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FDIC

Supervisory Insights

Supervisory Insights is published by the Division of Risk Management Supervision of the Federal Deposit Insurance Corporation to promote sound principles and practices for bank supervision.

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Issue at a Glance

Volume 17, Issue 1 Summer 2022

Articles

Although the economic effects of the pandemic appear to be easing, the impacts, including on the commercial real estate (CRE) sector, may be lasting, may have exacerbated existing secular trends, or both. This article highlights the financial performance of banks concentrated in CRE lending as well as examination observations about CRE lending risk management practices. The article also describes the FDIC's forward-looking supervisory focus for banks with significant exposure in this sector.

Banking organizations continue to issue subordinated debt to meet regulatory capital and funding objectives, and a number of insured depository institutions have invested in the subordinated debt of other institutions. The issuance of subordinated debt has benefits and risks for banking organizations, and financial institutions should remain aware of the generally applicable capital rule's requirements. This article is intended to help financial institutions better understand the capital, investment, and financial reporting requirements for the issuance of and investment in subordinated debt. The article also describes the treatment of subordinated debt for deposit insurance assessment purposes.

Regular Features

This feature provides an overview of recently released regulations and other items of interest.

Letter from the Director

Supervisory Insights provides a forum for a discussion of issues and trends identified through the FDIC's examination and supervisory activities.

"Commercial Real Estate: An Update on Bank Lending Amid the Evolving Pandemic Backdrop" examines the financial performance of banks with a commercial real estate (CRE) concentration since the onset of the COVID-19 pandemic through year-end 2021. The article also provides examination observations related to CRE lending risk management practices and discusses the FDIC's supervisory focus for banks with significant CRE portfolios.

Banking organizations continue to issue subordinated debt to meet regulatory capital and funding objectives, and a number of insured depository institutions have invested in the subordinated debt of other institutions. "Subordinated Debt: Issuance and Investment Considerations" is intended to help financial institutions better understand the capital, investment, and financial reporting requirements for the issuance of and investment in subordinated debt. The article also describes the treatment of subordinated debt for deposit insurance assessment purposes.

The Summer 2022 issue of *Supervisory Insights* includes an overview of regulations and other items of interest released since January 2022. A listing of entries dating from the publication of the Fall 2019 issue of the journal through year-end 2021 is available upon request.

We hope you find both articles in this issue of *Supervisory Insights* to be useful. We encourage our readers to provide feedback and suggest topics for future issues. Please email your comments and suggestions to SupervisoryJournal@fdic.gov.

Doreen R. Eberley
Director
Division of Risk Management Supervision

Commercial Real Estate: An Update on Bank Lending Amid the Evolving Pandemic Backdrop

Introduction

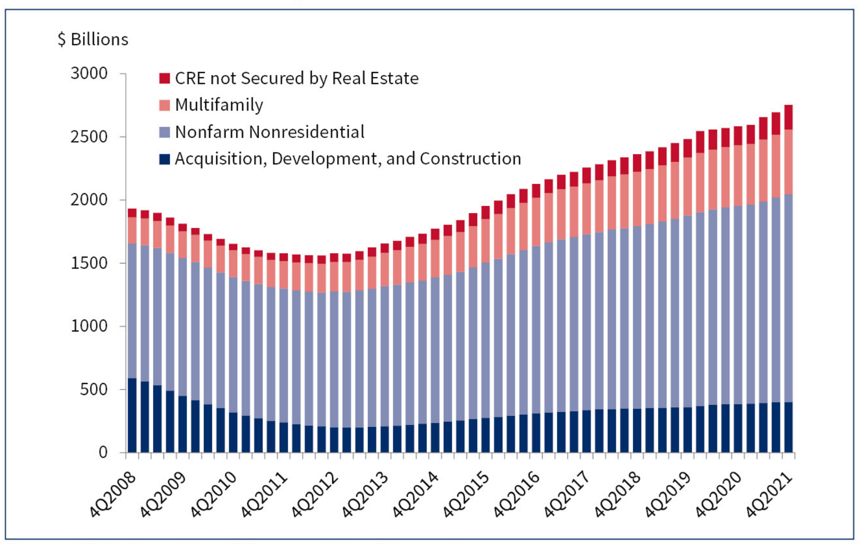
Banks[1] serve an essential role in their communities by providing commercial real estate (CRE) financing. In fact, more than 98 percent of banks engage in CRE lending and CRE loans are the largest loan portfolio type for nearly half of all banks. The dollar volume of CRE loans is at an historic high, and a growing number of banks report CRE concentrations. But lending concentrations – sometimes a necessity of doing business, particularly for smaller banks – are not by definition problematic. The majority of banks with CRE loan concentrations are satisfactorily rated. Nevertheless, CRE loan concentrations add dimensions of risk that necessitate continued attention from banks and their regulators, especially as the pandemic lingers and uncertainties remain.

This article examines the financial performance and credit quality metrics of CRE-concentrated banks through year-end 2021, as well as pandemic impacts on CRE markets. The article also provides examination observations about CRE lending risk management practices. Lastly, the article discusses the FDIC's supervisory focus for banks with significant CRE portfolios.

CRE Lending is a Significant Business Line for Many Banks

Banks remain heavily engaged in CRE lending with the volume of CRE loans held by banks recently peaking at more than $2.7 trillion. This is well above the $1.9 trillion held in 2008 (see Chart 1). At year-end 2021, FDIC-supervised banks held almost $1.1 trillion in CRE loans.

Chart 1: CRE Loan Trends, by Type, at Banks



Source: FDIC; Consolidated Reports of Condition and Income.

[1] For purposes of this article, the term "banks" refers to FDIC-insured depository institutions.

Commercial Real Estate

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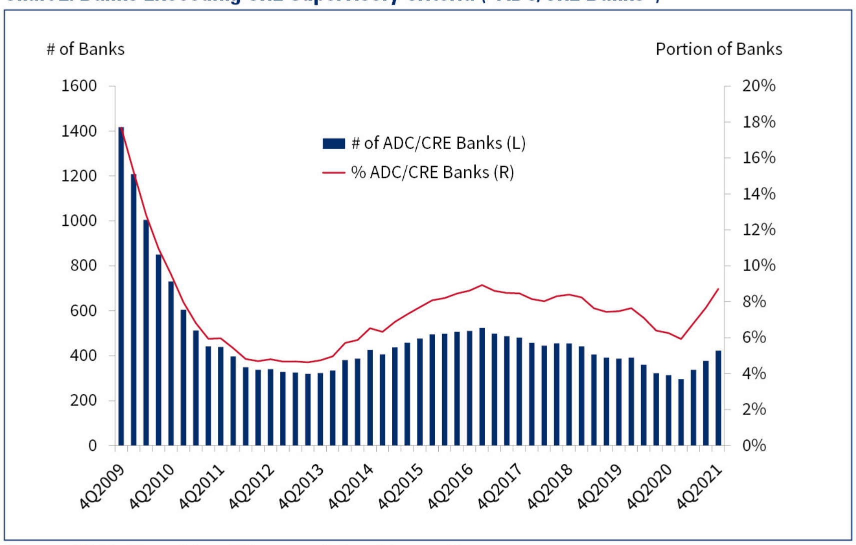
Community banks, which are largely FDIC-supervised, held $795.7 billion.[2] As reported in the FDIC's fourth quarter 2021 *Quarterly Banking Profile* (QBP), growth in nonfarm nonresidential CRE loan balances drove that quarter's increase in community banks' loan balances.[3] In addition, the banking industry is exposed to CRE via holdings of commercial mortgage-backed securities (CMBS), albeit below the levels of CRE loan exposures.[4]

Chart 2: Banks Exceeding CRE Supervisory Criteria ("ADC/CRE Banks")



Source: FDIC; Consolidated Reports of Condition and Income.

At year-end 2021, 25 percent of banks had a funded CRE loan concentration in excess of 300 percent of tier 1 capital and reserves for loan losses.[5] This is relatively unchanged compared to year-end 2019, prior to the pandemic.

Meanwhile, at year-end 2021, 422 banks met one or both of the supervisory criteria pursuant to the interagency supervisory guidance entitled "*Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*," up from 313 the previous year (see Chart 2).[6] One criterion is that total reported loans for construction, land development, and other land represent 100 percent or more of the bank's tier 1 capital plus the allowance for loan and lease losses (ALLL) or the portion of the allowance for credit losses (ACL) attributable to loans and leases, as applicable (hereafter referred to as the Acquisition, Development, and Construction (ADC) Lender Group). The other criterion is that total CRE loans as defined therein[7] represent 300 percent or more of the bank's tier 1 capital plus the ALLL or applicable portion of the ACL, and the outstanding balance of the bank's CRE portfolio has increased by 50 percent or more during the prior 36 months (hereafter referred to as the

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[2] "Community banks" refer to FDIC-insured institutions meeting the criteria for community banks described in the *FDIC Community Banking Study* published in December 2020. See page A-1 at https://www.fdic.gov/resources/community-banking/report/2020/2020-cbi-study-full.pdf.

[3] See the QBP at https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/2021dec/. The community bank performance section starts on page 15 of that report; loan growth comments begin on page 16.

