rma®
THE RISK MANAGEMENT ASSOCIATION
Serving the Financial Services Industry

1801 Market Street • Suite 300 • Philadelphia, PA 19103
215-446-4124 • Fax 215-446-4032
e-mail: bgithens@rmahq.org
www.rmahq.org

William F. Githens, CRC
President and CEO

September 22, 2011

Arthur J. Murton
Director
Division of Insurance and Research

Sandra L. Thompson
Director
Division of Risk Management Supervision

Diane Ellis
Deputy Director
Division of Insurance and Research

Robert Storch
Chief Accountant
Division of Supervision and Consumer Protection

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

RE: Federal Deposit Insurance Corporation
12 CFR Part 327
Federal Register / Vol. 76, No. 38, February 25, 2011 / Rules and Regulations
Assessments, Large Bank Pricing
Final Rule: Risk-Based Assessment System for Large Insured Depository Institutions

Ladies and Gentlemen:

In May 2011 RMA and its member banks responded to the Final Rule citing strong support for the concept of applying risk-based evaluation tools in the determination of FDIC assessment fees. We also noted serious concern, however, that the definitions, as they appear in the Final Rule for "leveraged loans" and for "subprime loans," will yield a ratio that does not accurately represent the risk incurred. One important unintended consequence of the definitions is that banks with less risky portfolios will be treated equally with banks having more risky portfolios, which is tantamount to the banks with less risky portfolios subsidizing the FDIC assessment fees for banks with riskier portfolios.

In the time since May, RMA and many of its member banks have actively participated in discussions with the FDIC regarding the definitions of those terms. In addition, it has become very apparent that meeting the October 1, 2011 deadline for submission of the June 30, 2011 assessment based on the Final Rule definitions is impossible due to the enormous resources and time required to comply.

RMA and a group of member banks that have been actively working on the subject have arrived at a consensus definition which would adequately address the appropriate level of risk that an institution undertakes. The goal of this group was to bring simplicity and consistency to the definitions while being able to differentiate risk among large insured depository institutions that are underwriting higher risk credits from those that are not.

An outline of our approach for leveraged loans and for sub-prime is found on the following pages. In particular it should be noted that our "1st Choice" sub-prime proposal is geared toward identifying a high-level way forward; and, if it is acceptable in principle we hope that it will serve as the basis to facilitate discussion between the banks and the FDIC in order to identify and develop important details that underpin the proposal; e.g. the number of probability of default bands, the range of each of those bands, and the scope of exposure for inclusion – all or new and renewals. With regard to leveraged loans it is important to note that the most critical aspect of our proposed definition, either our 1st Choice or 2nd Choice, is the inclusion of a *purpose test*.

Accordingly, we respectfully request that the FDIC reopen discussions.

	FDIC Definition – Final Rule	Concern	RMA Proposed 1st Choice Definition	RMA Proposed 2nd Choice Definition
Leveraged Loans	Leveraged loans include: (1) All commercial loans (funded and unfunded) with an original amount greater than $1 million that meet any one of the conditions below at either origination or renewal, except real estate loans; (2) securities issued by commercial borrowers that meet any one of the conditions below at either origination or renewal, except securities classified as trading book; and (3) securitizations that are more than 50 percent collateralized by assets that meet any one of the conditions below at either origination or renewal, except securities classified as trading book. • Loans or securities where borrower's total or senior debt to trailing twelve-month EBITDA (i.e. operating leverage ratio) is greater than 4 or 3 times, respectively. For purposes of this calculation, the only permitted EBITDA adjustments are those adjustments specifically permitted for that borrower in its credit agreement; or • Loans or securities that are designated as highly leveraged transactions (HLT) by syndication agent. Note: The total liabilities to asset ratio test has been removed from the definition; the remaining tests are consistent with the OCC Handbook.	• No distinction is made for several important criteria, resulting in a ratio that, as currently defined, will be the same, but with a much different risk profile * 1. No distinction is made for the type of transaction, i.e. the use of the funds. ○ Short term, e.g. working capital, or ○ Long term, e.g. buyout, recapitalization. 2. No distinction is made for the type of collateral. ○ Secured (w/ tangible assets), or ○ Unsecured. 3. No distinction is made for the type of industry and or business activity. ○ E.g. traditional, high-operating -leverage industries, e.g. floor - plan financing vs. enterprise value. • Without these distinctions, i.e. a more granular view, the measure has become homogenized, compromising its value as a differentiator between and across institutions. ○ For instance, a bank that primarily pursues a short-term, secured leveraged lending book of	Leveraged loans include: All commercial loans (funded and unfunded) that meet the conditions below at either origination, renewal or refinance – provided that the loan was determined to be leveraged prior to renewal or refinance, except real estate loans: • The original purpose of the debt was for the financing of a material acquisition, merger, recapitalization (including dividends, stock repurchases, cash-outs); equity buyout, ESPOs, or tender offer; <u>and</u> • The borrower's total or senior debt to trailing twelve-month EBITDA (i.e. operating leverage ratio) is greater than 4 or 3 times, respectively. For purposes of this calculation, the only permitted EBITDA adjustments are those adjustments specifically permitted for that borrower in its credit agreement; <u>or</u> • The debt is designated as a highly leveraged transaction (HLT) by a syndication agent. • Also, as most leveraged lending is performed in the corporate lending area, it is recommended that the de minimus level be raised from $1 million to $5 million. This level reflects one that more closely recognizes how banks are tracking leveraged lending presently and will not have an	Leveraged loans include: All commercial loans (funded and unfunded) that meet any one of the conditions below at either origination or renewal – provided that the loan was determined to be leveraged prior to renewal, except real estate loans: (Source - 2008 OCC Comptroller's Handbook): • "Proceeds used for buyouts, acquisition, and recapitalization. • Transaction results in a substantial increase in borrower's leverage ratio. Industry benchmarks include a twofold increase in the borrower's liabilities, resulting in a balance sheet leverage ratio (total liabilities/total assets) higher than 50 percent, or an increase in the balance sheet leverage ratio more than 75 percent. Other benchmarks include increasing the borrower's operating leverage ratios [total debt/EBITDA (earnings before interest, taxes, depreciation, and amortization) or senior debt/EBITDA) above defined levels such as above 4.0X EBITDA or 3.0X EBITDA, respectively. • Transaction designated as a highly leveraged transaction (HLT) by the syndication agent. • The OCC broadly considers a leveraged loan to be a transaction where the borrower's post-financing leverage, when measured by debt-to-asset, debt-to-equity, cash flow-to-total debt, or other such standards unique to particular

