

September 26, 2011

Communications Division
Office of the Comptroller of the Currency
Mail Stop 2-3
Attention: 1557-0081
250 E Street, SW
Washington, DC 20219

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551

Mr. Gary Kuiper
Counsel
Attn: Comments, Room F-1086
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Information Collection Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: 1550-0023
(TFR Schedule DI Revisions)

Re: Proposed Agency Information Collection Activities; Comment Request 76 Federal Register 44987; July 27, 2011; Joint Notice and Request for Comment; Consolidated Reports of Condition and Income (FFIEC 031 and 041) **OCC**: 1557-0081; **FRB**: FFIEC 031 and 041; **FDIC**: 3064-0052; **OTS**: 1550-0023 (TFR: Schedule DI Revisions)

Ladies and Gentlemen:

The American Bankers Association (ABA), The Clearing House Association L.L.C., and The Financial Service Roundtable appreciate the opportunity to comment on the proposed revisions to the Consolidated Reports of Condition and Income (Call Report), the Thrift Financial Report (TFR), and the FFIEC Reports 002 and 002S as issued by the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS) (collectively, the agencies).^{1,2} These revisions include several changes to implement the FDIC rule that redefines the deposit insurance assessment base and the Large Bank Pricing (LBP) rule.³

This letter not only provides comments on the proposed Call Report and TFR changes, it also addresses serious concerns about some key definitions that underlie them in the LBP rule. We

¹ Descriptions of the associations that participated in this comment are provided in the Appendix at the end of this

² 76 *Fed. Reg.* 44987 (July 27, 2011).

³ On February 7, 2011, the FDIC adopted a rule implementing the requirements of Section 331(b) of the Dodd-Frank Act by amending Part 327 of the FDIC's regulations to redefine the assessment base used for calculating deposit insurance assessments, as well as to implement the LBP assessment pricing system for banks over \$10 billion in assets, effective April 1, 2011. See 76 *Fed. Reg.* 10672 (February 25, 2011), at <http://edocket.access.gpo.gov/2011/pdf/2011-3086.pdf>.

offer solutions to improve the definitions in this letter. Our associations collectively represent all of the banks that are affected or may be affected by the rule and reporting. The comments and solutions in this letter reflect the consensus of opinion developed across many conference calls that included bankers from nearly all the affected banks.

Before detailing our comments, we want to commend the FDIC staff for its willingness to discuss the issues and concerns of the industry, and to consider with the banks subject to LBP reporting (LBP banks) workable solutions to the problems that have arisen as the implementation process has evolved. We share with the FDIC the goal of accurately measuring relative risk and the need for reporting that is as consistent as possible across institutions.

The industry greatly appreciates the decision by the agencies to enable banks to report second and third quarter 2011 numbers for two items based on current collection methods. In anticipation of meeting the LBP rule's requirements for fourth quarter 2011 (and beyond), LBP banks have and continue to work hard to develop systems and to educate personnel to capture the data required. In doing so, it has become clear that there continue to be real practical barriers to capturing and reporting data consistently, even prospectively. The banks have found that automated solutions are not available and cannot be easily created to capture the information. As a consequence, they have had to look to manual methods for data capture, which is very costly and time consuming, and involves considerable training for thousands of employees.

More importantly, as banks move to meet the reporting requirements, there continues to be frustration that the definitions under the LBP rule of "subprime" and "leveraged" loans do not effectively capture the risk that the FDIC desires or needs for the LBP model. Rather, the current rule's definitions would capture loans that are *not* subprime or leveraged (*i.e.*, "higher-risk assets"). The concern is not only the excessive reporting this entails but the fact that the "exposure" would be greatly overstated, often inconsistent across banks, and a biased representation of relative risk. As these definitions have significant financial implications in terms of premiums paid to the FDIC, finding an appropriate formula is in both the FDIC's and the banking industry's interests.

As a consequence, the banks affected under the rule have come together to recommend a consensus solution that significantly improves the definitions of subprime and leveraged loans. These solutions have considerable benefits for the FDIC and for banks. For the FDIC, the suggested definitions more accurately reflect the risks and can be provided by banks in a more consistent fashion; for banks, the suggested definitions better correspond to industry standards and practices of classification of these types of loans and are significantly less expensive to capture and provide to the FDIC. The solution for redefining subprime consumer loans provides the FDIC with much greater information about the probability of default across banks' consumer portfolios and, therefore, provides better insight regarding the relative risk among large banks. The proposed redefinition for leveraged loans focuses the data to be reported on the higher-risk commercial loans and securities that most concern the FDIC.

We realize that adopting the industry's proposed new definitions would require the LBP rule to be revised. *We believe that the importance of having the right definitions is so great that a revision to the rule is imperative.* We note the expectation of the FDIC is that as experience is gained, modifications to the rule would be considered.⁴ While re-visiting the FDIC rule on deposit insurance assessments so quickly after its initial approval is perhaps unusual, it is no surprise that such a complex rule with such significant new data capture and reporting requirements would have immediate unintended consequences that should be addressed as quickly as possible. We believe that the required change in the LBP rule does not alter the fundamental framework of the model but rather significantly improves the data the model relies upon. Because there are financial consequences to banks if this rule does not accurately differentiate relative risk, the need for prompt action to improve the rule is necessary.