[4] See "CRE: Resilience, Recovery, and Risks Ahead" within *FDIC Quarterly*, 2021, Volume 15, Number 4, at https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2021-vol15-4/article1.pdf.

[5] This measure is not a regulatory limit nor is it a safe harbor. For purposes of this article, concentration calculations do not consider unfunded commitments.

[6] See FIL-104-2006, "Commercial Real Estate Lending Joint Guidance,"at https://www.fdic.gov/news/financial-institution-letters/2006/fil06104.html.

[7] Essentially defined as non-owner occupied.

CRE Lender Group).[8] These levels are not safe harbors nor regulatory limits. Rather, regulators may identify a bank that is approaching or meets the criteria, or that has notable exposure to a specific type of CRE, for further supervisory analysis. Going forward, this article refers to the ADC Lender Group and the CRE Lender Group as ADC/CRE Banks in aggregate and defines banks not meeting either of the criteria as All Other Banks.

In 2020 and into first quarter 2021, the count of ADC/CRE Banks dipped as in-process construction projects stalled and project starts were delayed in response to the economic impact of pandemic-related shutdowns. Concurrent with easing of the pandemic's impact on economic activity, lending began to rebound. Largely due to ADC lending, the count of ADC/CRE Banks increased by 127 between the first and fourth quarters of 2021. At about nine percent, the level of ADC/CRE Banks to total banks remains well below the same measure during the Great Recession (see Chart 2). About 70 percent of the ADC/CRE Banks are FDIC-supervised.

Select Performance Trends at CRE-Concentrated Banks

When banks select and underwrite risks prudently and oversee portfolios diligently, consistent with safe and sound lending principles,[9] CRE lending can be a profitable business line. As displayed by medians in Table 1, the CRE Lender and ADC Lender Groups currently exhibit higher pre-tax returns on average assets (ROAA) than All Other Banks.[10] However, they still operate with a generally higher-risk profile, including

Table 1: Median Financial Metrics

Comparison of Median Financial Ratios (as of December 31, 2021)

	ADC Lender Group	CRE Lender Group	All Other Banks
Tier 1 Leverage Ratio	9.53%	9.50%	10.01%
Tier 1 Leverage Capital and Reserves to Total Assets	10.23%	10.24%	10.64%
Pre-tax ROAA	1.57%	1.49%	1.26%
Wholesale Funding to Assets Ratio	10.55%	13.96%	11.09%
Total Past Due Loans Ratio	0.48%	0.36%	0.73%
Loan Loss Reserves to Gross Loans Ratio	1.22%	1.18%	1.30%
One Year Total Loan Growth Ratio	9.09%	13.54%	1.37%

Source: FDIC; Consolidated Reports of Condition and Income.

[8] At the end of the fourth quarter 2021, the ADC Lender Group was comprised of 301 banks and the CRE Lender Group was comprised of 175 banks (54 banks met both prongs).

[9] Section 39 of the *Federal Deposit Insurance (FDI) Act* requires the FDIC to establish safety and soundness standards. For FDIC-supervised banks, Part 364 of the *FDIC Rules and Regulations* establishes safety and soundness standards by guideline, as set forth in its Appendix A, Interagency Guidelines Establishing Standards for Safety and Soundness. Refer to the guidelines at https://www.ecfr.gov/current/title-12/chapter-III/subchapter-B/part-364. Also, Section 18(o) of the FDI Act requires the federal banking agencies to adopt uniform regulations prescribing standards for loans secured by liens on real estate or made for the purpose of financing permanent improvements to real estate. Subpart A of Part 365 of the FDIC Rules and Regulations prescribes standards for real estate lending to be used by FDIC-supervised banks in adopting internal real estate lending policies. Refer to Part 365 and its Appendix A to Subpart A, Interagency Guidelines for Real Estate Lending Policies, at https://www.ecfr.gov/current/title-12/chapter-III/subchapter-B/part-365.

[10] This article displays financial metrics for banks as medians to reflect the "typical" bank in the relevant categories rather than as averages, which outliers can distort.

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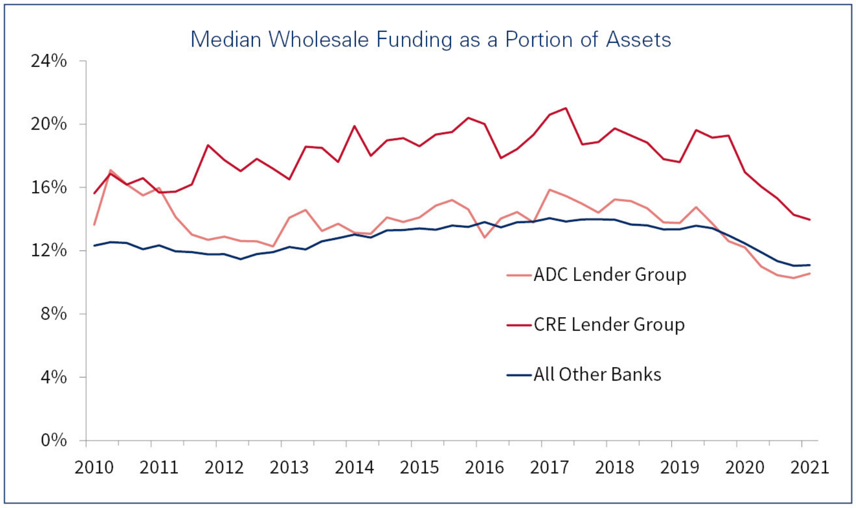
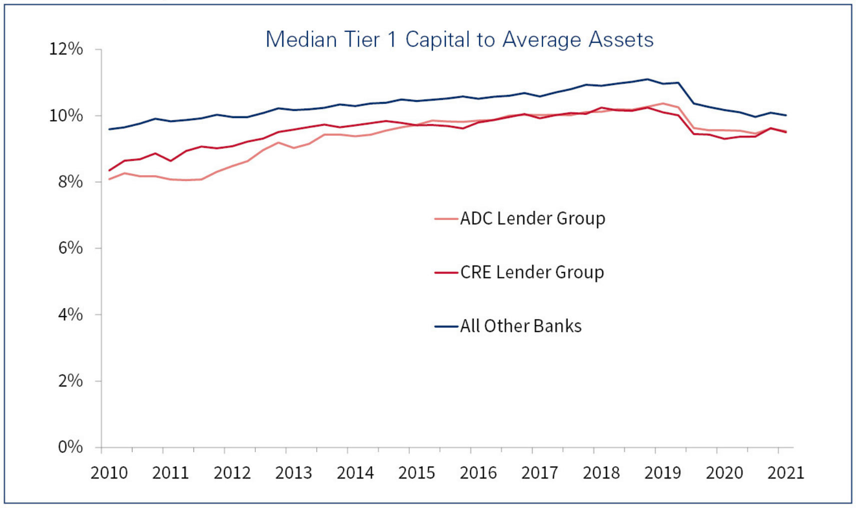
Chart 3: Wholesale Funding Trends



Source: FDIC; Consolidated Reports of Condition and Income.
Note: Quarterly data, fourth quarter 2010 through fourth quarter 2021.

Chart 4: Tier 1 Capital Trends



Source: FDIC; Consolidated Reports of Condition and Income.
Note: Quarterly data, fourth quarter 2010 through fourth quarter 2021.

lower capital and loan loss reserve levels compared to All Other Banks.

Robust deposit growth, driven by government stimulus and other relief measures enacted during the pandemic, and generally lower overall loan demand led to banks relying less on wholesale funding.[11] However, the CRE Lender Group continues to rely on wholesale funding more than the ADC Lender Group and All Other Banks (see Chart 3). As shown in the chart, the ADC Lender Group is the least reliant on wholesale funding among the groups. The ADC Lender Group recently showed a slight upturn in dependence on wholesale funding, not yet indicative of a sustained trend.

At the median, banks' capital positions appeared stable during the pandemic. However, the CRE Lender Group and the ADC Lender Group each continued to hold lower capital than All Other Banks (see Chart 4). As part of assessing the adequacy of a bank's capital, regulators consider the level and nature of inherent risk in the CRE portfolio as well as management expertise, historical performance, underwriting standards, risk management practices, market conditions, and any loan loss reserves allocated for CRE concentration risk.

