MBCA

MID-SIZE BANK COALITION OF AMERICA

May 29, 2012

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Re: Assessments, Large Bank Pricing Definition Revisions
Notice of Proposed Rulemaking
RIN 3064-AD92

Ladies and Gentlemen:

On behalf of the Midsize Bank Coalition of America ("MBCA"), I am writing to provide the MBCA's comments on the above-referenced notice of proposed rulemaking ("Proposal") published by the Federal Deposit Insurance Corporation ("FDIC") on March 27, 2012.[1]

By way of background, the MBCA is a non-partisan financial and economic policy organization comprising the CEOs of mid-size banks doing business in the United States. Founded in 2010, the MBCA, now with 28 members, was formed for the purpose of providing the perspectives of mid-size banks on financial regulatory reform to regulators and legislators. As a group, the MBCA banks do business through more than 3,800 branches in 41 states, Washington D.C. and three U.S. territories. The MBCA's members' combined assets exceed $450 billion (ranging in size from $7 to $30 billion) and, together, its members employ approximately 77,000 people. Member institutions hold nearly $336 billion in deposits and total loans of more than $260 billion.

[1] *Assessments, Large Bank Pricing*, 77 FR 18109 (Mar. 27, 2012).

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The Proposal is the latest in a series of rulemakings to implement a risk-based assessment system for the Deposit Insurance Fund.[2] In brief, the Proposal would amend the FDIC's assessment rules by renaming, and revising the definitions of, certain types of loans. It would also clarify the timing for classifying certain assets as "higher risk," and refine the definitions of certain terms used in the rules. The MBCA supports the FDIC's efforts to address these matters, which stem from concerns that were raised in comment letters on the earlier proposals to amend the assessment rules.

I. Definition of "Higher-Risk C&I Loans and Securities."

Broadly speaking, assets that are deemed "higher risk" under the assessment rules will increase an institution's initial base assessment rate. In the past, "higher risk" loans have included a category termed "leveraged loans." The FDIC's proposal would replace this term with the more descriptive "higher-risk commercial and industrial (C&I) loans and securities." This term would be defined to include:

- Any commercial loan owed by a borrower to the bank with an original amount greater than $5 million if either condition specified below is met as of origination, or as of refinance, and the loan does not meet either of two exclusions (outlined further below).

  (a) The purpose of any of the borrower's debt (no matter to whom owed) incurred within the prior seven years was to finance a buyout, acquisition, or capital distribution and such debt was "material" (*i.e.*, it increased the borrower's funded debt by 20% or more within 12 months); *and* the ratio of the borrower's total debt to trailing twelve-month EBITDA is greater than 4 or the ratio of the borrower's senior debt to trailing twelve-month EBITDA is greater than 3; or

  (b) Any of the borrower's debt (no matter to whom owed) is designated as a highly leveraged transaction (HLT) by a syndication agent.

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

- All securitizations held by the bank that are more than 50 percent collateralized by commercial loans or securities that would meet the above definition if they were directly held, except "trading book" securities.

[2] See e.g. *Adjustment Guidelines*, 76 FR 21256 (Apr. 15, 2011); *Assessments, Assessment Base and Rates*, 75 FR 72582, (Nov. 24, 2010); *Assessments, Large Bank Pricing*, 75 FR 72612 (Nov. 24, 2010).

In General.

MBCA supports the FDIC's proposal to increase the threshold for a "higher-risk C&I loan" to $5 million. This threshold is an appropriate benchmark to distinguish loans that are generally of smaller value, but which are typically subject to guarantees or collateral arrangements.

At the same time, we urge the FDIC to further refine the proposed definitions in order to better differentiate risks to the Deposit Insurance Fund and mitigate unnecessary regulatory burdens. First, we believe that, in addition to loans fully secured by cash collateral, loans that are fully secured by other highly liquid assets (including certain bonds or marketable securities), after the application of appropriate discounts to the market value of such assets, should also be excluded from the higher-risk C&I loan designation. For example, a loan may be secured by securities issued or guaranteed by the U.S. government, a government agency, or a government sponsored entity, and the Proposal already recognizes that a loan should be excluded up to the maximum amount recoverable from the U.S. government, its agencies or government -sponsored agencies. Accordingly, there seems to be little reason to treat a loan that is secured by cash in a deposit account differently from a loan secured by government securities. Similarly, a loan should be excluded from the definition of a "higher-risk C&I loan" to the extent of the appropriately discounted amount of any guarantees or other credit enhancements that would reduce the lender's loss in the event of default.