We also realize that revising the LBP rule cannot be done instantaneously. *Therefore, we strongly recommend that the current transition reporting rules⁵ be continued until the LBP rule is revised to reflect the new definitions.* This would enable continuity of reporting during the transition to better, more workable, and more accurate definitions. Without continuation of the current transition reporting, banks would be forced to begin collecting data on October 1, 2011, under the current ill-advised definitions, which would waste precious resources that could better be employed to deliver banking services to customers. As LBP banks are expending considerable staff-time and resources to begin tracking loans under the current definitions, quick action to continue the transition reporting rules is critical and would be greatly appreciated by the industry.

Detailed Comments

The following is a brief summary of the recommendations for the risk-based system for LBP banks and changes in reporting under the revised assessment base. The remainder of this letter covers each recommendation in detail.

Risk-Based Assessment System for Large Insured Depository Institutions

- Subprime Consumer Loans: We propose that a measure of subprime consumer loans be developed by the FDIC with a formula that uses balances reported as follows: LBP banks would report consumer loans in their retail portfolios stratified by the one-year probability of default at origination for borrowers as determined by a credit scoring algorithm or system (developed either internally or by a recognized third party vendor), segregated by distinct product categories. The product categories would be determined by the FDIC.
- Nontraditional Mortgage Loans: We propose that nontraditional mortgage loans would be measured in the matrix for subprime consumer loans.

⁴ FDIC, "Assessments, Large Bank Pricing; Final Rule," 76 *Fed. Reg.* 10700 (February 25, 2011).

⁵ Adopted under the existing OMB-approved agencies' emergency clearance request to implement the assessment-related reporting revisions to the Call Report, TFR, and the FFIEC 002/002S reports.

- Leveraged Loans: We propose that factors for the original purpose of commercial loans and securities as well as collateral be added to the definition of “leveraged” loans, and that the *de minimis* threshold be raised to \$5 million.
- Refinancing and Renewal: We recommend that “refinancing” and “renewal” be dropped from the classification point for “higher-risk assets.” Alternately, the terms should be clarified consistent with the goal of capturing risk creation.
- Securitizations: We request a delay in implementing reporting relative to securitizations to provide time for the industry to develop a solution to the insurmountable reporting challenges.
- Implementation Schedule: LBP banks will need time to implement the definitions of “subprime,” “leveraged,” and “securitizations.” If the agencies do not make the changes proposed here, then the LBP institutions will need until at least the second quarter of 2012 to install reliable classification systems and educate staff.
- Derivative Counterparty Exposures: Clarification is needed so that there is a simple and workable approach to reporting counterparty exposures on a consolidated basis. Resolution is needed for the inconsistency between the data used to calibrate the HCI LBP model and data to be reported under the proposal.

Redefined Assessment Base

- Deferred Tax Assets Calculation for Average Tangible Equity: We recommend that banks be permitted to report at each month-end of the quarterly reporting period a pro-rated, one-third estimate of the quarter-end reported amount of deferred tax assets.
- Prepaid Assessments: Prepaid assessments should be deducted from the assessment base or alternately allowed a zero risk-weighting to reflect the absence of risk for this asset.

Risk-Based Assessment System for Large Insured Depository Institutions

Subprime and Leveraged Loans

In a series of conference calls with broad participation from the LBP banks – including literally hundreds of bankers and all of the cosigning trade associations on each call – serious concerns have been voiced with respect to the proposed reporting for subprime and leveraged loans. These concerns stem from how these two terms are defined in the LBP rule. We recommend that the rule’s definitions be revised to measure risk more accurately and consistently across institutions and that reporting in the Call Report and TFR be reconsidered in light of the revised definitions. The recommended definitions presented below represent a consensus among the LBP banks. As noted above, the transition period reporting requirements should be continued until the LBP rule can be changed, and a reasonable implementation period for the revised definitions should be provided as part of the revised rule.

We understand and support the FDIC’s intent to have definitions that improve risk measurement and are applied consistently across insured banks. However, the current specifications do not accomplish this. In modifying systems to implement these definitions, LBP banks are discovering many lingering questions, which make it clear that there will never be consistent application across institutions under these definitions. The growing list of questions being put to the FDIC, some of which are reflected in the expanding “Q&A” document, demonstrates the continuing uncertainties.⁶

The banks are also finding that implementation of the new definitions is not only confusing but costly. It is not a simple matter to rework risk classification systems to be able to flag “subprime” and “leveraged” exposures. In fact, the banks are finding that for some types of loans the classification simply cannot be automated and will always have to be done manually. Based on the implementation experience to date, it is clear that the cost expected by the agencies was significantly underestimated.

