOP);

(b) An acquisition, defined as the purchase by the borrower of any equity interest in another company, or the purchase of all or a substantial portion of the assets of another company; or

(c) A capital distribution, defined as a dividend payment or other transaction designed to enhance shareholder value, including, but not limited to, a repurchase of stock.

At the time of refinance, whether the original loan met the purpose test may not be easily determined by a new lender. In such a case, the new lender must use its best efforts and reasonable due diligence to determine whether the original loan met the test.

Materiality test

A loan or refinance meets the materiality test if:

(a) The original amount of the loan (including funded amounts and the amount of unfunded commitments, whether irrevocable or unconditionally cancellable) equals or exceeds 20 percent of the total funded debt of the borrower; total funded debt of the borrower is to be determined as of the date of the original loan and does not include the loan to which the materiality test is being applied; or

(b) Before the loan was made, the borrower had no funded debt.

When multiple loans must be aggregated to determine the original amount, the materiality test is applied as of the date of the most recent loan.

At the time of refinance, whether the original loan met the materiality test may not be easily determined by a new lender. In such a case, the new lender must use its best efforts and reasonable due diligence to determine whether the original loan met the test.

Leverage test

A borrower meets the leverage test if:

(a) The ratio of the borrower's total debt to trailing twelve-month EBITDA (commonly known as the operating leverage ratio) is greater than 4; or

(b) The ratio of the borrower's senior debt to trailing twelve-month EBITDA (also commonly known as the operating leverage ratio) is greater than 3.

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

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.

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.

When calculating either of the borrower's operating leverage ratios, the only permitted EBITDA adjustments are those specifically permitted for that borrower in the loan agreement (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. If the loan is made to a subsidiary of a larger organization, the debt-to-EBITDA ratio may be calculated using the financial statements of the

subsidiary or, if the parent company has unconditionally and irrevocably guaranteed the borrower's debt, using the consolidated financial statements of the parent company.

In the case of a merger of two companies or the acquisition of one or more companies or parts of companies, 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.

Exclusions

Cash Collateral Exclusion

To exclude a loan based on cash collateral, the cash must be in the form of a savings or time deposit held by a bank. The bank (or lead bank or agent bank in the case of a participation or syndication) must have a perfected first priority security interest, a security agreement, and a collateral assignment of the deposit account that is irrevocable for the remaining term of the loan or commitment. In addition, the bank must place a hold on the deposit account that alerts the bank's employees to an attempted withdrawal. If the cash collateral is held at another bank or at multiple banks, a security agreement must be in place and each bank must have an account control agreementin place.[11] For the exclusion to apply to 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).

Asset-Based and Floor Plan Lending Exclusions

The FDIC retains the authority to verify that banks have sound internal controls and administration practices for asset-based and floor plan loans that are excluded from a bank's reported higher-risk C&I loans and securities totals. If the bank's PFR has cited a criticism of the bank's controls or administration of its asset-based or floor plan loan

[11] An account control agreement, for purposes of this Appendix, means a written agreement between the lending bank (the secured party), the borrower, and the bank that holds the deposit account serving as collateral (the depository bank), that the depository bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the borrower (or any other party).

portfolios in an MRA, the bank is not eligible for the asset-based or floor plan lending exclusions.

Asset-based lending conditions

Asset-based loans (loans secured by accounts receivable and inventory) that meet all the following conditions are excluded from a bank's higher-risk C&I loan totals:

(a) The loan is managed by a loan officer or group of loan officers at the reporting bank who have experience in asset-based lending and collateral monitoring, including, but not limited to, experience in reviewing the following: collateral reports, borrowing base certificates (which are discussed herein), collateral audit reports, loan-to-collateral values (LTV), and loan limits, using procedures common to the industry.

(b) The bank has taken, or has the legally enforceable ability to take, dominion over the borrower's deposit accounts such that proceeds of collateral are applied to the loan balance as collected. Security agreements must be in place in all cases; in addition, if a borrower's deposit account is held at a bank other than the lending bank, an account control agreement must also be in place.

(c) The bank has a perfected first priority security interest in all assets included in the borrowing base certificate.

