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HEADNOTE: DODD-FRANK MOVES FORWARD
Steven A. Meyerowitz

FEDERAL RESERVE ADOPTS KEY DODD-FRANK ACT DEFINITIONS
Satish M. Kini, Michael P. Harrell, and Gregory J. Lyons

IN *FONTAINEBLEAU* DECISION, ELEVENTH CIRCUIT CONFIRMS THAT TERM LENDERS LACK STANDING TO ENFORCE REVOLVING LENDERS' COMMITMENTS
Jason White, Joseph Frank, Daniel Kahn, and Adam Dickson

USING PATENTS TO PROTECT FINANCIAL PROCESS INNOVATIONS IN EUROPE, CHINA, AND INDIA
Stephen T. Schreiner and Noah M. Lerman

EVOLVING DDOS ATTACKS PROVIDE THE DRIVER FOR FINANCIAL INSTITUTIONS TO ENHANCE RESPONSE CAPABILITIES
Kimberly K. Peretti and Maki DePalo

WHAT DEPTH OF RESPONSIBILITY DO CREDITORS AND LENDERS HAVE TO MAINTAIN THE VALUE OF COLLATERAL IN THEIR POSSESSION?
Eric J. Rans and David Williams

NEW FDIC RULES ON "HIGHER RISK SECURITIZATIONS" AND THE IMPACT ON CLOS: THE TEAPOT TEMPEST
John M. Timperio and Gordon L. Miller

INTEREST, RIBIT, AND RIBA: MUST THESE DISPARATE CONCEPTS BE INTEGRATED OR IS A MORE NUANCED APPROACH APPROPRIATE FOR THE GLOBAL FINANCIAL COMMUNITY? — PART II
Leonard Grunstein

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New FDIC Rules on "Higher Risk Securitizations" and the Impact on CLOs: The Teapot Tempest

JOHN M. TIMPERIO AND GORDON L. MILLER

The authors argue that the new FDIC rules on CLOs will not result in a significant slowdown in CLO issuance, a material increase in the price of CLO liabilities or a permanent reduction in the CLO buyer base.

The Federal Deposit Insurance Corporation's ("FDIC") new rules for calculating deposit insurance assessments for large institutions and highly complex institutions have provoked a considerable amount of debate, discussion, speculation and consternation among those institutions that are active investors in collateralized loan obligations ("CLOs") and other asset managers, investors and underwriters in the CLO market.[1]

For reasons we will explain, we believe that, much like previous "crises" that would purportedly derail the resurgence of the CLO market (*e.g.*, the European debt crisis, the fiscal cliff and the new "commodity pool" regulations adopted by the Commodities Futures Trading Commission), the ultimate effect of the new FDIC rules will be far less significant than some are predicting in terms of their incremental impact on deposit insurance assessments attributable to CLO holdings and in all cases will be fact-specific to a given institution.

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Nevertheless, we do expect a number of impacts on CLOs, including the following:

- A temporary pullback by *some* bank purchasers of CLOs is possible as their internal regulatory departments sort through the impact of the new rules on the mix of assets owned by the institution. However, underscoring how idiosyncratic the impact of the new rules will be and the applicability of the old saw that there are two sides to every coin, it is possible that *other* banks that are maxed out under the concentration measure for higher risk assets under the new deposit assessment rates will be incentivized to *buy* CLOs since their assessment rate would not change under the new rules even with the increased concentration. Thus, a pullback by some bank and non-bank investors might be met and offset by a significant uptick in purchases by other such investors. In either event, we expect that any pullback by some banks will be short-lived and expect that the animal spirits and appetite for CLOs among all bank purchasers and other investors will rebound rather quickly;
- Rather than banks pursuing a wholesale strategy of purchasing low(er) rated tranches, we expect some internal hedging to emerge in which banks purchase both senior tranches as well as tranches further down the capital structure of CLOs and, in this way, create a natural mechanism for themselves to cover the real or perceived added cost attributable to the assessments;
- A pricing delta may open up between pre-April 1 and post-April 1 CLOs due to the application post-April 1 of the new standards for identifying leveraged loans and CLOs, since the new standards lack some of the latitude provided by the pre-April 1 transitional guidance and may require more CLOs to be classified as higher-risk assets than previously was the case. We do not expect the delta to be significant and expect it to diminish over time;
- The post-April 1 markets for both CLOs and leveraged loans should factor the projected additional assessment costs into their pricing structures and find a natural floor, thereby providing a means for CLOs of post-April 1 leveraged loans to create the type of arbitrage opportunity for the

equity class in a deal that would facilitate new issuance even in the face of narrower spreads;