Banks braced for potentially substantive losses across many types of loan portfolios in response to the economic impacts of the pandemic. Efforts by a portion of the industry to adopt the new Current Expected Credit Losses (CECL) accounting standard also coincided with the onset of the pandemic. Consequently, provision expenses for the banking industry swelled by $77.1 billion (140 percent) in 2020. The $84.9 billion decline in bank net income as compared to 2019 was primarily due to higher provision expenses in first half 2020, driven by pandemic-related deterioration in economic activity. Conversely, and in tandem with signs of macroeconomic improvement in

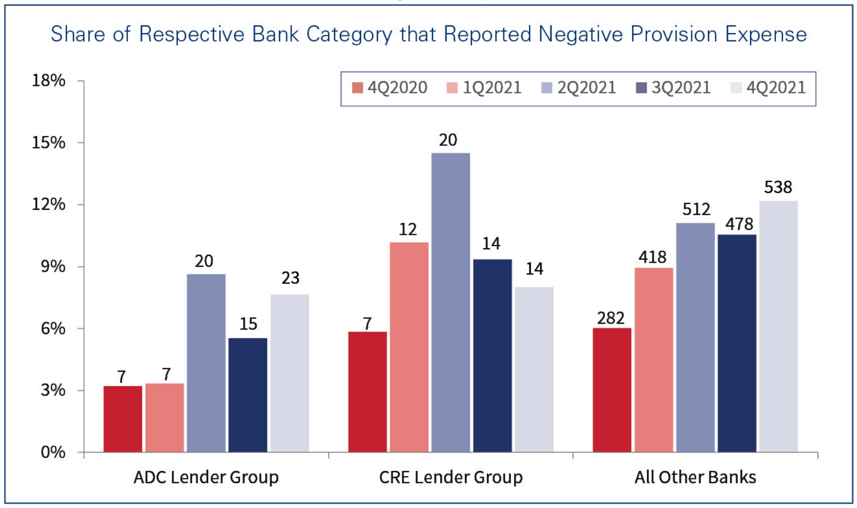
[11] For the purposes of this article, wholesale funding is defined primarily as the sum of the following Call Report categories: federal funds purchased and securities sold under agreements to repurchase, other borrowed money, brokered deposits, deposits gathered through listing services, and uninsured deposits of state and political subdivisions. This is for analysis purposes only and does not constitute an official regulatory definition.

the wake of substantial government stimulus and losses that had not materialized, the primary driver of higher quarterly net income in the second half of 2020 was a reduction in provision expenses. Negative provisions were a key reason bank net income increased $132.0 billion for the full year 2021 compared to 2020.[12] Banks in the CRE Lender Group and the ADC Lender Group were among banks that booked negative provision expenses (see Chart 5).[13]

As shown previously, in Table 1, ADC/CRE Banks currently hold levels of loan loss reserves to total loans that range eight to twelve basis points lower than the level held by All Other Banks. However, history has demonstrated that CRE portfolios, particularly the ADC subset, have the propensity to produce significant losses during periods of economic stress, especially when not properly managed.

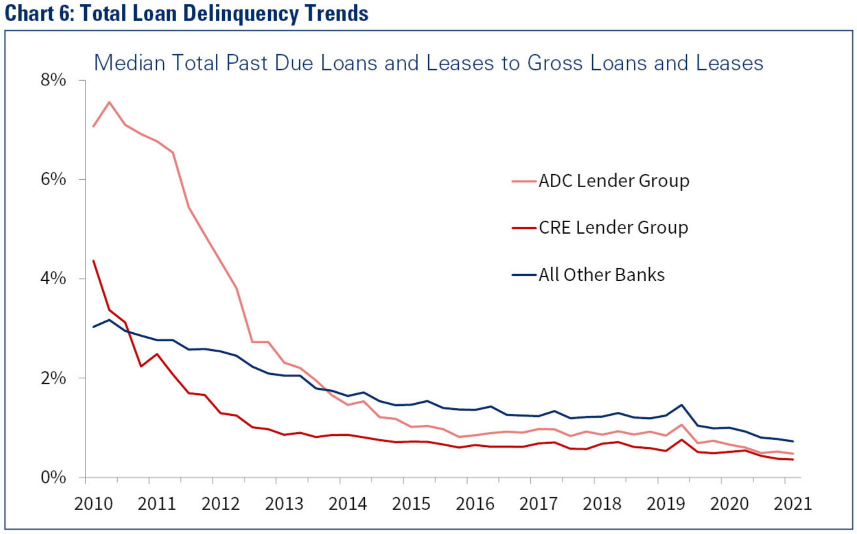
Although most CRE-concentrated banks felt some stress from the pandemic, CRE loan delinquencies are at historically low levels (see Chart 6), and aggregate loan losses have been nominal. These trends are at least partly attributable to stimulus and relief programs as well as low borrowing costs. In addition, banks worked extensively with borrowers experiencing stress during the pandemic, which likely suppressed delinquencies and may have ultimately limited losses by giving borrowers time and flexibility to address issues.

Chart 5: Banks with Negative Provision Expenses by Quarter



Source: FDIC; Consolidated Reports of Condition and Income.
Note: Counts above the bars are number of banks reporting negative provision expense.

Chart 6: Total Loan Delinquency Trends



Source: FDIC; Consolidated Reports of Condition and Income.
Note: Quarterly data, fourth quarter 2010 through fourth quarter 2021.

[12] See QBPs at https://www.fdic.gov/analysis/quarterly-banking-profile/.

[13] Thirty-three of the ADC/CRE Banks adopted CECL through fourth quarter 2021. Sixteen of the 33 had negative provisions in 4Q2021; the 16 included nine from the ADC Lender Group and seven from the CRE Lender Group. In all, 310 banks adopted CECL through fourth quarter 2021, and 144 of those 310 had negative provisions in fourth quarter 2021.

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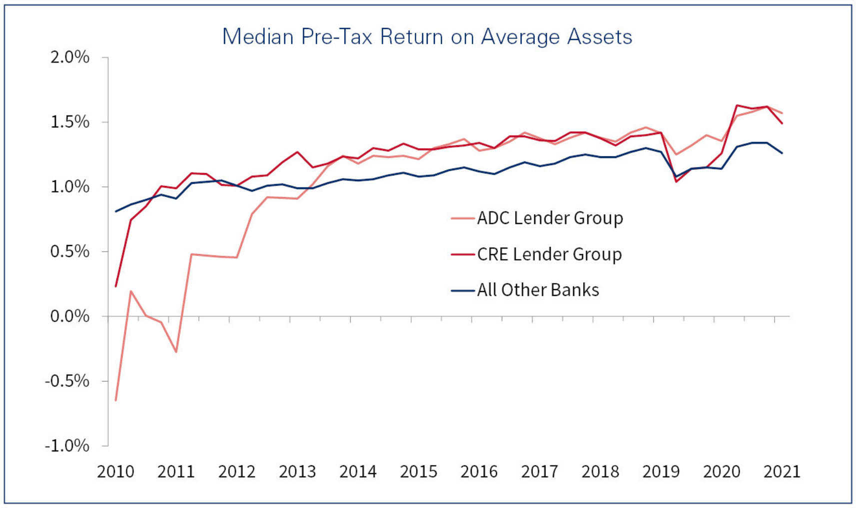
Chart 7: Pre-Tax ROAA Trends



Source: FDIC; Consolidated Reports of Condition and Income.
Note: Quarterly data, fourth quarter 2010 through fourth quarter 2021.

Against the backdrop of low delinquencies and a recovering economy, ADC/CRE Banks are outpacing All Other Banks in terms of pre-tax ROAA (see Chart 7). Their medians are 1.57 percent and 1.49 percent, while the median for All Other Banks is 1.26 percent. The higher returns for the ADC/CRE Banks may reflect, at least in part, the functioning of "higher risk, higher reward," although many factors complicate the core earnings analysis.

Paycheck Protection Program (PPP) fee income and negative provisions boosted income for many banks in 2021, while reduced overdraft charges and nonsufficient funds fees and elevated liquidity invested in lower yielding assets, along with robust loan competition, served as counterbalances. In addition, other pressures persist on bank earnings. Inflation, competition, and tight labor markets are affecting expenses. Actions such as loosening underwriting in a competitive environment could ultimately hinder future bank earnings if credit quality is compromised, credit relationships are not properly managed, or both.

Certain Pandemic Impacts May be Long Lasting

The onset of the COVID-19 pandemic led to stress across several CRE property types and tested bankers' risk management practices. The pandemic's initial impact across certain CRE sectors was severe. Hotel vacancies were significant; many office employees began working from home; and foot traffic at retail shopping centers, restaurants, and entertainment spaces ground to a halt.

Certain CRE sectors largely held up or recovered quickly, such as industrial properties and multifamily properties; although even within these sectors, strength and recovery has not been even across geographies. The significant increase in demand for industrial warehouse space to meet the rise in e-commerce helped that sector exceed pre-pandemic performance. In other cases, the pandemic exacerbated trends affecting CRE use, such as the move away from brick-and-mortar shopping venues and the increasing preference for work-from-home options, particularly in densely populated metropolitan areas.

During the pandemic, the federal banking regulatory agencies (agencies)[14] issued regulatory and banking supervision measures which, among other purposes, encouraged bankers to work with adversely affected customers and communities (see inset box below).