Even more serious is the significant mischaracterization of risk in the definitions. The definitions in the LBP rule simply do not correlate with measurements from the highly complex and sophisticated risk grading systems used by all large banking firms. As evidence, an ABA survey found that 10-to-40 percent of the consumer and commercial loan portfolios for most of the LBP banks would be classified as “higher-risk assets” under the LBP definitions, levels unsupportable based on past performance. The broad misclassification of risk will result in systematic mispricing of risk and FDIC assessments.⁷

There are important negative consequences to sticking with the LBP rule definition. LBP banks may factor into the terms of loans and the availability of credit the increased cost of making loans as a result of the regulatory requirements. We note that the LBP banking firms currently hold 87 percent of consumer and 63 percent of commercial bank credit in the U.S. Large segments of the loan book will be misclassified as “higher-risk” and, therefore, will be costly for LBP banks to hold. The banks will have to consider how they can offset the additional cost of student loans, credit services to retirees, asset-based lending, and other credit services, for example.

The proposal acknowledges that “the agencies are currently unable to estimate the amount of this initial burden” of reporting “subprime” and “leveraged” balances under the LBP rule definitions.⁸ Based on the above considerations, we believe that there are very high costs – not just for implementation but also for maintenance of this reporting. In that we see negative benefits – in the form of misclassification of risk, inconsistent application, and harmful effects on credit – we believe that the definitions cannot satisfy a cost-benefit test.

⁶ FDIC, “Questions and Answers Pertaining to the Final Rule on Assessments, Dividends, Assessment Base and Large Bank Pricing: 8/18/11,” www.fdic.gov/deposit/insurance/Final_Rule_QandA.pdf.

⁷ The overstatement of exposure also may serve to disguise the true underlying *trend* in exposures. Thus, more accurate definitions would not only eliminate the overstatement but would make any changes in those holdings over time more apparent and meaningful to the FDIC.

⁸ 76 *Fed. Reg.* 44989 (July 27, 2011).

To address the problems with the current definitions of “subprime” and “leveraged” loans, we offer simple yet effective changes to the definitions to achieve the FDIC’s goals of better risk classification and consistent application, but at a much more manageable cost. Note that our proposed “subprime” definition is sufficiently robust to incorporate “nontraditional mortgage loans” as well, as we recommend. We understand that our recommendations raise a number of new concepts that may require further coordination and cooperation among the agencies and affected banks. LBP institutions and the undersigned trade associations are prepared to participate in discussions with the agencies to flesh out the details of our proposal and to resolve any concerns.

Subprime Consumer Loans

The agencies’ proposal would require LBP banks to report “subprime consumer loans” based on the definition in the LBP rule:⁹

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 mortgage 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;
- 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 percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

LBP banks’ advanced risk grading systems consider these and other factors jointly; banks do not consider a consumer to be a higher-risk borrower solely because he or she was either delinquent on a few recent payments or had a past judgment or has a high debt-to-income ratio. Rating retail credit applicants based on one factor alone would catch many borrowers who are *not* subprime. For example, a lender considers extenuating circumstances that can cause a “prime” individual to miss a payment or two. Moreover, the size and type of delinquencies are important factors as well. Lenders also consider the nature and context of any delinquency, because falling behind on a large installment loan or mortgage is clearly more significant than on a small credit card balance. Lenders further consider the size of any judgment, foreclosure, repossession, or charge-off. If a credit applicant has a minor medical charge-off, a bank would consider whether he or she has otherwise impeccable credit.

Moreover, basing risk classification on debt-service-to-income, ignoring other indicators of debt capacity, is overly simplistic. A borrower with low income but high net worth and a solid credit history, such as many retirees, should not be classified as “subprime.” A loan should also not be automatically characterized as “subprime” if there is good collateral or if there is a guarantor that would not be characterized as “subprime.”

⁹ FDIC, “Assessments, Large Bank Pricing,” 76 *Fed. Reg.* 10723 (February 25, 2011).

The artificially high FDIC assessments, which result from loans being misclassified as “subprime,” will impact some consumer credit segments as the cost of assessments will be factored into the terms of loans and the willingness to provide credit. An example of the problem is the treatment of student loans. Student loans are unlike other consumer loans in that they are evaluated based on an anticipated future income stream, and payments are deferred until some period in the future. In particular, in considering a credit application from a graduate student working toward a professional degree, where there is seldom a cosigner or much income, a lender would consider the future earnings – a factor not considered in the LBP rule’s “subprime” definition. Thus, it seems illogical for student loans to be classified utilizing the same characteristics as other consumer loans.

Proposed Solution:

To alleviate these problems, we recommend that a measure of subprime consumer loans would be developed by the FDIC with a formula that uses balances reported as follows: LBP banks would report consumer loans in their retail portfolios stratified by the one-year probability of default (PD) at origination for borrowers as determined by a credit scoring algorithm or system (developed either internally or by a recognized third party vendor), segregated by distinct product categories. The product categories would be determined by the FDIC.