(d) 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.[12] Other non-self-liquidating assets may be part of the borrowing base, but the outstanding balance of the loan must be fully secured by the portion of the borrowing base that is composed of self-liquidating assets. Fully secured is defined as a 100 percent or lower LTV ratio after applying the appropriate discounts (determined by the loan agreement) to the collateral. If an over advance (including a seasonal over advance) causes the LTV to exceed 100 percent, the loan may not be excluded from higher-risk C&I loans owed by a higher-risk C&I borrower. Additionally, the bank must have the ability to withhold funding of a draw or advance if the loan amount exceeds the amount allowed by the collateral formula.

(e) A bank's lending policy or procedures must address the maintenance of an accounts receivable loan agreement with the borrower. This loan agreement must establish a maximum percentage advance, which cannot exceed 85 percent, against eligible accounts receivable, include a maximum dollar amount due from any one account debtor, address the financial strength of debtor accounts, and define eligible receivables. The definition of eligible receivables must consider the receivable quality, the turnover and dilution rates of receivables pledged, the aging of accounts

[12] 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.

receivable, the concentrations of debtor accounts, and the performance of the receivables related to their terms of sale.

Concentration of debtor accounts is the percentage value of receivables associated with one or a few customers relative to the total value of receivables. Turnover of receivables is the velocity at which receivables are collected. The dilution rate is the uncollectible accounts receivable as a percentage of sales.

Ineligibles must be established for any debtor account where there is concern that the debtor may not pay according to terms. Monthly accounts receivable agings must be received in sufficient detail to allow the bank to compute the required ineligibles. At a minimum, the following items must be deemed ineligible accounts receivable:

(i) 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;

(ii) Entire account balances where over 50 percent of the account is over 60 days past due or 90 days past invoice date;

(iii) Accounts arising from sources other than trade (*e.g.*, royalties, rebates);

(iv) Consignment or guaranteed sales;

(v) Notes receivable;

(vi) Progress billings;

(vii) Account balances in excess of limits appropriate to account debtor's credit worthiness or unduly concentrated by industry, location or customer;

(viii) Affiliate and intercompany accounts; and

(ix) Foreign accounts receivable.

(f) Loans against inventory must be made with advance rates no more than 65 percent of eligible inventory (at the lower of cost valued on a first-in, first-out (FIFO) basis or market) based on an analysis of realizable value. When an appraisal is obtained, or there is a readily determinable market price for the inventory, however, up to 85 percent of the net orderly liquidation value (NOLV) or the market price of the inventory may be financed. Inventory must be valued or appraised by an independent third-party appraiser using 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, unless there is a readily available and determinable market price for the inventory (*e.g.*, in the case of various commodities), from a recognized exchange or third-party industry source, and a readily available market (*e.g.*, for aluminum, crude oil, steel, and other traded

commodities); in that case, inventory may be valued using current market value. When relying upon current market value rather than an independent appraisal, the reporting bank's management must update the value of inventory as market prices for the product change. Valuation updates must be as frequent as needed to ensure compliance with margin requirements. In addition, appropriate mark-to-market reserves must be established to protect against excessive inventory price fluctuations. An asset has a readily identifiable and publicly available market price if the asset's price is quoted routinely in a widely disseminated publication that is readily available to the general public.

(g) A bank's lending policy or procedures must address the maintenance of an inventory loan agreement with the borrower. This loan agreement must establish a maximum percentage advance rate against acceptable inventory, address acceptable appraisal and valuation requirements, and define acceptable and ineligible inventory. 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. Monthly inventory agings must be received in sufficient detail to allow the bank to compute the required ineligibles. At a minimum, ineligible inventory must include:

(i) Slow moving, obsolete inventory and items turning materially slower than industry average;

(ii) Inventory with value to the client only, which is generally work in process, but may include raw materials used solely in the client's manufacturing process;

(iii) Consigned inventory or other inventory where a perfected security interest cannot be obtained;

(iv) Off-premise inventory subject to a mechanic's or other lien; and

(v) Specialized, high technology or other inventory subject to rapid obsolescence or valuation problems.