Although some of the economic effects of the pandemic appear to be easing, some of its impacts may be lasting, or may have exacerbated existing secular trends, or both. "Commercial Real Estate: Resilience, Recovery, and Risks Ahead," a featured article in *FDIC Quarterly*,

Select Credit-Related Regulatory and Supervisory Resources: Coronavirus Pandemic Response

Amid the stress and volatility posed by the pandemic, the agencies executed regulatory and banking supervision measures to mitigate the impacts on the U.S. financial system and support the credit needs of American households, communities, and small businesses. Measures related to credit included, but were not limited to:

- FDIC Announces Steps to Protect Banks and Consumers and to Continue Operations (March 2020 press release) at: https://www.fdic.gov/news/press-releases/2020/pr20029.html
- Revised Interagency Statement on Loan Modifications by Financial Institutions Working with Customers Affected by the Coronavirus (April 2020) at: https://www.fdic.gov/news/financial-institution-letters/2020/fil20036.html
- Joint Statement on Additional Loan Accommodations Related to COVID-19 (August 2020) at: https://www.fdic.gov/news/financial-institution-letters/2020/fil20074.html
- Interagency Statement on Appraisals and Evaluations for Real Estate Related Financial Transactions Affected by the Coronavirus (April 2020) at: https://www.fdic.gov/news/press-releases/2020/pr20051.html
- Final Rule on Revised Transition of the Current Expected Credit Losses Methodology for Allowances (August 2020) at: https://www.fdic.gov/news/financial-institution-letters/2020/fil20084.html
- Final Rule on Certain Real Estate Transactions for Financial Institutions and Consumers Affected by the Coronavirus (September 2020) at: https://www.fdic.gov/news/financial-institution-letters/2020/fil20094.html

The agencies' respective websites provide additional information. The FDIC's Coronavirus webpage can be found at https://www.fdic.gov/coronavirus/index.html. Resources are also available in the "Working with Borrowers" section at https://www.fdic.gov/resources/bankers/credit/commercial-real-estate-lending/.

[14] The federal banking regulatory agencies include the Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System (Board), and the Office of the Comptroller of the Currency (OCC).

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further explores recent CRE market conditions and the challenges ahead.[15] According to the article, the delinquency rates for CMBS backed by hotel and retail properties reached double digits in 2020, surpassing peak rates in the previous real estate cycle. While more recently improved, the delinquency rates remain above pre-pandemic levels. The article indicates that economic stress caused by the pandemic is one of the challenges facing the CRE industry and the lending landscape.

Results of the 2021 Shared National Credit (SNC) Review echo sentiments that challenges lie ahead and that CRE warrants attention.[16] The SNC press release notes year-over-year weakening in CRE, demonstrated by a higher classified rate for CRE as well as increasing levels of CRE loans listed for Special Mention, with risk most evident in the hotel, office, and retail sub-sectors. As stated in the release, the direction of risk may be affected by the level of success in managing the pandemic and by other concerns, including inflation, supply chain imbalances, labor challenges, and vulnerability to rising interest rates. These additional risks could adversely affect the financial condition and repayment capacity of borrowers in a variety of industries.

Observed CRE Lending Risk Management Practices

Throughout the pandemic, the FDIC continued to perform risk management examinations and other supervisory activities, predominantly in an offsite capacity. Assessing the effectiveness of banks' CRE lending risk management practices has remained a critical part of the FDIC's forward-looking, risk-focused supervision.

Overall, banks with comprehensive, well-developed risk management practices generally adapted better during the pandemic. For banks substantively involved in CRE lending, this was especially true when robust contingency planning and stress testing/scenario analysis processes were in place. For the most part, banks focused on CRE lending have exhibited satisfactory risk management practices. However, a few themes emerged as opportunities for improvement, as summarized below.

Governance, Credit Underwriting, Risk Management Practices

Over the 2021 examination cycle, FDIC examiners observed a notable level of loan policy exceptions as well as opportunities for improvements in tracking and monitoring policy exceptions. Additionally, examiners noted some areas of underwriting weaknesses.

[15] See "CRE: Resilience, Recovery, and Risks Ahead" within *FDIC Quarterly*, 2021, Volume 15, Number 4, at https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2021-vol15-4/article1.pdf

[16] See Agencies Issue 2021 Shared National Credit Review, FDIC: PR-18-2022, February 14, 2022 at https://www.fdic.gov/news/press-releases/2022/pr22018.html.

Assessing repayment capacity is one of the more common credit underwriting concerns that examiners have reported through supervisory recommendations.[17] The pandemic has complicated repayment capacity analyses. For example, considerations include when and how to consider PPP loan funds, stimulus funds, or other relief-driven support. Given the temporary nature and wind-down of many support measures, a reasonable path observed by examiners is to obtain the most relevant projections available and also consider whether and how the borrower's business is expected to rebound and replace the interim support measures. Nevertheless, examiners have observed other instances of stale financial information and unsupported projections underpinning repayment capacity analyses.

Continued uncertainties surrounding economic forecasts combined with varying pandemic impacts by sector and geography also present bankers and appraisers with challenges in developing well-supported and timely collateral valuations for CRE properties. While 2021 saw improvement in the commercial property market compared to 2020, some sectors, such as hotel (particularly those that are business/ convention-oriented) and office, and some geographies, such as the Manhattan borough of New York City, lagged. In another example, the previously referenced *FDIC Quarterly* article discusses observed declines in shopping mall valuations in 2021.[18] Pandemic impacts and other uncertainties remain poised to potentially affect CRE property values.

Credit Risk Rating Systems

A strong credit review function is critical for a bank's self-assessment of emerging risks. An effective, accurate, and timely risk rating system provides the foundation for the credit risk review function to assess credit quality, and, ultimately, to identify problem loans.

Recent assessments of bank-assigned borrower risk ratings revealed that many banks identified at least some credit deterioration since the onset of the pandemic that warranted more severe risk ratings. Deterioration was primarily limited to shifts within non-classified rating tiers. In more severe cases, the pandemic generally exacerbated pre-existing credit problems. Although banks are taking steps to update borrower risk ratings and watch lists, in some instances examiners assigned more severe risk ratings.

Risk rating frameworks justifiably vary from bank-to-bank. However, examiners sometimes found that rating frameworks were largely judgmental and lacked an element of well-defined, objective financial metrics or criteria to differentiate meaningfully between, and appropriately rank-order, internally assigned risk grades. In response to

[17] The FDIC intends supervisory recommendations, which are conveyed to banks in writing, to inform the bank of the FDIC's views about changes needed in its practices, operations, or financial condition. Conditions leading to supervisory recommendations generally are correctable in the normal course of business; however, material issues and recommendations that require the attention of the institution's board of directors and senior management are communicated using a subset of supervisory recommendations referred to as Matters Requiring Board Attention. For more detail, refer to the Statement of FDIC Board of Directors on the Development and Communication of Supervisory Recommendations at https://www.fdic.gov/regulations/examinations/supervisory/guidance/recommendations.html.

[18] See page 35 of the *FDIC Quarterly* article referenced in footnote 4.

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the pandemic, some banks suspended, modified, or added new categories to existing frameworks. Generally, examiners caution that suspending a risk rating framework during periods of stress, even when unprecedented, may ultimately hinder longer-term efforts to conduct meaningful historical migration analysis and could present near-term challenges for timely identification of problem assets. Adding new categories to, or modifying existing categories within, current risk rating frameworks may be appropriate when notable risk identification gaps or weaknesses have become apparent.

Market Analysis

With consideration of the real estate lending standards appended to Part 365 of the FDIC's *Rules and Regulations,*[19] the vast majority of banks with elevated CRE exposure are performing some type of market analysis, although the level of formality varies. Some banks do not refresh their analyses as frequently as warranted, have applied segmentation techniques ineffectively, or have not drawn conclusions from the analyses performed. A thorough understanding of the current and forward-looking economic and business factors influencing markets is particularly important for making safe and sound decisions about entering new markets, pursuing new lending activities, or reducing or expanding investment in existing markets. When performed well, market analysis can help generate reasonable assumptions for use in planning and modeling and can assist bank management in avoiding bad investments.

Management Information Systems

Accurate, reliable, and timely data and reporting at the portfolio and loan levels are also critical to support business decisions. Examiners have observed some instances of insufficient policy exception reporting and tracking. In addition, at some banks, loan-level data were missing or were derived pre-pandemic and, therefore, were not as useful in understanding portfolio stress. For example, net operating income, debt service coverage, or loan-to-value metrics were sometimes absent, out-of-date, or limited to a stand-alone entity basis (rather than considering the cumulative relationship).

Stress Testing and Sensitivity Analyses

It is important for bank management to understand how risk in a bank's loan portfolio can affect its financial condition. A common way to do this is through portfolio stress testing and sensitivity analyses. A review of supervisory recommendations included in Reports of Examination indicates there are opportunities for improvement in this area.

Some banks with significant CRE portfolios have not performed sufficient risk analysis, despite elevated risk profiles. Others have not addressed the board of directors' expectations with respect to such testing and analysis in their policies. In addition, examiners observed that the design and complexity of some testing or analysis methods were inconsistent with the nature of the CRE portfolios and lending environments. For example, examiners have observed that banks with CRE concentrations

[19] See footnote 9.

in multiple geographies sometimes applied broad stress assumptions to the entire portfolio instead of considering relevant variations in market conditions across the geographies. In other cases, stress testing time horizons did not align with the amortization periods or construction timelines typical of the bank's CRE product offerings. These inconsistencies may ultimately weaken the usefulness of the results for the bank's board of directors and management.

Other concerns noted included the quality and quantity of data inputs and insufficient magnitude of stress levels applied. Additionally, sometimes, management did not consider how results would impact the bank's capital and asset quality. This final step in the stress testing process provides critical capital planning information to the bank's board of directors.