		business will have a significantly lower risk profile than a bank that pursues a long-term, unsecured strategy. However, as currently defined, both of these banks would be viewed the same. • The use of a single ratio (operating leverage ratio) is overly simplistic, especially without simultaneously taking into consideration a number of other factors, such as the purpose of the financing. * • An original amount of $1 million or greater will result in the inclusion of the small business banking book where the volume of transactions are sufficiently large and other factors, such as personal guarantees and government guarantees, help to mitigate the risk. • By broadly including loans that are defined as leveraged at renewal, you may be including loans that became leveraged as the result of a deteriorating economy versus a loan whose purpose at origination was leveraged.	impact on small business lending which typically falls below $5 million dollars in the largest banks. N.B. under no scenario above do we envision that asset based loans – those borrowers where the extension of credit and the risk is actively managed (i.e. collateral monitoring, cash dominion, and a borrowing base), would be considered a leverage loan.	industries, significantly exceeds industry norms for leverage. • Banks engaging in this type of activity should define leveraged lending within their lending policy. Examiners should expect the bank's definition to clearly describe the purpose and financial characteristics common in these transactions." Also, 2001 OCC, FRB, FDIC, and OTS Sound Risk Management Practices paper on Leveraged Lending – • "A transaction is considered leveraged when the obligor's post-financing leverage as measured by debt-to-assets, debt-to equity, cash flow-to-total debt, or other such standards unique to particular industries significantly exceeds industry norms for leverage. "

** The operating leverage ratio, by itself, is not the best measure of risk for all borrowers in all industries. The nature and reasonable predictability of business earnings and cash flow, particularly for amortizing debt, allows for substantially more financial leverage in some industries than in others. Public utilities, for example, have always enjoyed more leverage than other industries, e.g. contractors that are generally considered highly risky, even for relatively small measures of working capital borrowings. Secured traditional asset-based lending, with well conceived collateral values and margin requirements and controls, though highly leveraged by the proposed measures, may bear considerably less risk of loss than a borrower with a substantially lower operating leverage ratio. However, the latter borrower may be far more risky if it is in an industry that has little tangible*

asset value and large proportions of enterprise value-type intangible assets on its balance sheet.

The proposal to use a single ratio as the measure of risk in leveraged loans, i.e. a single proxy, is diametrically opposed to the well thought out and increasingly complex credit risk-rating systems in use that take far more into account than the proposed ratio. Bank risk-rating systems are designed to measure the probability of default (PD) and the loss given default (LGD), and to provide for this assessment throughout the economic and credit cycle. The definitions of criticized and classified assets used by the banks mirror the traditional regulatory definitions, and they are tested frequently by the industry's primary regulators. Accordingly, the use of a single ratio as a proxy for risk is inappropriate and inconsistent with the historical practices of commercial bank regulators, international regulatory practices (and probable U.S. adoption in some form) regarding Basel II.

Lastly, a single ratio will produce an undesirable level of volatility through the cycle. It will be pro-cyclical with the kinds of defects that plagued the calculation of the loan loss provision and the ALLL during the most recent cycle. It will not apply a consistent measure of risk to individual loans or portfolios of loans in commercial banks, and it will produce unfair and unintended consequences in the assessment of risk of the insured banks.