(h) The bank must maintain documentation of borrowing base certificate reviews and collateral trend analyses to demonstrate that collateral values are actively, routinely and consistently monitored. A borrowing base certificate is a form prepared by the borrower that reflects the current status of the collateral. A new borrowing base certificate must be obtained within 30 days before or after each draw or advance on a loan. A bank is required to validate the borrowing base through asset-based tracking reports. The borrowing base validation process must include the bank requesting from the borrower a list of accounts receivable by creditor and a list of individual items of inventory and the bank certifying that the outstanding balance of the loan remains within the collateral formula prescribed by the loan agreement. Any discrepancies between the list of accounts receivable and inventory and the borrowing base certificate must be reconciled with the borrower. Periodic, but no less than annual, field

examinations (audits) must also 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 bank is correcting audit exceptions.

Floor plan lending conditions

Floor plan loans may include, but are not limited to, loans to finance the purchase of various vehicles or equipment including automobiles, boat or marine equipment, recreational vehicles (RV), motorized watersports vehicles such as jet skis, or motorized lawn and garden equipment such as tractor lawnmowers. Floor plan loans that meet all the following conditions are excluded from a bank's higher-risk C&I loan totals:

(a) The loan is managed by a loan officer or a group of loan officers at the reporting bank who are experienced in floor plan lending and monitoring collateral to ensure the borrower remains in compliance with floor plan limits and repayment requirements. Loan officers must have experience in reviewing certain items, including but not limited to: collateral reports, floor plan limits, floor plan aging reports, vehicle inventory audits or inspections, and LTV ratios. The bank must obtain and review financial statements of the borrower (*e.g.*, tax returns, company-prepared financial statements, or dealer statements) on at least a quarterly basis to ensure that adequate controls are in place. (A "dealer statement" is the standard format financial statement issued by Original Equipment Manufacturers

(OEMs) and used by nationally recognized automobile dealer floor plan lenders.)

(b) For automobile floor plans, each loan advance must be made against a specific automobile 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 automobile at auction or the wholesale value using the prevailing market guide (*e.g.*, NADA, Black Book, Blue Book). The advance rate of 100 percent of dealer invoice plus freight charges on new automobiles, and the advance rate of the cost of a used automobile 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 bank over time and subject to strong controls. Otherwise, permissible advance rates must be lower than 100 percent.

(c) Advance rates on vehicles other than automobiles must conform to industry standards for advance rates on such inventory, but may never exceed 100 percent of dealer invoice plus freight charges on new vehicles or 100 percent of the cost of a used vehicle at auction or its wholesale value.

(d) 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).

(e) Vehicle inventories and collateral values are closely monitored, including the completion of regular (at least quarterly) dealership automotive or other vehicle dealer inventory audits or inspections to ensure accurate accounting for all vehicles held as collateral. The lending bank or a third party must prepare inventory audit reports and inspection reports for loans to automotive dealerships, or loans to other vehicle dealers, and the lending bank must review the reports at least quarterly. The reports must list all vehicles held as collateral and verify that the collateral is in the dealer's possession.

(f) Floor plan aging reports must be reviewed by the bank as frequently as required under the loan agreement, but no less frequently than quarterly. Floor plan aging reports must reflect specific information about each automobile or vehicle being financed (*e.g.*, the make, model, and color of the automobile or other vehicle, and origination date of the loan to finance the automobile or vehicle). Curtailment programs should be instituted where necessary and banks must ensure that curtailment payments are made on stale automotive or other vehicle inventory financed under the floor plan loan.

Detailed reports

Examples of detailed reports that must be provided to the asset-based and floor plan lending bank include:

(a) Borrowing Base Certificates: Borrowing base certificates, along with supporting information, must include:

(i) The accounts receivable balance (rolled forward from the previous certificate);

(ii) Sales (reported as gross billings) with detailed adjustments for returns and allowances to allow for proper tracking of dilution and other reductions in collateral;

(iii) Detailed inventory information (*e.g.*, raw materials, work-in-process, finished goods); and

(iv) Detail of loan activity.

(b) Accounts Receivable and Inventory Detail: A listing of accounts receivable and inventory that is included on the borrowing base certificate. Monthly accounts receivable and inventory agings must be received in sufficient detail to allow the lender to compute the required ineligibles.