The FDIC's Supervisory Approach to CRE in the 2022/2023 Examination Cycle

In addition to continuing to monitor for emerging systemic changes in CRE segments across the nation, the FDIC expects to continue its existing supervisory approach for banks with CRE concentrations. The June 2020 *Interagency Examiner Guidance for Assessing Safety and Soundness Considering the Effect of the COVID-19 Pandemic on Financial Institutions* (Examiner Guidance)[20] acknowledges that stresses caused by COVID-19 can adversely affect a bank's financial condition and operational capabilities, even when bank management has appropriate governance and risk management systems in place to identify, monitor, and control risk. The Examiner Guidance also instructs agency staff to continue to assess banks in accordance with existing policies and procedures,[21] which may result in supervisory feedback, or changes to a bank's composite or component ratings, when conditions or risk management practices warrant as such.

Examiners will consider the unique, evolving, and potentially long-term nature of the issues confronting banks in developing their supervisory response. For example, appropriate actions taken by banks in good faith reliance on such statements, within applicable timeframes described in such statements, will not be subject to criticism or other supervisory action. As another example, in considering the supervisory response for banks accorded a lower supervisory rating, examiners will give appropriate recognition to the extent to which weaknesses are caused by external economic problems related to the pandemic versus risk management and governance issues.

Per the Examiner Guidance, examiners will consider the bank's asset size, complexity, and risk profile, as well its customers' industry and business focus.

[20] See the Financial Institution Letter related to the Examiner Guidance, FIL-64-2020, at https://www.fdic.gov/news/financial-institution-letters/2020/fil20064.html.

[21] The Examination Documentation (ED) Modules are a tool used by FDIC examiners to carry out forward-looking, risk-focused examination programs. Because the ED Modules may not address every risk consideration, examiners have the discretion to perform and document additional examination procedures to assess risk, as needed. Refer to the ED Modules at https://www.fdic.gov/regulations/safety/manual/section22-1/index.html.

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As a continuance of the FDIC's longstanding risk-focused and forward-looking supervision principle, FDIC examiners prioritize resources toward areas presenting the highest risk at an individual bank, which often includes significant CRE lending concentrations. Among other provisions, the Examiner Guidance conveys that examiners will continue to:

- Assess credit quality in line with the interagency credit classification standards, while recognizing the constraints posed by the pandemic,
- Assess management's ability to implement prudent credit modifications and underwriting, maintain appropriate loan risk ratings, designate appropriate accrual status on affected loans, and provide for an appropriate reserve for credit losses, and
- Assign supervisory ratings in accordance with the applicable rating systems.

When assigning the composite and component ratings, examiners review management's assessment of risks presented by the pandemic, in the context of the bank's size, complexity, and risk profile. When assessing management, examiners will consider management's effectiveness in responding to the changes in the bank's business markets and whether management's longer-term business strategies address these changes.

Given the uncertain long-term impacts of changes in work and commerce in the wake of the pandemic, the effects of rising interest rates, inflationary pressures, and supply chain issues, examiners will be increasing their focus on CRE transaction testing in the upcoming examination cycle. In particular, examiners will be testing newer CRE credits, credits within stressed sub-categories and geographies, and credits with payments vulnerable to rising rates and rising costs.

Conclusion

CRE lending remains an important aspect of bankers' efforts to support their communities, including in response to the still-evolving impacts of the COVID-19 pandemic. The FDIC recognizes these efforts, when prudently undertaken and consistent with safe and sound banking practices, serve the public interest. As a result, the FDIC continues to encourage and support banks in taking prudent steps to assist affected customers. Examining the effectiveness of governance and risk management practices related to CRE lending will remain a supervisory priority.

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Subordinated Debt: Issuance and Investment Considerations

Many banking organizations, including smaller bank holding companies (BHCs) and insured depository institutions (IDIs), issue subordinated debt to achieve their regulatory capital and funding objectives. In addition, a number of IDIs invest in the subordinated debt of other institutions. The issuance of subordinated debt can have a variety of benefits for banking organizations, and financial institutions should remain aware of capital rules related to subordinated debt. In addition, there are a variety of benefits and risks associated with an IDI's investment in the subordinated debt of other financial institutions. Of particular importance, the capital rules include deductions from regulatory capital for certain investments in subordinated debt instruments issued by financial institutions. Institutions that invest in subordinated debt should consider the credit quality and repayment capacity of the issuer, and how such investments may affect the institution's risk profile.

The purpose of this article is to help support FDIC-supervised institutions' understanding of the applicable capital, investment, and regulatory reporting requirements that may apply when such institutions issue or invest in a subordinated debt instrument. It also describes the treatment of subordinated debt for purposes of an institution's Federal deposit insurance assessment.

The article aims to highlight certain requirements under the FDIC's regulations and should not be viewed as supervisory guidance or a directive.

What is Subordinated Debt?

Subordinated debt, a junior fixed income instrument, is an unsecured loan or bond that ranks below more senior loans or debt securities with respect to claims on assets and earnings. Its payment priority rights fall between senior debt and equity in the capital priority "stack." For example, if an obligor defaults, subordinated debt holders will be paid after depositors, general creditors, and secured bond holders are repaid and before equity shareholders. Consequently, subordinated debt is generally viewed as riskier than senior secured or unsecured debt in a default scenario.

Subordinated Debt Issuance from a Capital Perspective[1]

BHCs and IDIs issue subordinated debt as an efficient way to raise regulatory capital and long-term funding without diluting equity shareholders. From a regulatory capital perspective, subordinated debt can qualify as tier 2 capital of the issuer provided that the instrument satisfies the requirements of the FDIC's capital rule.[2] Institutions with BHCs often issue subordinated debt at the parent level and contribute the proceeds from the offering to subsidiary IDIs as additional paid-in capital in order to help the IDI meet its tier 1 capital requirements.

The down-streamed proceeds must meet all of the requirements in Part 324 of the FDIC's capital rule to

[1] This section does not cover additional requirements for the issuance of subordinated debt applicable to advanced approaches banking organizations. In addition, it does not cover the capital treatment of pre-Dodd-Frank instruments such as trust preferred instruments. The section refers to holding companies but does not attempt to describe the Federal Reserve's holding company requirements.

[2] See 12 CFR § 324.20(d)(1).

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qualify for the applicable tier of regulatory capital.[3]

Several criteria are required for subordinated debt to be eligible as tier 2 capital.[4] Among other things, subordinated debt:

- must be subordinated to depositors and general creditors of the banking organization;
- must not be covered by a guarantee or subject to other arrangement that legally or economically enhances the seniority of the instrument in relation to more senior claims;
- must have a minimum original maturity of at least five years; and
- must not have any terms or features that create significant incentives for the banking organization to redeem the instrument prior to maturity.

The capital rule further requires that during the last five years of the instrument, the amount eligible for tier 2 capital must be reduced by 20 percent of the original amount annually (net of redemptions) and that no amount of the instrument is eligible for inclusion in tier 2 capital when the remaining maturity of the instrument is less than one year.[7] These requirements are designed to allow the subordinated debt issuance to support a stable capital structure and to be available to absorb losses on a gone-concern basis and support the sale or resolution of a failed IDI.

Because tier 2 capital is not recognized in the community bank leverage ratio (CBLR) framework,[8] CBLR institutions are less likely to issue subordinated debt directly as there is no immediate regulatory capital benefit. However, if a CBLR institution has a BHC, it could benefit from down-streamed capital that the parent generates through the issuance of subordinated debt at the BHC.

Please note that FDIC-supervised institutions must seek prior approval to reduce or retire subordinated debt issued at the IDI level.

Regulatory Notice and Prior Approval Requirements for Retiring Subordinated Debt

- FDIC-supervised institutions should be aware of several regulatory notice and prior approval requirements for reducing or retiring subordinated debt, as well as restrictions on subordinated debt interest and principal payments by critically undercapitalized institutions.
- Specifically, FDIC-supervised institutions seeking to reduce, retire, call, or otherwise pay down principal on a subordinated debt capital instrument must apply for prior approval.[5]
- Further, all critically undercapitalized FDIC-supervised institutions must seek prior approval before paying interest or principal on subordinated debt instruments.[6]
- Questions about these requirements should be directed to the appropriate FDIC regional office.

Down-streaming Capital from a BHC

Institutions with BHCs often issue subordinated debt at the BHC-level and contribute the proceeds of the offering to the subsidiary IDI as additional paid-in capital to help support IDI-level tier 1 capital requirements.

[3] See 12 CFR § 324.20.

[4] See 12 CFR § 324.20(d)(1).

[5] See 12 U.S.C. §1828(i); 12 CFR §303.241.

[6] See 12 U.S.C. § 1831o; 12 CFR § 303.206. See also 12 CFR § 324.405.

[7] See 12 CFR §324.20(d)(1)(iv).

[8] See 12 CFR § 324.12.

The subordinated debt and the down-streamed proceeds must meet *all* of the requirements under the capital rule to qualify for the applicable tier of regulatory capital.[9]

In most cases, the BHC passes the down-streamed capital directly to the IDI as common equity through a credit to paid-in capital. Thus, funds from issuing subordinated debt that may count as tier 2 at the holding company level may be downstreamed as a common equity or additional tier 1 capital investment at the IDI level.