Second, a bank should not have to examine the purpose of every debt that a borrower incurred in as long a period as the previous seven years. The Proposal explains that the seven-year test would be imposed because

> [d]uring the most recent buyout boom of the mid to late 2000s, a seven year maturity was often the longest dated maturity for loans that facilitated a leveraged buyout. Under the proposal, where the purpose test is met, loans originated in 2007 (near the end of the leveraged buyout boom) to a borrower that remains above the proposed debt-to-EBITDA ratio thresholds would continue to be classified as higher-risk … .[3]

Thus, the proposal to require a seven-year review is driven by practices associated with one specialized type of lending: leveraged buyouts. But few MBCA members engage in lending for the purpose of leveraged buyouts. This is a business conducted by the largest of the large banks in major world financial centers. We believe that the required review period should be consistent with typical credit analysis, and should not be determined by a particular type of lending transaction that is not common outside of major financial centers. In

[3] *Assessments, Large Bank Pricing*, 77 FR at 18112.

any event, for MBCA members, a seven-year look-back is problematic because loans could be refinanced multiple times using various credit facilities and structures over such a long period of time. Without the manpower and facilities that the largest banks maintain, it is difficult for smaller banks to determine whether a particular debt was incurred to finance a buyout, acquisition, or capital distribution. Moreover, it is not easy for many local businesses to produce records extending back that far for a bank's review. Finally, a bank should not be required to review the purpose of loans that have already been repaid, as they would not be relevant to the borrower's ability to repay new loans. Therefore, the MBCA believes that only outstanding loans and loans incurred within the previous three years should have to be reviewed, which is consistent with diligent and sound practices.

Third, the MBCA believes that the proposed threshold for determining the materiality of a debt should be altered. A 20% threshold for determining materiality will cause an unduly large number of loans to be deemed "high risk" – especially if the review period is as long as seven years. Rather, a debt should not be considered "material" unless it results in a 50% or greater increase in the total funded debt of the borrower. In the experience of the members of the MBCA, a 20% increase in indebtedness does not generally materially increase the credit risk of the borrower. In any event, consistent with the standard for a "higher-risk C&I loan," any debt in an amount of $5 million or less should not be considered material.

Finally, the MBCA requests clarification of three aspects of the Proposal. First, the Proposal refers to "higher-risk C&I loans" that include "any commercial loan (funded or unfunded, including irrevocable and revocable commitments)."[4] It is not clear what "revocable commitments" refers to: it is not otherwise defined in the Proposal or in FDIC regulations, and we have not found it in industry use. Accordingly, we suggest that the FDIC clarify or delete the reference to "revocable commitments." Second, we request that the FDIC clarify what adjustments to EBITDA are permitted in calculating the borrower's operating ratio. The Proposal states that "the only permitted EBITDA adjustments are those specifically permitted for that borrower at the time of underwriting."[5] It is unclear if adjustments "specifically permitted for that borrower" refers to adjustments specified in the applicable loan agreement. Third, we request that the FDIC clarify that a deposit account held in a depository institution other than the lender qualifies as cash collateral that may exclude a loan from the higher-risk designation, if the lender acquires control of the account through an account control agreement with the account-holding institution, as provided in Article 9-104 of the Uniform Commercial Code.

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[4] *Assessments, Large Bank Pricing*, 77 FR at 18111, 18119.

[5] *Assessments, Large Bank Pricing*, 77 FR at 18120.

II. Asset-Based Lending Exclusion.

As noted above, the Proposal would exclude two types of lending transactions from being treated as “higher-risk C&I loans.” The first would be for “asset-based” loans that meet a series of specific conditions. The MBCA supports the FDIC’s proposal to exclude asset-based loans that meet certain conditions from an institution’s higher-risk C&I loan total. However, we suggest the following revisions to the conditions.