(c) Accounts Payable Detail: A listing of each accounts payable owed to the borrower. Monthly accounts payable agings must be received to monitor payable performance and anticipated working capital needs.

(d) Covenant Compliance Certificates: A listing of each loan covenant and the borrower's compliance with each one. Borrowers must 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 must be promptly addressed.

(e) Dealership Automotive Inventory or Other Vehicle Inventory Audits or Inspections: The bank or a third party must prepare inventory audit reports or inspection reports for loans to automotive dealerships and other vehicle dealerships. The bank must review the reports at least quarterly. The reports must list all vehicles held as collateral and verify that the collateral is in the dealer's possession.

(f) Floor Plan Aging Reports: Borrowers must submit floor plan aging reports on a monthly or quarterly basis (depending on the terms of the loan agreement). These reports must reflect specific information about each automobile or other type of vehicle being financed (*e.g.*, the make, model, and color of the automobile or other type of vehicle, and origination date of the loan to finance the automobile or other type of vehicle).

3. Higher-risk consumer loans

Definitions

Higher-risk consumer loans are defined as 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) is greater than 20 percent, excluding those consumer loans that meet the definition of a nontraditional mortgage loan.[13,14]

Higher-risk consumer loans exclude:

(a) The maximum amounts recoverable from the U.S. government or its agencies under guarantee or insurance provisions; and

(b) Loans fully secured by cash collateral. To exclude a loan based on cash collateral, the cash must be in the form of a savings or time deposit held by a bank. The lending bank (or lead or agent bank in the case of a participation or syndication) must, in all cases, (including instances in which cash collateral is held at another bank or banks) have a perfected first priority security interest under applicable state law, a security agreement in place, and all necessary documents executed and measures taken as required to result in such perfection and priority. In addition, the lending bank must place a hold on the deposit account that alerts the bank's employees to an attempted withdrawal. For the exclusion to apply to a revolving line of credit, the cash collateral must be equal to, or greater

[13] For the purposes of this rule, consumer loans consist of all loans secured by 1-4 family residential properties as well as loans and leases made to individuals for household, family, and other personal expenditures, as defined in the instructions to the Call Report, Schedule RC-C, as the instructions may be amended from time to time. Higher-risk consumer loans include purchased credit-impaired loans that meet the definition of higher-risk consumer loans.

[14] The FDIC has the flexibility, as part of its risk-based assessment system, to change the 20 percent threshold for identifying higher-risk consumer loans without further notice-and-comment rulemaking as a result of reviewing data for up to the first two reporting periods after the effective date of this rule. Before making any such change, the FDIC will analyze the potential effect of changing the PD threshold on the distribution of higher-risk consumer loans among banks and the resulting effect on assessments collected from the industry. The FDIC will provide banks with at least one quarter advance notice of any such change to the PD threshold through a Financial Institution Letter.

than, the amount of the total loan commitment (the aggregate funded and unfunded balance of the loan).

Banks must determine the PD of a consumer loan as of the date the loan was originated, or, if the loan has been refinanced, as of the date it was refinanced. The two-year PD must be estimated using an approach that conforms to the requirements detailed herein.

Loans originated or refinanced before April 1, 2013, and all acquired loans

For loans originated or refinanced by a bank before April 1, 2013, and all acquired loans regardless of the date of acquisition, if information as of the date the loan was originated or refinanced is not available, then the bank must use the oldest available information to determine the PD. If no information is available, then the bank must obtain recent, refreshed data from the borrower or other appropriate third party to determine the PD. Refreshed data is defined as the most recent data available, and must be as of a date that is no earlier than three months before the acquisition of the loan. In addition, for loans acquired on or after April 1, 2013, the acquiring bank shall have six months from the date of acquisition to determine the PD.

When a bank acquires loans from another entity on a recurring or programmatic basis, the acquiring bank may determine whether the loan meets the definition of a higher-risk consumer loan using the origination criteria and analysis performed by the original lender only if the acquiring bank verifies the information provided. Loans acquired from another entity are acquired on a recurring basis if a bank has acquired other loans from that entity at least once within the calendar year of the acquisition of the

loans in question or in the previous calendar year. If the acquiring bank cannot or does not verify the information provided by the original lender, the acquiring bank 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.