As a demonstration, we suggest a new reporting table such as Exhibit 1 with six PD bands. Correspondingly, Call Report Schedule RC-O Memorandum Item 8 “Subprime consumer loans” (and the parallel TFR items) would be removed. The data reported in this table would be kept confidential as they reflect the proprietary business strategy of each bank.

Exhibit 1							
Demonstration of Reporting to Determine a Measure of Subprime Consumer Loans and Nontraditional Mortgage Loans							
Probability of Default	Type of Loan						Total
	Category A	Category B	Category C	Category D	Category E	Category F	
Band 1							
Band 2							
Band 3							
Band 4							
Band 5							
Band 6							
Total							

If the reporting form and risk translation algorithm are designed effectively, in collaboration with LBP banks, then this method of assigning a risk measure for exposure to subprime consumer lending would handle many of the misclassification problems in the LBP rule definition. Our proposed definition incorporates and appropriately weighs all the factors articulated in the FDIC’s LBP rule. It would factor in at least some of the unique underwriting, mitigation and other risk characteristics of different consumer loan products; it could be applied consistently across institutions; and it would be much less costly and intrusive for LBP banks to implement

and use. It is a more accurate, comprehensive, and consistent measure of risk exposure than the definition in the final LBP rule.

We anticipate that further discussions would be needed to develop a PD mapping model.

Under the LBP rule and transition provision, individual loans that meet specified conditions are identified as “subprime,” and loans originated or refinanced before October 1, 2011, are to be classified using a bank’s current identification procedures. Because the alternative definition proposed here involves a different system, a different implementation procedure would be required. We propose that banks would classify their entire consumer loan portfolios in the PD distribution when the system as proposed is first put in place. The expectation is that affected banks would try, as best they can, to determine PDs at origination for every consumer loan on their books. However, the banks should be permitted to use refresh PDs in cases where this is not economically feasible.

Two further refinements would be appropriate for special situations with respect to guaranteed loans and batch processing:

- Consistent with how banks evaluate credit, ***if there is a co-signer or guarantor for a consumer loan, then the loan should be considered based on the higher-rated credit of either the borrower or co-borrower/guarantor.*** The Call Report instructions should clarify what the term cosigner means, specifically whether it includes a guarantor.
- ***LBP banks should be allowed to determine “subprime” status at loan origination or alternately in batch at the end of the quarter of origination.*** This provision is consistent with the intent to classify “subprime” lending consistently between institutions, yet it could provide substantial savings of time and cost for banks. Even without this reasonable flexibility, dating the origination of a loan is ambiguous – should it be when a loan agreement is offered, or signed, or when funds are extended? Therefore, this provision would not bias classifications.

Nontraditional Mortgage Loans

The agencies proposed an additional data item for both the Call Report and TFR for reporting nontraditional mortgage loans (*e.g.*, the balance sheet amount of nontraditional 1-4 family residential mortgage loans, including certain securitizations of such mortgages). The new data item would be reported by large institutions and highly complex institutions. Referencing Appendix C of the FDIC’s final rule, which applies only for assessment purposes, the proposal states what would be included in reporting nontraditional mortgage loans, including “teaser rate mortgages.”

We appreciate the clarifications in the current proposal,¹⁰ which address some of the concerns we previously raised in response to the initial request for comment.¹¹ Our comments focus on an

¹⁰See 76 *Fed. Reg.* 45002 (July 27, 2011).

¹¹76 *Fed. Reg.* 14460 (March 16, 2011).

important remaining issue: we believe that nontraditional mortgage loan reporting, as proposed by the agencies, does not distinguish risk between banks or within the population being reported.

Proposed Solution:

Consistent with the recommendation above for subprime consumer loans, *we recommend that banks report nontraditional mortgage loans in their retail portfolios stratified by the one-year probability of default bands at origination for borrowers, as determined by a credit scoring algorithm or system (developed either internally or by a recognized third party vendor)*. This recommendation is consistent with the matrix proposed above for determining subprime consumer loan reporting (see Exhibit 1), and thus we recommend that it be incorporated into that reporting. Correspondingly, Call Report Schedule RC-O Memorandum Item 7, “Nontraditional 1-4 family residential mortgage loans” (and the parallel TFR items) would be removed.

Leveraged Loans

The LBP banks believe that the definition of “leveraged” loans in the LBP rule and the agencies’ proposal does not truly capture the risk as intended. Rather, it captures such a large portion of a LBP bank’s portfolio that it does not provide an adequate method of determining relative risk among institutions.

The problem is that judging risk based solely on EBITDA ratios – with no consideration of the purpose of financing, collateral, or other factors – is not reliable. Such a one-dimensional risk rating does not adequately capture the true exposure and contrasts sharply with the developed and increasingly complex credit risk-rating systems of large banks.