Subordinated debt may also be issued as convertible debt, which requires or permits the issuer to exchange the debt instrument for qualifying common or perpetual preferred stock by a certain date or before maturity. Convertible debt may qualify as tier 2 capital, without limitation, if it meets all of the requirements described in the FDIC's capital rule. The conversion feature does not present a barrier to qualification as tier 2 capital if the instrument converts to a tier 1 capital instrument.

In addition, minority interest[10] generated by a subordinated debt issuance by a subsidiary of an IDI may be included as tier 2 capital by the IDI if the instrument terms meet the capital rule's requirements. However, under the regulatory capital rule, the total amount of minority interests that a non-advanced approaches FDIC-supervised institution may include in total capital must be no greater than 10 percent of the sum of all total capital elements (not including the total capital minority interest itself), less any total capital regulatory adjustments and deductions.[11]

Subordinated Debt Issuance: Key Takeaways

- Subordinated debt can be included in tier 2 capital if the requirements of Part 324 are met.
- Proceeds from subordinated debt issued at the holding company can be down-streamed to the IDI as tier 1 capital.
- Institutions must seek approval from their primary federal regulator to reduce or retire subordinated debt.

Call Report Instructions for Subordinated Debt Issuances

On the Consolidated Report of Condition and Income (Call Report), issuers report subordinated debt in Schedule RC, in the liabilities section on line item 19, subordinated notes and debentures. However, when issued by a subsidiary, subordinated debt may or may not be explicitly subordinated to the deposits of the parent bank that may report subordinated debt in Schedule RC, item 16, "Other borrowed money," or item 19, "Subordinated notes and debentures," as appropriate.

Cost of Servicing Subordinated Debt

As part of the business decision and capital planning efforts, IDIs evaluate the annual cost of servicing subordinated debt obligations as well as the impact it could have on earnings performance. Issuing subordinated debt may be attractive because of its relatively low cost, but capital deployment options that generate adequate returns to investors may be constrained by factors such as a low interest rate environment. Additionally, if subordinated debt is issued by a holding company and injected into an IDI subsidiary, the IDI may need to pay higher

9 See 12 CFR § 324.20.

10 The term "minority interest" refers to an interest in the capital of a consolidated subsidiary that is not owned by the parent FDIC-supervised institution.

11 See 12 CFR § 324.21(a)(4).

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dividends to the holding company to service the obligation unless the parent has other sources of capital or funding. Also, subordinated debt is often issued at a fixed rate for the first five years before converting to a variable coupon rate. Therefore, if interest rates rise over the instrument's life, servicing costs may increase.

Subordinated Debt from an Investment Perspective

FDIC-supervised institutions and their subsidiaries may purchase subordinated debt instruments of BHCs and IDIs[12] as set forth in supervisory due diligence standards.[13] In certain circumstances, an FDIC-supervised institution may invest in a subordinated debt instrument that is not permissible for a national bank or Federal savings association; however, to make such an investment the institution must receive prior FDIC approval and the investment must be permissible under the laws of the State (for aggregated investment and lending limits) where the FDIC-supervised institution is chartered.

To meet supervisory due diligence standards for subordinated debt investments, institutions may consider internal analyses; external research and analytics (including credit ratings, internal risk ratings, default statistics of external credit rating agencies); and other sources of information, as appropriate. As part of prudent risk management, an institution is expected

Subordinated Debt Investments: Key Takeaways

- Institutions may generally only purchase investment grade subordinated debt securities that are permissible investments for national banks.
- Investments in subordinated debt are assigned a risk-weight and may also be subject to capital deduction.
- Investments in subordinated debt that are deemed reciprocal cross-holdings are immediately deducted from capital.
- Aggregated investments in subordinated debt may be subject to prudential credit concentration considerations, as well as State investment and lending limits.

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[12] Section 24 of the FDI Act prohibits an insured State bank from engaging as principal in any type of activity that is not permissible for a national bank. 12 U.S.C. § 1831a. National banks may invest in subordinated debt if the debt is both marketable and investment grade. See 12 CFR § 1.2(f) and 1.2(d). Part 362 of the FDIC's Rules and Regulations allow State banks to apply to the FDIC to make investments that are not permissible for national banks provided applicable state law allows the investment. See 12 CFR Part 362, Subpart A. State savings associations have similar, but not identical requirements, under section 28 of the FDI Act. 12 U.S.C. § 1831e. Additionally, State savings associations have a specific prohibition against acquiring or retaining any corporate debt security that does not meet FDIC's standards of creditworthiness unless it is retained by a qualified affiliate. 12 U.S.C. § 1831e(d). State savings associations may apply to the FDIC to make investments not permissible for a Federal savings association if allowed by state law. See 12 CFR Part 362, Subpart C. All State bank and State savings association investments are subject to FDIC safety and soundness determinations.

[13] Financial institutions can refer to the Revised Standards of Creditworthiness for Investment Securities, and the Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment when contemplating subordinated debt investments.

to maintain documentation of its due diligence efforts.[14]

The analysis of a potential subordinated debt investment would be similar to the evaluation of bonds that do not carry explicit or implied support from the U.S. government. Therefore, IDIs consider the credit, market, concentration, and other risks that arise from investing in subordinated debt. In the normal course of examinations, FDIC examiners evaluate institutions' pre-purchase analyses, ongoing monitoring, and concentration risk for investment securities. Please note that subordinated debt instruments not meeting investment grade standards may be subject to adverse classification as described in the *Uniform Agreement on the Classification and Appraisal of Securities Held by Financial Institutions.*

In addition to each issuer's idiosyncratic risk, IDIs may consider the risk caused by regional or national economic turbulence. Macroeconomic stress episodes frequently have amplifying or correlation effects that can weaken the debt-servicing capacity of issuers while simultaneously subjecting the investor bank to financial difficulties.

Due Diligence for Subordinated Debt Investment by CBLR Institutions

Although subordinated debt investments are not subject to a deduction or risk-based capital calculation for CBLR institutions, they still merit prudent due diligence efforts, monitoring, and diversification. Consistent with non-CBLR institutions, subordinated debt investments by

Call Report Instructions for Subordinated Debt Investments

Subordinated debt investments are generally accounted for as debt securities on Call Report Schedule RC-B, and categorized as trading, available-for-sale, or held-to-maturity consistent with ASC Topic 320, Investments–Debt Securities. Management should periodically reassess its security categorization decisions to ensure that the designations remain appropriate. If accounted for as a security, the subordinated debt instrument would be reported on Schedule RC-B Item 6.a, as "Other domestic debt securities" if the issuer were an U.S. entity. It would be reported in Item 6.b, as "Other foreign debt securities" if the issuer were a non-U.S. entity. If the security were accounted for as held for trading or under the fair value option, the investment would be reported on Schedule RC Item 5, "Trading Assets" and for the FFIEC 031 or FFIEC 041 Call Reports, as applicable, on Schedule RC-D, Item 5.b. for, "All other debt securities."

In cases where the criteria for a security are not met, institutions may instead classify and report subordinated debt as a loan rather than a security depending on the instrument's facts and circumstances. This sometimes occurs when one institution acquires the entire subordinated debt issuance of another institution. If accounted for as a loan, the subordinated debt instrument would be reported in Schedule RC-C according to borrower type (such as a depository institution) and accounted for as held for investment or held for sale based on the institution's designation, unless the fair value option were elected. If the loan is held for trading, the instrument would be reported on Schedule RC Item 5, "Trading Assets" and for the FFIEC 031 or FFIEC 041 Call Reports, as applicable, in the appropriate category in Schedule RC-D Item 6, "Loans."

[14] See FIL-54-2014, Filing and Documentation Procedures for State Banks Engaging, Directly or Indirectly, in Activities or Investments that are Permissible for National Banks, November 19, 2014, https://www.fdic.gov/news/financial-institution-letters/2014/fil14054.html

Subordinated Debt

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CBLR institutions should adhere to regulatory standards for investment quality, loan underwriting, and risk management.

Regulatory Capital Deductions and Risk-Weights for Subordinated Debt Exposures

FDIC-supervised institutions should be aware of the regulatory requirements affecting investments in the subordinated debt of another unconsolidated financial institution (IDI or BHC). There are two aspects to the treatment of investments in the capital instruments of unconsolidated financial institutions, including investments in another financial institution's subordinated debt. The first aspect is a potential deduction from capital for reciprocal cross holdings or when a FDIC-supervised institution has reached the applicable deduction threshold(s) in Part 324. The second aspect is regulatory capital risk-weighting. A detailed description of these considerations is presented below.

Required Capital Deductions

The first step is to determine whether there are any applicable capital deductions associated with holding subordinated debt of other financial institutions (not consolidated). Banks following the generally applicable capital rule are reminded that reciprocal cross holdings (See 12 CFR § 324.22(c)(3)) of capital instruments with another bank, including subordinated debt, are deducted from capital. That is, FDIC-supervised institutions must deduct investments in the capital of other financial institutions they hold reciprocally, where such reciprocal cross holdings result from a formal or informal arrangement to swap, exchange, or otherwise indicate intention to hold each other's capital instruments. The purpose of this deduction is to prevent banking organizations from artificially inflating each other's regulatory capital levels such that stress in one institution directly causes loss and deterioration in the capital of another financial institution.