Loans that meet both higher-risk consumer loans and nontraditional mortgage loans definitions

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

General Requirements for PD Estimation

Scorable consumer loans

Estimates of the two-year PD for a loan must be based on the observed, stress period default rate (defined herein) for loans of a similar product type made to consumers with credit risk comparable to the borrower being evaluated. While a bank may consider additional risk factors beyond the product type and credit score (*e.g.,* geography) in estimating the PD of a loan, it must at a minimum account for these two factors. 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 C.F.R. 202.2(p), as it may be amended from time to time, 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, banks must adhere to the following requirements:

(a) 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:

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

(b) 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 24-month period). An "active" loan is defined as any loan that was open and not in default as of the observation date, and on which a payment was made within the 12 months prior to the observation date.

(c) 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 (and any additional risk factors) 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 each 24-month default rate must be calculated using a random sample of at least 1,200 active loans.

(d) Credit score strata must be determined by partitioning the entire credit score range generated by a given scoring system 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. Because performance data for scores at the upper and lower extremes of the population distribution is likely to be limited, however, the top and bottom bands may include a range of scores that suggest some variance in credit quality.

(e) Each credit score will need to have a unique PD associated with it. Therefore, when the number of score bands is less than the number of unique credit scores (as will almost always be the case), banks must use a linear interpolation between adjacent default rates to determine the PD for a particular score. The observed default rate for each band must be assumed to correspond to 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.

(f) 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.

(g) A loan is to be considered in default when it is 90+ days past due, charged-off, or the borrower enters bankruptcy.

Unscorable consumer loans

For unscorable consumer loans – where the available information about a borrower is insufficient to determine a credit score – the bank will be unable to assign a PD to the loan according to the requirements described above. If the total outstanding balance of the unscorable consumer loans of a particular product type (including, but not limited to, student loans) exceeds 5 percent of the total outstanding balance for that product type, including both foreign and domestic loans, the excess amount shall be treated as higher risk (the de minimis approach). Otherwise, the total outstanding balance of unscorable consumer loans of a particular product type will not be considered higher risk. The consumer product types used to determine whether the 5 percent test is satisfied shall correspond to the product types listed in the table used for reporting PD estimates.

A bank may not develop PD estimates for unscorable loans based on internal data.

If, after the origination or refinance of the loan, an unscorable consumer loan becomes scorable, a bank must reclassify the loan using a PD estimated according to the general requirements above. Based upon that PD, the loan will be determined to be either higher risk or not, and that determination will remain in effect until a refinancing occurs, at which time the loan must be re-evaluated. An unscorable loan must be reviewed at least annually to determine if a credit score has become available.

Alternative Methodologies

A bank may use internally derived default rates that were calculated using fewer observations or score bands than those specified above under certain conditions. The bank must submit a written request to the FDIC either in advance of, or concurrent with, reporting under the requested approach. The request must explain in detail how the

proposed approach differs from the rule specifications and the bank 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 bank, which the bank must provide. The bank may report using its proposed approach while the FDIC evaluates the methodology. If, after reviewing the request, the FDIC determines that the bank's methodology is unacceptable, the bank will be required to amend its Call Reports and report according to the generally applicable specifications for PD estimation. The bank will be required to submit amended information for no more than the two most recently dated and filed Call Reports preceding the FDIC's determination.

Foreign Consumer Loans

A bank must estimate the PD of a foreign consumer loan according to the general requirements described above unless doing so would be unduly complex or burdensome (*e.g.*, if a bank had to develop separate PD mappings for many different countries). A bank may request to use default rates calculated using fewer observations or score bands than the specified minimums, either in advance of, or concurrent with, reporting under that methodology, but must comply with the requirements detailed above for using an alternative methodology.

When estimating a PD according to the general requirements described above would be unduly complex or burdensome, a bank that is required to calculate PDs for foreign consumer loans under the requirements of the Basel II capital framework may:

(1) use the Basel II approach discussed herein, subject to the terms discussed herein; (2) submit a written request to the FDIC to use its own methodology, but may not use the methodology until approved by the FDIC; or (3) treat the loan as an unscorable consumer loan subject to the de minimis approach described above.