- We expect a new alignment of interests to emerge between managers of CLOs and banks that are senior investors in seeking to maximize ways to add new assets to existing pre-April 1 CLOs, including through the use of amend-to-extend transactions to extend the life of those transactions;
- Market participants will have license to explore the limits of their creativity (and the bounds of investor appetite) to structure new CLO products that do not fall within the definition of "higher risk securitizations," including by looking at hybrid pools of assets that consist of less than 50 percent of leveraged loans and include a mix of other cash-flowing assets that would not trigger a negative assessment; and
- Finally, the new rules may also give impetus to middle-market CLOs, which typically price wide of CLOs of broadly syndicated loans.

BACKGROUND OF THE NEW RULE

On February 25, 2011, the FDIC published a final rule, as required by the Dodd-Frank Act, which established a new methodology for calculating deposit insurance assessments ("2011 Rule").[2] The 2011 Rule replaced the previous supervisory ratings-based and capital-based methodology with an asset-based methodology, which measures and evaluates an institution's assets in order to set its assessment base and its assessment rate. For large institutions and highly complex institutions,[3] the 2011 Rule, among other things, introduced a "scorecard" that combines an institution's CAMELS ratings and certain forward-looking financial ratios to assess the risk the institution poses to the Deposit Insurance Fund.[4]

One of the financial ratios included in the scorecard is the ratio of an institution's higher risk assets to tier 1 capital and reserves.[5] In the 2011 Rule, four loan categories–construction and development loans, leveraged loans, nontraditional mortgage loans and subprime consumer loans–were combined to create the numerator of this ratio.[6] The FDIC relied on existing interagency guidance to define the latter three of these four categories,

including guidance on leveraged loans in the Office of the Comptroller of the Currency's handbook on leveraged loans ("OCC Handbook").[7] However, since banks and thrifts prior to the 2011 Rule did not report data separately for these types of loans in their call reports and thrift financial reports, respectively, the FDIC and the other federal banking agencies proposed to revise these reporting forms to add new line items for these loan categories.[8] In public comments, the FDIC learned that many institutions were concerned that they would be unable to implement the proposed reporting requirements, and the FDIC postponed the deadline for implementing the higher risk asset definitions from June 30, 2011 to October 1, 2011, then to April 1, 2012 and finally to April 1, 2013.[9]

During this transitional period, large institutions and highly complex institutions were required to use the 2011 Rule scorecard to calculate their deposit insurance assessment rate. However, instead of using the criteria in Appendix C of the 2011 Rule to identify leveraged loans, nontraditional mortgage loans and consumer subprime loans, they were permitted to use their existing internal methodologies or the criteria in existing supervisory guidance.[10]

In anticipation of final implementation of the new reporting requirements and in response to public comments, the FDIC in the 2013 Rule revised the scorecard in certain respects. It added a fifth category of higher risk assets, described as "higher risk securitizations," in which securitizations containing assets in the four higher risk categories included in the 2011 Rule are covered.[11] The 2013 Rule also clarifies how leveraged loans are to be identified, as described below.[12] The FDIC rejected suggestions that credit enhancements and the structure of a securitization (*i.e.*, the position and width of the particular tranche purchased) be taken into account when determining whether a securitization is a higher risk securitization.[13]