	FDIC Definition – Final Rule	Concern	RMA Proposed 1st Choice Definition	RMA Proposed 2nd Choice Definition

Subprime Loans	Subprime Loans include loans made to borrowers that display one or more of the following credit risk characteristics (excluding subprime loans that are previously included as nontraditional loans) at origination or upon refinancing, whichever is more recent.
	• Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months; or
	• Judgment, foreclosure, repossession, or charge-off in the prior 24 months;
	• Bankruptcy in the last 5 years; or
	• Debt service-to-income ratio of 50% or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.
	• Loans identified by an insured depository institution as subprime loans based upon similar borrower characteristics and securitizations where more than 50 percent of assets backing the securitization meet one or more of the preceding criteria for subprime loans, excluding those securities classified as trading book.
	Note:
	The definition excludes any reference
		• The use of a single ratio (debt service-to-income) & threshold is overly simplistic without simultaneously considering other undefined factors that are indicative of a stressed borrower. *
		• The definition does not make any distinction as to size or type of 30-day and 60-day delinquency (i.e., a large installment loan or mortgage is clearly more important than a small retail trade).
		• No distinction is made for the size of the judgment, foreclosure, repossession, or charge off (e.g., someone with a minor medical charge-off with otherwise impeccable credit would be classified as subprime under this definition).
			Financial institutions will report the results of their credit scoring algorithm/system whether provided by a vendor, developed internally, or some combination of the two resources, expressed as:
			• Exposure on a dollar basis
			• Probability of default (PD) "bands"
			• For retail products as determined by the FDIC.
			
			Probability of default is defined as a 12 month PD measure at origination or a refreshed assessment if the origination information is not available.
			
			The FDIC will then determine based on their understanding of the financial institution's credit scoring algorithm/system and their probability of default assignments what constitutes subprime. Once this determination is made the assessment ratio can be calculated.
			
			N.B. Please see attached table as an example.
				Subprime Loans include loans made to borrowers that display one or more of the following credit risk characteristics (excluding subprime loans that are previously included as nontraditional loans) at origination or upon refinancing, whichever is more recent.
				• Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months; or
				• Judgment, foreclosure, repossession, or charge-off in the prior 24 months;
				• Bankruptcy in the last 5 years; or
				• A measure of risk presented by the applicant, produced by a credit scoring algorithm/system, that conforms to sound mathematical practices, regulatory guidance and rules, as well as any applicable laws.
				  ○ The credit scoring algorithm/system may be provided by either a vendor (e.g. FICO or Vantage) or developed internally, or some combination of the two resources.
				  ○ The measure of risk, i.e. a relatively high probability of default, would establish a threshold (subject to product type and

	to FICO or other credit bureau scores. The Rule focuses on borrower credit history.			collateral) for determining what is considered subprime. The threshold would be determined by the market or the institution. • Debt service-to-income ratio of 50% or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income. • Loans identified by an insured depository institution as subprime loans based upon similar borrower characteristics and securitizations where more than 50 percent of assets backing the securitization meet one or more of the preceding criteria for subprime loans, excluding those securities classified as trading book.

** For example:*

1. Residual Income:

A head of household with:

a) $3,000 of monthly income at 50% DTI has $1,500 of residual income to cover living expenses and cushion for debt service.

b) $10,000 of monthly income at 50% DTI has $5,000 of residual income to cover living expenses and cushion for debt service.

The financial flexibility for b) is certainly much better than a) and not likely a subprime borrower without some other negative factor.

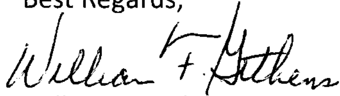
2. Asset Base: Clients with larger net worths, but lower income (i.e. retirees) could become classified as subprime due to this 50% DTI criteria when the ratio is not indicative of their ability to repay their obligations due to asset depletion availability.

3. The debt-service ratio calculation is undefined leaving broad room for interpretation:

- *How is a payment calculated for revolving debt (% of balance or line, what %).*
- *When can a near full-term installment loan be excluded from the calculation (3-month remaining or 6-months remaining or more)?*
- *What income is included?*
- *How is irregular income treated?*

We hope that you find this helpful, and if you wish to discuss this further, we would welcome the opportunity.

Best Regards,



William F. Githens
President and CEO, RMA

Cc:

John Walsh
Acting Comptroller of the Currency

David Wilson
Senior Deputy Comptroller for Bank Supervision Policy and
Chief National Bank Examiner

Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, DC 20219

Patrick M. Parkinson
Director
Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System
20th and C Streets, NW
Washington, DC 20551

Martin J. Gruenberg
Vice Chairman and Acting Chairman

Thomas Curry
Director

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Demonstration of Reporting to Determine a Measure of Subprime Consumer Loans

Probability of Default	Type of Loan						
	Automobile	Credit Cards	Nontraditional Mortgage	Other Secured Residential	Student	Personal and Other	Total
0-10%							
10-20%							
20-30%							
30-40%							
40-50%							
Over 50%							
Total							