When estimating a PD according to the general requirements described above would be unduly complex or burdensome, a bank that is not required to calculate PDs for foreign consumer loans under the requirements of the Basel II capital framework may: (1) treat the loan as an unscorable consumer loan subject to the de minimis approach described above; or (2) submit a written request to the FDIC to use its own methodology, but may not use the methodology until approved by the FDIC.

When a bank submits a written request to the FDIC to use its own methodology, the FDIC may request additional information from the bank regarding the proposed methodology and the bank must provide the information. The FDIC may grant a bank tentative approval to use the methodology while the FDIC considers it in more detail. If the FDIC ultimately disapproves the methodology, the bank may be required to amend its Call Reports; however, the bank will be required to amend no more than the two most recently dated and filed Call Reports preceding the FDIC's determination. In the amended Call Reports, the bank must treat any loan whose PD had been estimated using the disapproved methodology as an unscorable domestic consumer loan subject to the de minimis approach described above.

Basel II approach

A bank that is required to calculate PDs for foreign consumer loans under the requirements of the Basel II capital framework may estimate the two-year PD of a foreign consumer loan based on the one-year PD used for Basel II capital purposes.[15] The bank 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 one-year PDs calculated under the Basel II framework are translated to two-year PDs that meet the requirements above. While the range of acceptable approaches is potentially broad, any proposed methodology must meet the following requirements:

(a) The bank must use data on a sample of loans for which both the one-year Basel II PDs and two-year final rule PDs can be calculated. The sample may contain both foreign and domestic loans.

(b) The bank must use the sample data to demonstrate that a meaningful relationship exists between the two types of PD estimates, and the significance and nature of the relationship must be determined using accepted statistical principles and methodologies. For example, to the extent that a linear relationship exists in the sample data, the bank may use an ordinary least-squares regression to determine the best linear translation of Basel II PDs to final rule PDs. The estimated equation should fit the data reasonably well based on standard statistics such as the coefficient of determination; and

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

(c) The method must account for any significant variation in the relationship between the two types of PD estimates that exists across consumer products based on the empirical analysis of the data. For example, if the bank is using a linear regression to determine the relationship between PD estimates, it should test whether the parameter estimates are significantly different by product type.

The bank may report using this approach (if it first notifies the FDIC of its intention to do so), while the FDIC evaluates the methodology. If, after reviewing the methodology, the FDIC determines that the methodology is unacceptable, the bank will be required to amend its Call Reports. The bank will be required to submit amended information for no more than the two most recently dated and filed Call Reports preceding the FDIC's determination.

Refinance

For purposes of higher-risk consumer loans, a refinance includes:

(a) Extending new credit or additional funds on an existing loan;

(b) Replacing an existing loan with a new or modified obligation;

(c) Consolidating multiple existing obligations;

(d) Disbursing additional funds to the borrower. 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. A material increase in the amount of a line of credit is defined as a 10 percent or greater increase in the quarter-end line of credit limit; however, a temporary increase in a credit card line of credit is not a material increase;

(e) Increasing or decreasing the interest rate (except as noted herein for credit card loans); or

(f) Rescheduling 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.

A refinance for this purpose does not include:

(a) A re-aging, defined as returning a delinquent, open-end account to current status without collecting the total amount of principal, interest, and fees that are contractually due, provided:

(i) The re-aging is part of a program that, at a minimum, adheres to the re-aging guidelines recommended in the interagency approved Uniform Retail Credit Classification and Account Management Policy;[16]

[16]Among other things, for a loan to be considered for re-aging, the following must be true: (1) the borrower must have demonstrated a renewed willingness and ability to repay the loan; (2) the loan must have existed for at least nine months; and (3) the borrower must have made at least three consecutive minimum monthly payments or the equivalent cumulative amount.