If such reciprocal cross holdings exist, the institution's management team would apply the corresponding deduction approach outlined in the rule. Bankers and examiners should refer to the Call Report instructions for complete details on the mechanics of the deductions. In general, the full amount of cross holdings would first be deducted from the applicable tier of capital in order to determine the starting amount of regulatory capital to calculate the applicable threshold for the remaining investments in other financial institutions.

In most cases, a reciprocal cross holding would not exist. In this case, the institution's management team would determine whether its investment in the capital instruments of unconsolidated financial institutions exceeds the 25 percent of common equity tier 1 capital threshold limit (see the description and deduction requirement in 12 CFR § 324.22(c)(4)). Investments in the capital of unconsolidated financial institutions include investments in common equity, additional tier 1 capital instruments such as preferred shares, and investments in tier 2 capital instruments such as subordinated debt. These items are summed and compared against the 25 percent limit. Amounts over the limit are deducted. Institutions have the flexibility of deciding which of the investments in the capital of unconsolidated financial institutions that they choose to risk weight and which they choose to deduct (see the instructions for line item 13a in Schedule RC-R Part I in the FFIEC 031 and 041 forms).

For CBLR institutions, there is no deduction for investment in another financial institution's subordinated debt under the CBLR framework as electing institutions do not calculate tier 2 capital. CBLR institutions are required to report all investments in the tier 2 capital instruments of nonconsolidated financial institutions – an important disclosure mechanism that was included in the CBLR framework.

Risk-Weights for Subordinated Debt Exposures

After an FDIC-supervised institution determines whether a capital deduction is appropriate, the next step is risk-weighting the subordinated debt investment, whether in the form of a security or loan instrument. Please note that FDIC-supervised institutions are not required to risk weight the amounts of any investments in the capital of unconsolidated financial institutions that have been deducted from capital (see 12 CFR § 324.22(g)).

The portion of subordinated debt that is not deducted is generally subject to a minimum 100 percent risk-weight. If in the rare case the IDI that owns the subordinated debt obtains a guarantee or other credit risk mitigant recognized under the capital rule, the IDI may be allowed to apply a risk-weight of less than 100 percent (see § 324.36 and § 324.37(b)). On the other hand, in the event the subordinated debt is past due the IDI must apply a risk-weight of 150 percent (see § 324.32(k)). While CBLR institutions do not report risk-weighted assets, management teams should be aware of the requirements under the generally applicable capital rule regarding deductions and risk-weighting in case the FDIC-supervised institution were to revert to the generally applicable capital rule at a future date.

Call Report Instructions for Subordinated Debt Capital Deductions, Risk-Weights, and CBLR Disclosure Information on Investments on Schedule RC-R

Capital Deductions

- For the FFIEC 041 or FFIEC 051 Call Reports, the deduction for amounts over the 25 percent limit are recorded on RC-R Part I, Items 13 and/or 17, 24, and 45. The deduction for the portion of subordinated debt that qualifies for tier 2 capital occurs in Item 45.
- For the FFIEC 031 Call Reports, the deduction for amounts over the 25 percent limit are recorded on RC-R Part I, Items 13a and/or 17, 24, and 45. The deduction for the portion of subordinated debt that qualifies for tier 2 capital occurs in Item 45.
- CLBR institutions are not subject to the corresponding deduction approach. Aggregated investments in subordinated debt may be subject to prudential credit concentration considerations, as well as State investment and lending limits.

Regulatory Capital Risk-Weights

- Investments in subordinated debt of unconsolidated financial institutions are assigned a 100 percent risk-weight. Subordinated debt of other banking organizations is generally risk weighted in Item 2 Securities in Schedule RC-R Part II. If the asset is held for trading, it would be reported in Item 7.
- CBLR institutions do not calculate risk-weighted assets, but they have disclosure requirements that other institutions are not required to make.

CBLR Disclosure of Subordinated Debt and Other Tier 2 Instruments Held for Investment Capital Risk-Weights

- CBLR institutions report their investments in the tier 2 capital of unconsolidated financial institutions on line item 36 of Schedule RC-R, Part I.

Treatment of Subordinated Debt for Deposit Insurance Assessments

IDIs that issue or invest in subordinated debt may also experience adjustments to their deposit insurance assessments. All other things equal, greater amounts of long-term unsecured debt can reduce the FDIC's loss in the event of a failure. In recognition of this, the assessment system includes an unsecured debt adjustment that lowers a financial institution's initial base assessment rate (determined by the ratio of the financial institution's long-term unsecured debt to its assessment base). The unsecured debt adjustment cannot exceed the lesser of 5 basis points or 50 percent of an institution's initial base assessment rate. It also does not apply to new (de novo) financial institutions or insured branches.

However, when unsecured debt, such as subordinated debt, issued by a financial institution is held by other IDIs, the Deposit Insurance Fund remains exposed to risk of loss. Therefore, the depository institution debt adjustment increases the

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assessment rate when an IDI holds long-term, unsecured debt issued by another financial institution. An IDI pays a 50-basis point adjustment on the amount of unsecured debt it holds that was issued by another IDI to the extent that such debt exceeds three percent of the institution's tier 1 capital.[15]

Summary

Banking organizations have successfully issued, serviced, and retired subordinated debt instruments for decades. Although regulatory capital requirements and eligibility criteria for subordinated debt issuance can be complex, over the years these instruments have helped banking organizations achieve their long-term capital planning and funding objectives. In addition, institutions may be able to prudently diversify their investment portfolios with subordinated debt securities and loans issued by other financial institutions, while complying with permissibility, diversification, and investment quality standards. Investing in subordinated debt must be done in compliance with the capital rule, which requires capital deductions for reciprocal cross holdings and/or exceeding threshold limits in the rule. Even questions as to how to report subordinated-debt investment holdings on quarterly Call Reports sometimes can be less than straightforward and require an analysis of the instrument documentation.

FDIC-supervised institutions that issue subordinated debt, take down-streamed capital injections, or invest in the capital of an unconsolidated financial institution should review the applicable rules to ensure the institution can enjoy the capital and investment benefits that subordinated debt can offer. Management of FDIC-supervised institutions is encouraged to seek technical assistance from their regional office contacts when needed.

This article was prepared by staff from the Division of Risk Management Supervision's Capital Markets and Accounting Branch.

[15] Long-term unsecured debt issued by other IDIs is reported in Call Report Schedule RC-O, item 6.

Overview of Selected Regulations and Other Items of Interest

This section provides an overview of recently released regulations and other items of interest, arranged in reverse chronological order. Press Release (PR) and Financial Institution Letter (FIL) designations are included so the reader can obtain more information.

A longer version of the Roundup that includes entries following the publication of the Fall 2019 issue of *Supervisory Insights* through year-end 2021 is available upon request.

ACRONYMS and DEFINITIONS	
CFPB	Consumer Financial Protection Bureau
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FinCEN	U.S. Department of the Treasury's Financial Crimes Enforcement Network
FRB	Federal Reserve Board
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
Federal bank regulatory agencies	FDIC, FRB, and OCC
Federal financial institution regulatory agencies	CFPB, FDIC, FRB, NCUA, and OCC

Roundup

Subject	Summary
FDIC Board of Directors Amends Restoration Plan and Issues a Proposed Rule on Assessments, Revised Deposit Insurance Assessment Rates (FIL-26-2022, PR-49-2022, June 21, 2022)	The FDIC Board of Directors issued a notice of proposed rulemaking to increase deposit insurance assessment rates by 2 basis points for all insured depository institutions in order to increase the likelihood that the reserve ratio of the Deposit Insurance Fund (DIF) reaches the statutory minimum of 1.35 percent by the statutory deadline of September 2028. The Board also adopted an Amended Restoration Plan, which incorporates the increase in assessment rates. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22026.html
FDIC-Insured Institutions Reported Net Income of $59.7 Billion in First Quarter 2022 (PR-45-2022, May 24, 2022)	FDIC-insured institutions reported aggregate net income of $59.7 billion in first quarter 2022, a decline of $17.0 billion, or 22.2 percent, from a year ago. An increase in provision expense drove the annual reduction in net income. These and other financial results are included in the *Quarterly Banking Profile* for first quarter 2022. See https://www.fdic.gov/news/press-releases/2022/pr22045.html

