



Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Financial Institution Letter
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October 9, 2012

ASSESSMENTS

Final Rule on Assessments, Large Bank Pricing

Summary: On October 9, 2012, the FDIC Board of Directors (FDIC Board) adopted the attached final rule, which amends and clarifies some definitions of higher-risk assets as used in the deposit insurance pricing scorecards for large and highly complex insured depository institutions.

Statement of Applicability to Institutions Under \$1 Billion in Total Assets: The final rule applies only to institutions with \$10 billion or more in assets. It has no impact on institutions with less than \$1 billion in assets.

Distribution:

All FDIC-Insured Institutions

Suggested Routing:

Chief Executive Officer
President
Chief Financial Officer

Related Topics:

FDIC Regulations Governing the Assessment Process, 12 CFR Part 327

Attachment:

[Final Rule: Assessments, Large Bank Pricing](#)

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Note:

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Highlights:

The final rule:

- Revises the definitions of certain higher-risk assets, specifically leveraged loans, which are renamed "higher-risk C&I loans and securities," and subprime consumer loans, which are renamed "higher-risk consumer loans";
- Clarifies when an asset must be identified as higher risk; and
- Clarifies the way securitizations are identified as higher risk.

Implementation and Effective Date:

- The final rule generally is effective April 1, 2013. The subsequent pages explain the effective date in more detail.

Final Rule: Assessments, Large Bank Pricing

On October 9, 2012, the FDIC adopted the attached final rule related to the FDIC's large bank pricing methodology. The rule amends the assessment regulations for large bank pricing that were adopted on February 25, 2011 (February 2011 rule). A summary of the major provisions of the final rule follows.

Definitions

The final rule revises the definition of certain higher-risk assets and clarifies terms that are used in the definition of higher-risk assets in the February 2011 rule. These definitions affect the higher-risk concentration measure (higher-risk assets to Tier 1 capital and reserves) found in the large and highly complex institution scorecards.

Higher-Risk C&I Loans and Securities

The final rule defines a "higher-risk C&I loan or security" as all C&I loans owed to the reporting bank by a "higher-risk C&I borrower," as defined in the rule (and as explained 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. The final rule sets out specific exceptions to the definition.

A "higher-risk C&I borrower" is defined as 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 April 1, 2013, if the following conditions are met:

- 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.

All C&I loans that a borrower owes to the reporting bank that meet the purpose test when made, that are in the amount of \$1 million or more, 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.¹ Thus, for example, if a bank makes a \$4 million C&I loan and five months later

¹ Loans made before the effective date of the rule do not need to be aggregated. 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 \$5 million) is the total original amount of the loan, not just the syndicated or participated portion held by an individual bank.

makes a \$2 million C&I loan, both of which meet the purpose test, the loans will have an original amount of \$6 million.

A “higher-risk C&I borrower” also includes a borrower that obtains a refinance 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.

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 total at least \$5 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 otherwise cease to be a higher-risk borrower.

Purpose Test

A loan or refinance meets the purpose test if it is to finance a buyout, acquisition, or capital distribution.² 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.³

² 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 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.

³ Enterprise value is a measure of the borrower’s value as a going concern.

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.⁴ A loan also meets the materiality test if, before the loan was made, the borrower had no funded debt.

Leverage Test

A borrower meets the leverage test if the ratio of the borrower's total debt to trailing 12-month EBITDA (commonly known as the operating leverage ratio) is greater than 4, or the ratio of the borrower's senior debt to trailing 12-month EBITDA (also commonly known as the operating leverage ratio) is greater than 3.⁵

Higher-Risk Consumer Loans

Under the final rule, a "higher-risk consumer loan" is defined as a consumer loan 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, as determined using a defined historical stress period, excluding those consumer loans that meet the definition of a nontraditional mortgage loan.⁶ The final rule details the methodology that must be used to determine PDs, the treatment of unscorable loans, and methodologies that may be used to determine PDs for foreign consumer loans.

Higher-Risk Securitizations

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 either the criteria for higher-risk C&I loans or securities, higher-risk consumer loans, or nontraditional mortgage loans.⁷

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 Call Report instructions. The instructions have been updated to reflect April 1, 2013, (formerly October 1, 2012) as the effective date of the final rule.

⁴ 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.

⁵ EBITDA stands for "earnings before interest, taxes, depreciation, and amortization."

⁶ 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, however, later ceases to meet the definition of nontraditional mortgage loan but continues to qualify as a higher-risk consumer loan, it must then be reported as a higher-risk consumer loan.

⁷ Unscorable consumer loans (including all foreign consumer loans) that exceed 5 percent of the loans in a securitization are deemed higher-risk.

Effective Date

The final rule applies to all C&I loans owed to a reporting bank by a higher-risk C&I borrower and all securities issued by a higher-risk C&I borrower that are owned by the reporting bank. To be classified as a higher-risk C&I borrower under the final rule, the borrower must obtain a C&I loan or refinance an existing C&I loan on or after April 1, 2013. Therefore, 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. In addition, for C&I loans and securities originated or purchased 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, a bank must either (1) continue to use its existing internal methodology or existing guidance provided by its primary federal regulator or (2) apply the final rule definition of higher-risk C&I loans and securities to all of its C&I loans and securities.⁸

Banks will need to start reporting the amount of higher-risk consumer loans for the quarter ending June 30, 2013, without regard to when the loans were originated or purchased.

The final rule applies to securitizations of C&I and consumer loans 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 all securitizations issued before April 1, 2013, banks must either (1) continue to use their existing internal methodology or existing guidance provided by their primary federal regulator or (2) apply the definitions of higher-risk C&I loans and securities, higher-risk consumer loans, and nontraditional mortgage loans in the final rule to all of its securitizations.⁹

Arthur J. Murton
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⁸ A bank that does so must also apply the final rule definition of a higher-risk C&I borrower without regard to when the loan is originally made or refinanced (that is, whether made or refinanced before or after April 1, 2013)

⁹ 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).