(ii) The program has clearly defined policy guidelines and parameters for re-aging, as well as internal methods of ensuring the reasonableness of those guidelines and monitoring their effectiveness; and

(iii) The bank monitors both the number and dollar amount of re-aged accounts, collects and analyzes data to assess the performance of re-aged accounts, and determines the effect of re-aging practices on past due ratios;

(b) Modifications to a loan that would otherwise meet this definition of refinance, but result in the classification of a loan as a TDR;

(c) Any modification made to a consumer loan pursuant to a government program, such as the Home Affordable Modification Program or the Home Affordable Refinance Program;

(d) Deferrals under the Servicemembers Civil Relief Act;

(e) A contractual deferral of payments or change in interest rate that is consistent with the terms of the original loan agreement (*e.g.*, as allowed in some student loans);

(f) Except as provided above, a modification or series of modifications to a closed-end consumer loan;

(g) An advance of funds, an increase in the line of credit, or a change in the interest rate that is consistent with the terms of the loan agreement for an open-end or revolving line of credit (*e.g.*, credit cards or home equity lines of credit);

(h) For credit card loans:

(i) Replacing an existing card because the original is expiring, for security reasons, or because of a new technology or a new system;

(ii) Reissuing a credit card that has been temporarily suspended (as opposed to closed);

(iii) Temporarily increasing the line of credit;

(iv) Providing access to additional credit when a bank has internally approved a higher credit line than it has made available to the customer; or

(v) Changing the interest rate of a credit card line when mandated by law (such as in the case of the Credit CARD Act).

4. Nontraditional mortgage loans

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. 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. 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.

Banks must determine whether residential loans meet the definition of a nontraditional mortgage loan as of origination, or, if the loan has been refinanced, as of refinance, as refinance is defined in this Appendix for purposes of higher-risk consumer loans. When a bank acquires a residential loan, it must determine whether the loan 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 bank must obtain refreshed data from the borrower or other appropriate third party. Refreshed data for residential loans is defined as the most recent data available. The data, however, must be as of a date that is no earlier than three months before the acquisition of the residential loan. The acquiring bank must also determine whether an acquired loan is higher risk not later than three months after acquisition.

When a bank acquires loans from another entity on a recurring or programmatic basis, however, the acquiring bank may determine whether the loan meets the definition of a nontraditional mortgage loan using the origination criteria and analysis performed by the original lender only if the acquiring bank verifies the information provided. Loans acquired from another entity are acquired on a recurring basis if a bank has acquired other loans from that entity at least once within the calendar year or the previous calendar year of the acquisition of the loans in question.

5. Higher-risk securitizations

Higher-risk securitizations are defined as securitizations (except securitizations classified as trading book), where, in aggregate, more than 50 percent of the assets backing the securitization meet either the criteria for higher-risk C&I loans or securities, higher-risk consumer loans, or nontraditional mortgage loans, except those classified as trading book. A securitization is as defined in 12 C.F.R. Part 325, Appendix A, Section II(B)(16), as it may be amended from time to time.

A bank must determine whether a securitization is higher risk based upon information as of the date of issuance (*i.e.*, the date the securitization is sold on a market to the public for the first time). The bank must make this determination within the time limit that would apply under this Appendix if the bank were directly acquiring loans or securities of the type underlying the securitization. In making the determination, a bank must use one of the following methods:

(a) For a securitization collateralized by a static pool of loans, whose underlying collateral changes due to the sale or amortization of these loans, the 50 percent threshold is to be determined based upon the amount of higher-risk assets, as defined in this Appendix, owned by the securitization on the date of issuance of the securitization.

(b) For a securitization collateralized by a dynamic pool of loans, whose underlying collateral may change by the purchase of additional assets, including purchases made during a ramp-up period, the 50 percent threshold is to be determined based upon the highest amount of higher-risk

assets, as defined in this Appendix, allowable under the portfolio guidelines of the securitization.

A bank is not required to evaluate a securitization on a continuous basis when the securitization is collateralized by a dynamic pool of loans; rather, the bank is only required to evaluate the securitization once.

A bank 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 memoranda, 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, a bank may use established criteria, model portfolios, or limitations published in the offering memorandum, indenture, trustee report, or similar documents.

Sufficient information necessary for a bank to make a definitive determination may not, in every case, be reasonably available to the bank as a sophisticated investor. In such a case, the bank may exercise its judgment in making the determination. In some cases, the bank need not rely upon all of the aforementioned pieces of information to make a higher-risk determination if fewer documents provide sufficient data to make the determination.