The definitions of leveraged loans, nontraditional mortgage loans and subprime consumer loans in the 2011 Rule did not go into effect during the transition period, but large institutions and highly complex institutions were required during this period to take their higher risk assets, including CLOs, into account when calculating their deposit insurance assessment rate. Applying the transitional call report instructions, these institutions were permitted to use a variety of criteria to identify CLOs. Institutions that already identified CLOs could continue to use their existing methodologies; other institutions

were required to follow guidance provided by their primary federal banking supervisor or by the OCC Handbook. These criteria may have been more or less inclusive than the single standard set to take effect under the 2013 Rule. For example, under the 2013 Rule, a leveraged loan (referred to as a "higher-risk C&I loan") must be in an original amount, funded and unfunded, of at least $5 million, subject to certain exclusions; prior thereto, for call report or other purposes, an individual institution may have used a higher or lower threshold amount and different exclusions. Under the 2013 Rule, a leveraged loan also must meet a purpose test (*i.e.*, be used to finance a buyout, acquisition or capital distribution) and a materiality test (*i.e.*, be equal to 20 percent or more of the borrower's total funded debt, not including the loan in question, or the borrower must have no other funded debt) on the date the loan is made; an individual institution's methodology may have been different. In addition, under the 2013 Rule's leverage test, a borrower's ratio of total debt to trailing 12-month EBITDA must be greater than 4:1 or its ratio of senior debt to trailing 12-month EBITDA must be greater than 3:1; an individual institution may have used a different leverage test.[14] Finally, the 2013 Rule defines a "higher risk securitization" of commercial and industrial loans (*i.e.*, a CLO) as a securitization in which more than 50 percent of the underlying obligations are leveraged loans (if the CLO is secured by a static pool) or more than 50 percent may be leveraged loans under the portfolio guidelines (if the CLO is secured by a dynamic pool).[15]

Based on this background, several observations may be made:

- Large institutions and highly complex institutions have been required to account for their CLO holdings in the calculation of their deposit insurance assessment rates since April 1, 2011, albeit for most institutions the new rules will require a change in the methodology employed to identify CLOs and will result in a concomitant increase in the amount of such holdings identified;
- The criteria for identifying leveraged loans under the 2013 Rule may be more inclusive than the criteria that an individual institution used previously or has used under the FDIC's transition guidance, but it should not be a sea change;
- The criteria for identifying CLOs under the 2013 Rule also should not

be a sea change. Under the 2011 Rule, an institution could use its previous methodology to identify leveraged loans and CLOs, if it had such methodology, or it could follow agency guidance to identify those assets, but ignoring CLOs was not an authorized option;[16] and

- While the 2013 Rule may be disappointing to some because it does not follow the federal banking agencies' capital adequacy guidelines and fails to recognize the seniority of a particular tranche of CLO notes in the capital structure of a securitization or a note's credit rating when identifying higher risk securitizations, this does not represent a loss or erosion of more favorable treatment previously in use, since asset-based deposit insurance assessments were not calculated before the 2011 Rule.

The points above should moderate the impact of the 2013 Rule on the amount of higher risk assets identified by an institution. Furthermore, as discussed below, the ratio of higher risk assets to tier 1 capital and reserves is only one of several data points used to calculate an institution's assessment rate. Other data points and subsequent calculations may further moderate or cancel altogether the effect of the treatment of CLOs on the assessment rate.

ADDITIONAL STEPS IN CALCULATING THE ASSESSMENT RATE

Following the determination by an institution of its ratio of higher risk assets to tier 1 capital and reserves, this ratio is converted into a score, and this score is compared to the institution's score for growth-adjusted portfolio concentration (in the case of large institutions) or to two separate scores for counterparty exposure (in the case of highly complex institutions). The higher (or highest) score constitutes an institution's concentration measure. If an alternative score is higher, an institution's ratio of higher risk assets to tier 1 capital and reserves plays no further direct role in the calculation of its deposit assessment rate. Indeed, an institution may have an incentive to increase its investment in CLOs or other higher risk assets if, for example, its score for this ratio has already reached its cap or an alternative score is higher.