Borrowing Base Certificates.

The Proposal would require a new borrowing base certificate at each draw or advance on the loan. It would also require the lending institution to validate the assets that compose the borrowing base certificate at the time of every draw. This is inconsistent with general industry practices and will require wide-ranging programmatic and systems changes to implement. The MBCA suggests that the FDIC require a current borrowing base certificate for every 30-day period, and validation of assets for every certificate. This would be consistent with current practices, which we have found to be sound and which have not led to any substantive concerns.

Dominion of Cash.

The FDIC would require an institution to have taken, or have “the legally enforceable unconditional ability to take, dominion of cash through account control agreements over the borrower’s depository accounts such that proceeds of collateral are applied to the loan balance as collected.”[6] The MBCA suggests that the FDIC remove the qualifier “unconditional” and the phrase “through account control agreements.” The qualifier “unconditional” would seem to preclude “springing dominion” transactions, where payments into the deposit account need not be applied to the loan balance if the outstanding debt is lower than the borrower’s available credit under the loan facility or the borrowing base. Such preclusion would be unnecessarily restrictive because, under Section 9-104 of the Uniform Commercial Code, the secured lender may have control of a deposit account even if the debtor retains the right to direct the disposition of funds from the account. Also, under Section 9-104 of the Uniform Commercial Code, if the secured lender is the bank with which a pledged deposit account is maintained, the lender has control of the account and need not obtain an account control agreement.

Appraisals.

In order for an asset-based loan to not be treated as a “higher-risk C&I loan,” the Proposal would require that assets securing the loan “be valued or

[6] *Assessments, Large Bank Pricing*, 77 FR at 18121.

appraised by an independent third-party appraiser." The MBCA believes that the appraisal requirement should not apply to inventory for which a readily determinable market value is available (as in the case of commodities such as steel).

III. Floor Plan Lines of Credit Exclusion.

The second exclusion from treatment as a "higher-risk C&I loan" would apply to "Floor Plan Lines of Credit Extension" for automobile dealers. We support the FDIC's proposal to exclude floor plan loans that meet certain conditions from an institution's higher-risk C&I loan total, but would suggest that the FDIC revise one of the proposed conditions of the exclusion.

The Proposal would require an institution to "obtain and review audited financial statements of the borrower on an annual basis." Typically, automobile dealerships are privately held. Almost universally, they are not required to have, and do not have audited financial statements prepared. Thus, as presently worded, the exclusion would exclude few, if any, floor plan lines of credit. In practice, for floor plan lending, banks generally require auto dealerships to provide monthly financial statements, an unaudited annual financial statement, and annual tax returns on an ongoing basis. The MBCA believes that the FDIC should adopt the industry's standards because such frequent financial reviews actually enable the lender to monitor the dealer's financial condition more effectively, and in any event, the vast majority of dealerships will not be able to provide audited financial statements.

IV. Definition of "Higher-Risk Consumer Loans and Securities."

The Proposal would re-name "subprime loans" as "higher-risk consumer loans and securities." Under the Proposal, a consumer loan would be considered "higher-risk" solely on the basis of the probability of default ("PD"), which is derived from the default rate corresponding to the borrower's credit score. The Proposal would treat a loan as "higher risk" if the PD within two years was greater than 20%. All securitizations (except those classified as trading book) that are more than 50 percent collateralized by consumer loans that exceed the PD threshold would also be considered "higher-risk."

Default Rate Methodology.

The Proposal would require that the default rate for any single product and credit score group be calculated from a sample size of at least 1,200 loans. If an institution uses internally derived default rates based on a smaller sample size, the institution would have to submit a written request to the FDIC and provide support for the statistical propriety of its methodology. We request that the FDIC publish criteria for its evaluation of alternative methodologies. Otherwise, an institution that uses a smaller sample size may inefficiently expend time and resources without confidence that the FDIC would accept its methodology. This would effectively limit the ability of an institution that has a smaller portfolio to use internally derived default rates. Such smaller institutions could be disadvantaged compared with large entities that have larger portfolios and can thus freely exercise the option of developing internal models. Publication of the FDIC's evaluative criteria would help to offset this competitive disadvantage, and allow smaller firms to be more efficient in the development of models.