In cases in which a securitization is required to be consolidated on the balance sheet as a result of SFAS 166 and SFAS 167, and a bank has access to the necessary information, a bank may opt for an alternative method of evaluating the securitization to

determine whether it is higher risk. The bank may evaluate individual loans in the securitization on a loan-by-loan basis and only report as higher risk those loans that meet the definition of a higher-risk asset; 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 bank must follow the provisions of section I.B herein. Once a bank evaluates a securitization for higher-risk asset designation using this alternative evaluation method, it must continue to evaluate all securitizations that it has consolidated on the balance sheet as a result of SFAS 166 and SFAS 167, and for which it has the required information, using the alternative evaluation method. For securitizations for which the bank does not have access to information on a loan-by-loan basis, the bank must determine whether the securitization meets the 50 percent threshold in the manner previously described for other securitizations.

B. Application of Definitions

Section I of this Appendix applies to:

(1) All construction and land development loans, whenever originated or purchased;

(2) C&I loans (as that term is defined in this Appendix) owed to a reporting bank by a higher-risk C&I borrower (as that term is defined in this Appendix) and all securities issued by a higher-risk C&I borrower, except securitizations of C&I loans, that are owned by the reporting bank;

(3) Consumer loans (as defined in this Appendix), except securitizations of consumer loans, whenever originated or purchased;

(4) Securitizations of C&I and consumer loans (as defined in this Appendix) issued on or after April 1, 2013, including those securitizations issued on or after April 1, 2013, that are partially or fully collateralized by loans originated before April 1, 2013.

For C&I loans that are either originated or refinanced by a reporting bank before April 1, 2013, or purchased by a reporting bank before April 1, 2013, where the loans are owed to the reporting bank by a borrower that does not meet the definition of a higher-risk C&I borrower as that term is defined in this Appendix (which requires, among other things, that the borrower have obtained a C&I loan or refinanced an existing C&I loan on or after April 1, 2013) and securities purchased before April 1, 2013, that are issued by an entity that does not meet the definition of a higher-risk C&I borrower, as that term is defined in this Appendix, banks must continue to use the transition guidance in the September 2012 Call Report instructions to determine whether to report the loan or security as a higher-risk asset for purposes of the higher-risk assets to Tier 1 capital and reserves ratio. A bank may opt to apply the definition of higher-risk C&I loans and securities in this Appendix to all of its C&I loans and securities, but, if it does so, it must also apply the definition of a higher-risk C&I borrower in this Appendix without regard to when the loan is originally made or refinanced (*i.e.*, whether made or refinanced before or after April 1, 2013).

For consumer loans (other than securitizations of consumer loans) originated or purchased prior to April 1, 2013, a bank must determine whether the loan met the definition of a higher-risk consumer loan no later than June 30, 2013.

For all securitizations issued before April 1, 2013, banks must either (1) continue to use the transition guidance or (2) apply the definitions in this Appendix to all of its securitizations. If a bank applies the definition of higher-risk C&I loans and securities in this Appendix to its securitizations, it must also apply the definition of a higher-risk C&I borrower in this Appendix to all C&I borrowers without regard to when the loans to those borrowers were originally made or refinanced (*i.e.*, whether made or refinanced before or after April 1, 2013).

II. 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:

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

where

N is bank *i*'s growth-adjusted portfolio concentration measure;[18]

k is a portfolio;

g is a growth factor for bank *i*'s portfolio *k*; and,

w is a risk weight for portfolio *k*.

[18] The growth-adjusted portfolio concentration measure is rounded to two decimal points.

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. [19,20]

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. [21] 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:

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

[19] All loan concentrations should include the fair value of purchased credit impaired loans.

[20] Each loan concentration category should exclude the amount of loans recoverable from the U.S. government under guarantee or insurance provisions.

[21] The growth factor is rounded to two decimal points.

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 t 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.[22] These loss rates were converted into equivalent risk weights as shown in Table C.1.

[22] 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.

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

By order of the Board of Directors.

Dated at Washington, D.C., this [xxx}
Federal Deposit Insurance Corporation

Robert Feldman
Executive Secretary (SEAL)

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