Other measurements are taken of an institution's ability to withstand

asset-related stress, consisting of the institution's tier 1 leverage capital ratio, ratio of core earnings to average quarter-end total assets and two measures of credit quality. The concentration measure constitutes 35 percent of the total asset-related stress score. This score is then combined with a score for the institution's ability to withstand funding-related stress and a score based on a weighted average of the institution's CAMELS ratings to arrive at a performance score. The total asset-related stress score constitutes 50 percent of the performance score.

An institution's performance score is combined with a separately calculated loss severity score to produce a total score, which is converted into a loss severity factor between 0.80 and 1.20. This factor may be adjusted by the FDIC upward or downward by a maximum of 15 basis points based on risk factors not captured by the measurements described above. This factor also may be adjusted downward based on the amount of unsecured debt issued by the institution and the amount of unsecured debt of other insured depository institutions that it holds, and upward based on the amount of brokered deposits that it holds. After these adjustments, if any, a large institution or highly complex institution has a deposit assessment rate.

The calculations above indicate that an institution's concentration measure contributes 17.5 percent of its performance score. An increase in the volume of identified CLOs may contribute incrementally to the concentration measure and to the performance score. All things being equal, more CLOs may increase a deposit assessment rate. However, there are more than 15 items in addition to the amount of higher risk securitizations that also are measured and that are unlikely to remain equal, and they also contribute to the performance score.

CONCLUSION

To sum up: We believe that the impact of the new FDIC rules on CLOs is a tempest in a teapot in that the predictions of a significant fluctuation in large institutions' or highly complex institutions' deposit assessment rates based on the implementation of the 2013 Rule substantially overstate the rule's likely effect. In addition, while we believe there will likely be some period of time post-April 1 during which the impact of the changes is di-

gested and socialized, the dire extrapolations of that impact suggesting a significant slowdown in CLO issuance, a material increase in the price of CLO liabilities and/or a permanent reduction in the CLO buyer base are implausible.

NOTES

[1] *See, e.g.*, Christine Idzelis, "FDIC Rule May Limit CLO Spread Narrowing, Morgan Stanley Says," Bloomberg (Mar. 11, 2013).
[2] 76 Fed. Reg. 10672.
[3] A "large institution" is an insured depository institution with assets of $10 billion or more that is not a highly complex institution. A "highly complex institution" is an insured depository institution, other than a special purpose credit card bank, with assets of $50 billion or more that is controlled, directly or indirectly, by a U.S. holding company with consolidated assets of $500 billion or more. 12 C.F.R. 327.8(f) and (g).
[4] *See* 2011 Rule at 10688.
[5] 12 C.F.R. 327.9(b)(1) and (2).
[6] 12 C.F.R. Part 327, App. A(VI).
[7] *See* 12 C.F.R. Part 327, App. C(A)(2) n.5.
[8] *See* 77 Fed. Reg. 66000 (Oct. 31, 2012) ("2013 Rule").
[9] 2013 Rule at 66000-66001.
[10] *See*, FFIEC Forms 031 and 041, Instructions for Preparation of Consolidated Reports of Condition and Income, Schedule RC-O—Other Data for Deposit Insurance and FICO Assessments, General Instructions for Memorandum Items 6 through 17 (updated through September 2012).
[11] 2013 Rule at 66001, 66010, and 66015-66016.
[12] 2013 Rule at 66017-66020.
[13] 2013 Rule at 66011.
[14] 2013 Rule at 66017-66018. "EBITDA" is defined in the 2013 Rule as earnings before interest, taxes, depreciation, and amortization. *Id.*
[15] 2013 Rule at 66023. Securitizations that are part of an institution's trading book are not included in the definition.
[16] Since June 2011, the transition guidance in the call report instructions has provided that an institution "may use its existing internal methodology for identifying… *leveraged loans and securities* as the basis for reporting those assets for deposit insurance assessment purposes…. Institutions that do not have an existing methodology in place to identify…*leveraged loans and securities*…may, as an alternative to applying

the definitions in the FDIC's assessment regulations …, apply existing guidance by their primary federal regulator…or the February 2008 Comptroller's Handbook on Leverage Lending for purposes of identifying…*leveraged loans…and leveraged securities*." (Emphasis added.) (Citation omitted.)