Some classes of commercial borrowers cannot be characterized effectively with one-size-fits-all operating leverage cutoffs. For some investment-grade industries, the predictability of business earnings and cash flows, particularly for amortizing debt, supports substantially more financial leverage. Public utilities, for example, have always enjoyed relatively high leverage (Exhibit 2).

Exhibit 2						
Median Long-Term Debt/EBITDA						
Rating →	AAA	AA	A	BBB	BB	B
Industrials	0.4	1.1	1.5	2.3	3.0	5.3
Utilities		3.0	3.6	4.2	4.6	6.1

Source: S&P 2009 Adjusted Key U.S. and European Industrial and Utility Financial Ratios, pages 1-2. These figures represent the medians over 2007-2009 for 999 U.S. industrials and 215 utilities.

Moreover, measuring all industry and business types on the same basis ignores differences in operations. Firms that traditionally carry high operating leverage, such as car dealerships with floor plan financing, are classified as equivalent credit risks to firms that have leveraged their balance sheets and/or enterprise values to execute significant capital transactions, such as buyouts or recapitalizations. For some industries, operating income ratios are not applicable, such as for lending where commercial real estate may be used for cash flow (as is recognized in the LBP definition).¹² Finally, risk

¹²Examples of segments where debt/EBITDA ratios may not typically be used in credit analysis include transportation, airlines, retail, oil and gas reserves, private equity, asset management, not-for-profit healthcare, real estate, community development, business banking, and loans to automobile dealers.

classification based on operating leverage ratios alone does not distinguish between long-term vs. short-term or working capital vs. capital financing.

Leveraged lending is commonly defined in the banking industry as finance used for buyout, acquisition, or recapitalization and is generally characterized by an under-secured position and reliance on enterprise value and/or intangibles. This lack of a strong secondary repayment source and the resulting increased probability of default (PD) and loss given default risk associated with a debt/EBITDA change is where the risk lies in this lending segment. Therefore, proper identification of risk requires consideration of **both** the ***purpose*** of the lending and the ***operating leverage***; neither the “purpose test” nor operating leverage by itself provides accurate determination. Without considering both tests together, a large number of loans would be captured as leveraged yet do not represent elevated risk. ***We strongly believe that the “purpose test” should be a primary determinant for classifying leveraged loans.***

Another major problem of relying solely on debt/EBITDA is that no consideration is given to the collateral position of a credit. As a result, too many loans are captured as leveraged even though they have a strong collateral backing. For example, under the existing definition, an institution with a large dealer floor-plan business will look the same in this comparison to an institution with a large targeted leveraged loan business, despite the obvious and very different risk profiles of these two business segments. In addition, the asset-based market would be unfairly targeted despite significant collateral, due diligence, and controls (such as increased reporting) typically in this segment. ***Thus, we believe that collateral should be considered in a revised definition.***

We also feel strongly that the *de minimis* level of \$1 million under the LBP rule is too low as it would capture large numbers of business banking/small business loans that would not be considered leveraged. Not only would this overstate “leveraged” exposure, it creates a significant reporting burden as banks generally do not gather all the data required per the existing definition on this segment. This segment is characterized by additional structural enhancements, such as guaranties, owner liquidity considerations, and additional assets and/or net worth from the owner – qualities not captured in a debt/EBITDA measure or in any simple measure. This segment is ***not*** generally characterized by large enterprise-value-based transactions, acquisitions and/or under-secured positions typical in the leverage loan market.

We understand that not all factors that impact the risk profile can be taken into account in a workable regulatory definition, and that there is a benefit to simplicity to improve consistency of application and the resulting comparability. Therefore, we have outlined a proposal that better identifies leveraged risk and provides greater consistency.

Proposed Solution:

We recommend that leveraged loans be defined to include:

- (1) all commercial loans (funded and unfunded) with an original amount greater than **\$5 million** that meet either of the following conditions (a) or (b) at origination, except real estate loans:
 - (a) all of the following:
 - the original purpose of the debt¹³ was to finance a material buyout (equity buyout or ESOP), acquisition (merger or tender offer), or recapitalization (dividends, stock repurchase, or cash-out); **and**
 - 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;¹⁴ **and**
 - the bank is not fully secured on a conforming basis per standard industry norms for the collateral taken;¹⁵ **or**
 - (b) the debt is designated as a highly leveraged transaction (HLT) by a syndication agent.
- (2) securities issued by a commercial borrower that meet either condition (a) or (b) above 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 either condition (a) or (b) above at either origination or renewal, except securities classified as trading book.

We also recommend that the agencies include a provision to allow for de-listing of a leveraged loan when conditions have changed that indicate that classification is no longer appropriate (*e.g.*, the borrowing firm has significantly reduced its debt after a reasonable period of time).

As a final element, we recommend that deposit overdrafts should not be included in either the “subprime” or “leveraged” categories. Such overdrafts are typically transitory and below the \$5 million proposed threshold for “leveraged” loans (even the \$1 million threshold in the current rule). It is unclear at what point a determination would be made as to whether an overdraft is “subprime” or “leveraged.” Requiring systems to make such determinations would impose a tremendous burden on LBP banks and their customers, would cause these banks to reconsider offering this service, and would not satisfy any cost-benefit test.