Higher-Risk Consumer Loan Designation.

We believe that the following changes should be made to the Proposal regarding the designation of higher-risk consumer loans:

- Loans made before the effective date of the Proposal should be exempt from PD reporting and designation as higher-risk loans. If the FDIC chooses to require small and medium-sized institutions to assess the PDs of existing loans in the portfolio, it should consider the large amount of time and expenses that will be needed and provide a transitional period of at least three years.

- Modified loans should be exempt from designation as higher-risk loans. Such an exemption would decrease an incentive for banks to foreclose on a home or other asset, and would encourage institutions to work with borrowers to modify their loans. Especially in today's environment of instability, the FDIC should recognize that a modification or refinancing actually decreases risk of default.

- The FDIC should provide specific guidance on how to determine the PDs of loans for which the lender does not require a credit score, such as student loans. The Proposal requires that the PD of a loan be based on the credit score of the borrower (or the co-borrower or co-signer, if applicable). In the absence of a credit score, an institution should not be required to automatically assign a PD above the higher-risk threshold and classify the loan as higher-risk. Otherwise, credit products such as student loans would become more expensive or less available.

- Re-evaluations of PD should not be required for a credit card account if the credit line is increased by no more than 10%, or if the credit line is increased only temporarily. Institutions generally do not obtain a new credit score in these circumstances, and requiring them to do so and reevaluate the PD would create costs and burdens with no significant improvement in risk differentiation.

- The FDIC should allow loans with conservative loan-to-value ratios (such as a loan-to-value ratio of 60%) to be excluded from the "higher-risk" designation. Our experience shows that loan-to-value ratios have a high correlation to the size of credit loss. Since a conservative loan-to-value ratio reduces loss in the event of default, it mitigates the credit risk of an asset.

- The FDIC should clarify that a deposit account held in a depository institution other than the lender qualifies as cash collateral that may exclude a loan from the higher-risk designation, if the lender acquires control of the deposit account through an account control agreement with the account-holding institution, as provided in Article 9-104 of the Uniform Commercial Code.

- In addition to loans fully secured by cash collateral, loans that are fully secured by other highly liquid assets (including certain bonds or marketable securities), after the application of appropriate discounts to the market value of such assets, should also be excluded from the higher-risk consumer loan designation (*e.g.*, as noted earlier, loans secured by U.S. government securities). Similarly, a loan should be excluded from the higher-risk consumer loan designation to the extent of the appropriately discounted amount of guarantees or other credit enhancements that would reduce the lender's loss in the event of default.

Changes to the PD Estimation Time Periods or Threshold.

The FDIC has indicated in the Proposal that it might change the PD estimation time periods or the PD threshold with at least one quarter's advance notice. The MBCA urges the FDIC to give at least six months' advance notice if the FDIC does make such changes. One quarter's notice would not give institutions enough time to modify their systems and models to comply with the FDIC's new instructions for calculating default rates and PDs. Moreover, when the PD estimation time periods or the PD threshold is changed, a loan that would not have been classified as higher-risk under the old standards could be required to be so classified under the new standards and increase the lender's FDIC assessment accordingly. Therefore, institutions would need to change the pricing of their credit products to account for the new cost, which would take longer than a quarter.

Furthermore, the MBCA believes that any lower PD threshold that the FDIC may adopt should apply only to loans made or acquired after the effective date of the new threshold. A loan that is classified as higher-risk will increase the lending or acquiring institution's deposit insurance assessment, and this cost should be reflected in the pricing of the loan. However, an institution would not be able to change the pricing of a loan to reflect this cost once the loan is made or acquired. If an institution is required to reclassify some existing loans as higher-risk without being able to increase the pricing of these loans, it may have to pass on the extra cost to new borrowers, which would impose an unfair burden on new borrowers and impede new lending.

PD Reporting.