¹³For purposes of this definition, we recommend that the phrase “original purpose of the debt” means the following: The purpose of the debt should be considered at the time the debt was originally incurred by the borrower. For the purpose of refinancing existing debt, the refinancing institution should consider the purpose of the debt when originally incurred by the borrower at a different institution. This consideration should go back for a period, up to 5 years, for debt that is proposed to be refinanced.

¹⁴For the purpose of this calculation, the only permitted EBITDA adjustments are those specifically permitted for that borrower in its credit agreement or the EBITDA as separately represented by the borrower to the reporting bank.

¹⁵LBP banks are prepared to discuss with the FDIC ways to clarify the term “standard industry norms” for collateral.

Refinancing and Renewal

According to the LBP rule and the agencies' proposal, a bank would classify an exposure as "nontraditional," "subprime," or "leveraged" upon origination or refinancing (consumer loans and mortgages) or renewal (commercial loans and securities). The terms refinancing and renewal are not defined in the rule or proposal but rather in the FDIC's "Q&A." Problematically, the Q&A defines "refinancing" and "renewal" so broadly that every conceivable default avoidance arrangement could trigger reclassification of a loan. At that point, the exposure would be double-counted in the LBP formula: once in the "higher-risk assets" measure and again in the "criticized and classified items" measure. "Higher-risk assets" is in the LBP formula to measure risk creation when the bank takes on the exposure, whereas "criticized and classified items" measures risk evolution. The resultant premium penalty may be so large that it could discourage LBP banks from undertaking workouts and encourage them to proceed directly with write-offs and foreclosures.

To alleviate this problem, *we recommend that "refinancing" and "renewal" be dropped from the classification point for "higher-risk assets."* If not removed, then the terms should be clarified to focus on capturing the creation of risk, not the evolution of risk.

Whether by deleting "refinancing" and "renewal" or clarifying the intent to coincide with risk creation, the following problems should be rectified.

- Troubled debt restructuring (TDR) should not automatically be characterized as "higher-risk." The LBP rule should not discourage default mitigation.
- A contractual deferral of payments should not trigger reclassification of a loan. For example, for most student loans, the original contract allows the borrower to defer the commencement of payments until after graduation. The Q&A specification of "refinancing/renewal" is not consistent with this point.
- To avoid establishing a barrier to bank mergers and acquisitions, reclassification of acquired assets should not be required until the first refresh for the credits – *i.e.*, when loans are recontracted or renegotiated. LBP banks are concerned that they will not have the requisite data to classify "higher-risk assets" in loans and securities acquired from another institution, including through acquisition of another institution, and thus the LBP rule could become a non-market barrier to bank mergers. As a result, it could raise the cost to the FDIC of resolving bank failures, since LBP banks may be unnecessarily inhibited from bidding on a failed bank. Moreover there may be legal challenges to what is called for in the rule.¹⁶

¹⁶Section 604(a) of the Fair Credit Reporting Act strictly limits when a credit bureau can furnish a consumer report to cases including (1) in response to a court order, (2) upon written request from a consumer, and (3) for use in a credit transaction, employment purposes, insurance underwriting, qualification for a government-issued license or benefit, a business transaction, or in review whether the consumer continues to meet the terms of an account.

- Clarification is needed as it relates to open-end lines of credit. The expectation is that evaluation should occur at the creation of extension of credit, so that reevaluation is not required when a line of credit is used, regardless of when that occurs in the immediate or distant future.¹⁷
- Simple rate modifications to reduce the interest rate, or change terms such as a blanket decision to reduce the margin on HELOCs for competitive reasons and not in relation to any recontracting or modification, should not mandate reclassification.

Securitizations

There are complex issues with regard to securitizations, and the resolution of those issues will require a thoughtful and comprehensive approach. ***The industry requests a delay in implementing reporting relative to securitizations to provide time for the industry to develop a solution to the insurmountable reporting challenges.***

A major problem is that the definitions of “subprime” and “leveraged” securitizations in the LBP rule and the proposal would mandate that LBP banks evaluate the underlying collateral assets on a loan-by-loan basis to meet the criterion to be captured for reporting purposes. This would leave the holders of securities dependent on third party investor reporting for the information needed to comply. However, ***the underlying data are not available for all securitizations because the collection of this information is not market standard.*** Certain securitizations contain loans from entities not subject to LBP reporting requirements and, therefore, do not collect the data required to determine whether such loans meet the definitions. In short, LBP institutions do not currently have access to granular obligor level data, and it has not been established that servicers/vendors have access to such data or that they have the infrastructure in place to capture granular obligor-level details.

We note that the standard for determination for a securitization has been set by FDIC staff in the “Q&A” – not through the public notice and comment process where the FDIC Board and other agencies have a chance to hear practical views on the issues involved.¹⁸ In consequence, insufficient consideration has been given to the challenges involved in compliance with classifying securitizations.

More fundamentally, categorizing securitizations as “higher-risk assets” based solely on the underlying collateral ignores important determinants of the risk of the exposure. This approach fails to differentiate between the positions of security holders in the cash flow waterfall or other structural components and the whole loan holder. Such structural components may include the daily or weekly mark-to-market requirement, conservative advance rates, and credit enhancements in the securitization structure. Therefore, simply using the nature of the underlying assets as the basis for reporting does not appropriately differentiate these assets.

¹⁷The answer to Q2 under “Determination of Higher-Risk Assets” in the Q&A could be construed to indicate that evaluation is required upon each draw.

¹⁸According to the response to “Q9” under “Determination of Higher-Risk Assets” in the Q&A, the FDIC specifies that the determination would depend on whether the security is acquired from a “large” bank, a non-“large” bank, or a non-bank.

The implications of moving forward are severe and should not be underestimated: what is being asked for may freeze the securitization market (which is already struggling to recover from the financial crisis). We note that LBP institutions are major participants in the market and holders of securitizations of all sorts. Requiring this reporting may create a scenario where LBP banks would have to stop purchasing these securities since they would not be able to comply. This would further limit the ability of other banks, including those not subject to LBP, to sell assets into securitizations. ***Therefore, we urge the agencies not to move forward until there is a workable solution to the challenge of reporting “higher-risk” securitizations.***

Implementation Schedule

LBP banks are discovering that, as hard as they are all working to implement the “subprime,” “leveraged” and “securitizations” definitions in the LBP rule and proposal, none is confident of having systems up and running to produce results that bank officials can attest to by October 1 when data capture must begin. As the implementation process has proceeded, question after question has been raised. While the FDIC has endeavored to post answers to questions, new ones arise every day. Every new question and answer posted in the Q&A adds to the adjustments needed, making the process a major operational challenge. In addition, the ambiguities of the definitions are such that very large numbers of individuals on LBP banks’ lending, financial reporting, and risk management staffs will have to become Q&A experts. Substantial training time is needed.

If the agencies amend the definitions of “subprime” and “leveraged” as recommended here, LBP banks believe that they can make the requisite adjustments faster. Even with these improved definitions, which the banks feel they can put in place faster than the LBP definitions, they will need time for implementation.

If, however the agencies do not make the proposed changes in the definitions, then the LBP institutions will need until at least the second quarter of 2012 to install reliable classification systems and train staff to input the required data.

Derivative Counterparty Exposures

The proposed Call Report revisions call for highly complex institutions (HCIs) to report two new line items for (1) the total amount of the institution’s 20 largest derivative counterparty exposures, and (2) the amount of the institution’s largest derivative counterparty exposure, respectively.

A counterparty exposure is defined in the proposal as 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 [of the counterparty]. This definition presents two major operational challenges to be addressed.

First, discussions among HCIs reveal that there are different interpretations of the term “legal consolidated entity”, and there is no clear view as to how counterparty exposures are to be rolled up to the consolidated level. ***Clarification is needed so that there is a simple and workable***

approach to reporting counterparty exposures on a consolidated basis. It is not always possible to recognize connections between counterparties, and there is no industry standard to do so. In fact, an outstanding Office of Financial Research proposal considers creation of unique identifiers for derivative counterparties, demonstrating regulatory recognition of unanswered questions on consolidating counterparty exposures.¹⁹ Thus, this reporting requirement is not appropriate at this time.

Second, ***resolution is needed for the inconsistency between the data used to calibrate the HCI LBP model and those to be reported under the proposal.***

In commenting on the March 16, 2011, proposal on reporting changes,²⁰ ABA recommended that HCIs be permitted to report the same EAD as in the FFIEC 101 schedules produced for the “parallel run.” Any institution that has received approval to use the Internal Models Methodology (IMM) from its primary federal regulator would seek to use this approach to report EADs.²¹ However, as proposed, without such approval, an HCI would have to calculate EADs using either the “current exposure methodology” in accordance with appropriate outstanding capital regulations or the credit-equivalent amount in accordance with Call Report Schedule RC-R item 54.

We continue to feel that any requirement to produce an EAD under a methodology different from that used in filing FFIEC 101 would be excessively burdensome for the HCIs and would be inconsistent with the risk associated with these exposures. Since the LBP was calibrated based on the EADs reported in the FFIEC 101, any deviation from these EADs would require a recalibration of the assessment.

We respect the agencies’ reservations against the use of IMM models that have not received regulatory approval. Therefore, until some HCIs have received such approval, we recommend that the FDIC should review the counterparty exposures that HCIs report as required as well as the EADs based on FFIEC 101 calculations that the HCIs submit separately, and consider whether the HCI assessment pricing model should be adjusted for calibration bias. Moreover, the FDIC should be sensitive to this issue when considering whether the assessment rate should be adjusted for each HCI under the established premium adjustment procedure.