The FDIC has also indicated in the Proposal that it would require institutions to report the outstanding amount of all consumer loans, stratified by ten product types and 12 two-year PD bands, subject to a Paperwork Reduction Act notice in the Federal Register regarding revisions to the Call Report (with an opportunity for comment). If such a requirement were adopted, institutions would have to report not only higher-risk consumer loans, but also consumer loans with a probability of default below the higher-risk threshold. Of the 12 PD bands published in the Proposal, eight would be below the proposed higher-risk threshold of 20%. The MBCA believes that it would be unduly burdensome to require institution to estimate the PD of every loan in a portfolio that has shown a history of low default rates. If a portfolio has a default rate that is consistently below 10% and the institution maintains prudent underwriting criteria and appropriate monitoring for loans that go into the portfolio, the institution should not be required to estimate and report the PD of the loans in the portfolio.

To the extent that PD reporting is nevertheless required, we urge the FDIC to allow for simplified methodology for such low-risk portfolios. As noted, under the proposed methodology, an institution could be precluded from developing its internal model for smaller portfolios, and the cost of obtaining PDs from a vendor could be unjustifiable, especially when the portfolio is marked by conservative underwriting criteria and a low historical default rate. Even if an institution is able to develop the PDs internally, it may need to hire an outside consultant to satisfy all the requirements of the Proposal, and this expenditure could still be unjustifiable in light of the proven low risk of the portfolio.

V. Nontraditional Mortgage Loans.

The MBCA urges the FDIC to revise the definition of "nontraditional mortgage loans" to exclude loans made to borrowers who meet underwriting criteria that have resulted in a low probability of default, as evidenced by the low default rate of the portfolio. Under the current definition, all interest-only mortgage products fall within the definition of nontraditional mortgage loans and are classified as higher-risk assets for assessment purposes. However, the credit risk of an interest-only loan depends on the credit history of the borrower, the resources of the borrower, customer practices, and local market conditions. Lenders sometimes offer interest-only mortgage products to borrowers with excellent credit scores and other relevant indicators of creditworthiness such as assets and income precisely because loans made to such borrowers pose little credit risk. Portfolios of interest-only loans made to such borrowers generally have default rates that are no higher than other types of loans to such borrowers. These types of loans should not automatically be treated as "non-traditional," but should be evaluated according to their historical probability of default.

VI. Audit.

The MBCA does not believe that it is necessary for the FDIC to state in the assessment rule that "the FDIC may review and audit for compliance all determinations made by insured depository institutions for assessment purposes," including determinations relating to whether certain assets may be excluded from the higher-risk asset totals**.** Institutions are required to report their higher-risk assets in their Call Reports. Under 12 U.S.C. § 1817(a)(3), a Call Report must be accompanied by the declaration of an officer and the attestations of at least two directors regarding its correctness. Therefore, any information contained in a Call Report, not just the information on higher-risk assets, must be accurate. Emphasizing that the FDIC may review and audit determinations relating to the exclusion of certain assets from the high-risk asset totals may be interpreted as an indication to future readers that this type of information requires some higher, but undefined, level of scrutiny as compared to other items reported in the Call Report.

Furthermore, the MBCA urges the FDIC to coordinate any audit of an institution's higher-risk asset determinations for assessment purposes with the institution's other regulators. Such coordination would help to avoid duplicative examination and conflicting findings. Moreover, a primary regulator's familiarity with the institution would benefit such audits.

VII. Effective Date.

The MBCA believes that the effective date of the proposed amendments (and correspondingly, the new expiration date for the transition guidance) should be extended to April 1, 2013. The proposed October 1, 2012 date would not give institutions sufficient time to put the necessary systems in place to accurately identify and report higher-risk assets as defined in the Proposal. Specifically, institutions would need to decide whether to purchase the necessary data from third-party vendors or develop internal models. If they choose to use third-party data, they would need to perform due diligence on the vendor, negotiate appropriate contracts, and learn how to use the data. If an institution decides to develop an internal model, it would also need to hire or train qualified staff, and perhaps use an outside consultant, requiring additional time to implement compliance.

VIII. Conclusion.

The MBCA supports the FDIC's efforts to refine its assessment rule to improve risk differentiation and reduce regulatory burden. We appreciate the opportunity to express our concerns and suggestions. We look forward to discussing these matters with you in the future.

Yours Truly,

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Chairman and CEO, City National Bank

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