Over the longer-run, after an HCI’s IMM models are accepted, it should be allowed to use its certified IMM models to revise earlier-reported counterparty EADs and true-up past FDIC assessments. Moreover, given the extended time observed to complete “parallel runs,” we recommend that the agencies accept for FDIC assessments purposes (not necessarily for capital

¹⁹ See 75 Fed. Reg. 74146 (November 30, 2010).

²⁰ 76 Fed. Reg. 14460 (March 16, 2011).

²¹ See Risk-Based Capital Reporting for Institutions Subject to the Advanced Capital Adequacy Framework – FFIEC 101.

purposes) results from an institution's IMM models – provided the IMM models are acceptable – prior to its exit from its parallel run.

Redefined Assessment Base

Deferred Tax Assets Calculation Frequency for Average Tangible Equity

In response to the agencies' March 16, 2011, proposal regarding average Tier 1 capital disclosure, ABA responded that while we believe "it is industry practice for many banks to calculate their risk-based capital numbers on a monthly basis, we do not believe it is industry practice for banks to update their provision/allowance and deferred tax calculations more than quarterly. Since these two items are potentially significant drivers of the capital calculations, we recommend that the agencies clarify that they accept that these two drivers may not be updated for the interim monthly capital calculations, and that a quarter-end calculation is acceptable."

After consideration of this comment, the agencies responded in the July 27, 2011, joint notice and request for comment.²² They stated "although the agencies acknowledge that institutions' 'provision/allowance and deferred tax calculations' many not be updated at month-ends prior to quarter-end by recording amounts determined in full compliance with GAAP, it would not be acceptable to recognize no provision or income tax expense in the months before quarter-end when an institution reasonably expects that some amount will need to be recognized for the quarter."

For some banks, the agencies' re-proposal requirement²³ that affected banks must still provide some estimate of a month-end Tier 1 capital number for Call Report Schedule RC-O, including deferred tax assets (DTAs), is problematic, given the fact that they do not have monthly provision calculations or DTA calculations.

We recommend that the agencies clarify that banks that do not have monthly provision or DTA calculation will be permitted to report at each month-end of the quarterly reporting period a pro-rated, one-third estimate of the quarter-end reported amount. In other words, the banks would report, for each month-end, the DTA calculated on a quarterly basis divided by three.

²²See 76 *Fed. Reg.* 44995 (July 27, 2011). The agencies stated "[m]onth-end averaging for tangible equity in the FDIC's final rule was not intended to impose a fully GAAP-compliant requirement for monthly updating of loan loss allowances and deferred tax calculations for months other than quarter-end. However, the agencies believe that it is sound practice to accrue provision for loan and lease losses expense and income tax expense on some reasonable basis during the first two months of a quarter and then 'true-up' these expenses for the quarter on a GAAP-compliance basis at quarter-end, rather than ignoring these expenses until the final month of the quarter."

²³See the proposal at 76 *Fed. Reg.* 44995 (July 27, 2011).

There would be significant costs for banks that do not currently calculate DTAs on a monthly basis to comply with the reporting requirements of the proposal, and it may require additional staff to do such calculations on a monthly basis. The costs of complying with the proposed requirement to provide some estimate for each month-end of the quarter would outweigh the benefit of reporting the calculation each month. Our recommended solution would help reduce the costs of compliance without biasing the result.

Prepaid Assessments

We feel strongly that prepaid FDIC assessments should not be included in the FDIC assessment base for any bank. There is no justification for the FDIC to force insured banks to give the funds to the agency then assess them fees for making the interest-free loans. ***If, however, the FDIC believes that it is constrained by law to include prepaid assessments in the assessment base, then this asset should be allowed a zero risk-weighting in the risk-based premiums formula to reflect the absence of risk for this asset.***

Conclusion

We appreciate the opportunity to comment on the proposed revisions included in the Joint Notice and Request for Comment. Please contact Robert Strand at (202) 663-5350 or rstrand@aba.com if you have any questions. Thank you for considering our comments and recommendations.

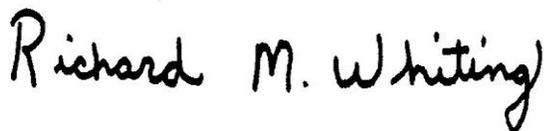
Sincerely,



Wayne A. Abernathy
Executive Vice President
Financial Institutions Policy
and Regulatory Affairs
American Bankers Association



Eli K. Peterson
Vice President & Regulatory Counsel
The Clearing House Association L.L.C.



Richard M. Whiting
Executive Director and General Counsel
Financial Services Roundtable

Appendix

The Associations

The **American Bankers Association** represents banks of all sizes and charters and is the voice for the nation's \$13.6 trillion banking industry and its 2.1 million employees. The majority of ABA's members are banks with less than \$165 million in assets. Learn more at www.aba.com.

Established in 1853, **The Clearing House** is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org.

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