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Subject	Summary
FDIC Publishes 2022 Risk Review (PR-44-2022,May 20, 2022)	The FDIC published its 2022 Risk Review, a comprehensive summary of emerging risks in the U.S. banking system as observed in 2021. The 2022 Risk Review expands coverage of risks from prior reports by examining operational risk to banks from cyber threats and illicit activity, and climate-related financial risks faced by banking organizations. See https://www.fdic.gov/news/press-releases/2022/pr22044.html
Small Entity Compliance Guide related to Simplification of Deposit Insurance Rules for Trust and Mortgage Service Accounts (FIL-23-2022, May 18, 2022)	On January 28, 2022, the Federal Deposit Insurance Corporation (FDIC) published a final rule to amend the deposit insurance regulations for trust accounts and mortgage servicing accounts. The FDIC added a Small Entity Compliance Guide to its website to assist insured depository institutions and community banking organizations in understanding and preparing for the changes in deposit insurance coverage. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22023.html
Amendments to Guidelines for Appeals of Material Supervisory Determinations (FIL-22-2022, May 17, 2022)	The FDIC adopted *Guidelines for Appeals of Material Supervisory Determinations* that restore the Supervision Appeals Review Committee (SARC) as the final level of review in the agency's supervisory appeals process. Consistent with the composition of the SARC as it stood in 2021, the SARC will include one inside member of the FDIC's Board of Directors (serving as Chairperson); a deputy or special assistant to each of the other inside Board members; and the General Counsel as a non-voting member. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22022.html
FDIC Issues Final Rule Regarding False Advertising, Misrepresentations About Insured Status, and Misuse of the FDIC's Name or Logo (FIL-21-2022, PR-41-2022, May 17, 2022)	The FDIC approved a final rule implementing its statutory authority to prohibit any person or organization from making misrepresentations about FDIC deposit insurance or misusing the FDIC's name or logo. In recent years, the FDIC has observed an increasing number of instances where individuals or entities have misused the FDIC's name or logo, or have made false or misleading representations about deposit insurance. To provide transparency into how the FDIC will address these and similar concerns, the final rule clarifies the FDIC's procedures for identifying, investigating, and where necessary, taking formal and informal enforcement actions against individuals or entities to address violations. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22021.html
Agencies Release Revised Interagency Questions and Answers Regarding Flood Insurance (FIL-20-2022, PR-40-2022, May 11, 2022)	The federal financial institution regulatory agencies jointly issued revised questions and answers (Q&As) regarding federal flood insurance law and the agencies' implementing regulations. These Q&As replace those originally published by the agencies in 2009 and 2011 and consolidate Q&As proposed by the agencies in 2020 and 2021. The revised Q&As reflect significant changes to the flood insurance requirements made by federal law in recent years. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22020.html

Subject	Summary
Agencies Issue Joint Proposal to Strengthen and Modernize Community Reinvestment Act Regulations (FIL-18-2022, PR-39-2022, May 5, 2022)	Federal bank regulatory agencies jointly issued a proposal to strengthen and modernize regulations implementing the *Community Reinvestment Act* (CRA) to better achieve the purposes of the law. The joint proposal recommends adjusting the CRA to expand access to credit, investment, and basic banking services in low- and moderate-income communities. It also proposes to adapt to changes in the banking industry and provide greater clarity, consistency, and transparency. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22018.html
FDIC Names Seven New Members to Advisory Committee on Community Banking (PR-35-2022, April 27, 2022)	The FDIC announced seven new members of the agency's Advisory Committee on Community Banking. The FDIC's Advisory Committee shares input on a broad range of community bank policy and regulatory matters. See https://www.fdic.gov/news/press-releases/2022/pr22035.html
Principals of U.S., European Banking Union, and U.K. Financial Authorities Meet for Regular Coordination Exercise on Cross-Border Resolution Planning (PR-33-2022, April 19, 2022)	The heads of resolution, regulatory and supervisory authorities, central banks, and finance ministries of the United States, the United Kingdom, and the European Banking Union were among leaders who participated in a Trilateral Principal Level Exercise on Saturday, April 23, 2022. The meeting was part of a series of regular exercises and exchanges among the principals of these key financial sector authorities to enhance understanding of each jurisdiction's resolution regime for global systemically important banks and strengthen coordination on cross-border resolution. See https://www.fdic.gov/news/press-releases/2022/pr22033.html
Consolidated Reports of Condition and Income for First Quarter 2022 (FIL-17-2022, April 14, 2022)	The federal bank regulatory agencies released materials pertaining to the Consolidated Reports of Condition and Income (Call Report) for the March 31, 2022, report date. For institutions that have adopted Accounting Standards Update (ASU 2022-02), "Financial Instruments - Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures," a new topic, "Accounting for Loan Modifications to Borrowers Experiencing Financial Difficulties," has been added to the attached March 2022 Supplemental Instructions. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22017.html
Agencies Propose to Update and Modernize the Uniform Rules of Practice and Procedure for Formal Administrative Enforcement Proceedings (PR-32-2022, April 13, 2022)	The FDIC invited comment on an interagency proposal to update the rules governing formal administrative proceedings for insured depository institutions. The proposed updates would modernize these rules, aligning them with current practices and facilitating the use of electronic communications and technology in formal administrative proceedings. See https://www.fdic.gov/news/press-releases/2022/pr22032.html

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Subject	Summary
James Madison University College of Business Wins FDIC's 2nd Annual Academic Challenge (PR-31-2022, April 11, 2022)	The FDIC announced a four-member team of undergraduate students from James Madison University College of Business won the agency's Second Annual FDIC Academic Challenge, a competition among university and college students concerning the U.S. banking sector. See https://www.fdic.gov/news/press-releases/2022/pr22031.html
Notification of Engaging in Crypto-Related Activities (FIL-16-2022, April 7, 2022)	All FDIC-supervised institutions that intend to engage in, or that are currently engaged in, any activities involving or related to crypto assets (also referred to as "digital assets") should notify the FDIC. FDIC-supervised institutions are requested to provide information described in this letter. The FDIC will review the information and provide relevant supervisory feedback. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22016.html
Request for Comment on Statement of Principles for Climate-Related Financial Risk Management for Large Financial Institutions (FIL-13-2022, PR-27-2022, March 30, 2022)	The FDIC requested comments on draft principles that would provide a high-level framework for the safe and sound management of exposures to climate-related financial risks. The draft principles are intended to support efforts by large financial institutions to focus on key aspects of climate-related financial risk management. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22013.html
Computer-Security Incident Notification Implementation (FIL-12-2022, March 29, 2022)	The federal bank regulatory agencies issued a joint final rule to establish computer-security incident notification requirements (Final Rule) for banking organizations and their bank service providers. Banks and their service providers must comply with the Final Rule starting May 1, 2022. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22012.html
FDIC Request for Information on Bank Merger Act (FIL-11-2022, PR-26-2022, March 25, 2022)	The FDIC sent for publication in the *Federal Register* a Request for Information seeking information and comments regarding the application of the laws, practices, rules, regulations, guidance, and statements of policy that apply to merger transactions involving one or more insured depository institution, including the merger between an insured depository institution and a noninsured institution. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22011.html
Acting Chairman Gruenberg Issues Statement on the Property Appraisal and Valuation (PAVE) Task Force Report (PR-24-2022, March 25, 2022)	FDIC Acting Chairman Martin J. Gruenberg issued a statement regarding the release of the Action Plan to Advance Property Appraisal and Valuation Equity (PAVE). Acting Chairman Gruenberg stated the PAVE Task Force is the first–ever federal government effort to explore and focus attention on discrimination in the mortgage market and appraisal bias that negatively impacts wealth building opportunities for minority homeowners and communities. He also outlined the number of commitments FDIC has made as a member of the Task Force. See https://www.fdic.gov/news/press-releases/2022/pr22024.html

Subject	Summary
Rescission of Statement on Part 363 Annual Reports in Response to the Coronavirus (FIL-10-2022, March 15, 2022)	On March 27, 2020, the FDIC issued FIL-30-2020, *Statement on Part 363 Annual Reports in Response to the Coronavirus*, which provided an additional 45 days for insured depository institutions (IDIs) subject to Part 363 of the FDIC's regulations to file Part 363 Annual Reports and Other Reports and Notices. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22010.html
FDIC-Insured Institutions Reported Net Income of $63.9 Billion in Fourth Quarter 2021 (PR-22-2022, March 1, 2022)	FDIC-insured institutions reported aggregate net income of $63.9 billion in fourth quarter 2021, an increase of 7.4 percent over one year ago. The increase was driven by further economic growth and improved credit conditions, which led to expanded net interest income and a fourth consecutive quarter of aggregate negative provision expense. These and other financial results for fourth quarter and full-year 2021 are included in the *Quarterly Banking Profile* for fourth quarter 2021. See https://www.fdic.gov/news/press-releases/2022/pr22022.html
2021 Financial Institution Diversity Self-Assessments: Voluntary Self-Assessments Accepted Now through June 30, 2022 (FIL-9-2022, February 28, 2022)	The FDIC's Office of Minority and Women Inclusion encourage FDIC-supervised financial institutions with 100 or more employees to submit voluntary self-assessments of their diversity practices and policies. Submitted information will be treated as confidential information. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22009.html
Interagency Statement on Special Purpose Credit Programs Under the Equal Credit Opportunity Act and Regulation B (FIL-8-2022, February 22, 2022)	The federal bank regulatory agencies, along with the Department of Housing and Urban Development, the Department of Justice, and the Federal Housing Finance Agency, issued an interagency statement to remind creditors of the ability under the Equal Credit Opportunity Act and Regulation B to establish special purpose credit programs to meet the credit needs of specified classes of persons. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22008.html
FDIC Releases Economic Scenarios for 2022 Stress Testing (PR-19-2022, February 15, 2022)	The FDIC released the hypothetical economic scenarios for use in the upcoming stress tests for covered institutions with total consolidated assets of more than $250 billion. The supervisory scenarios include baseline and severely adverse scenarios. See https://www.fdic.gov/news/press-releases/2022/pr22019.html
Joint Readout of Principals' Meeting of UK and U.S. Authorities Regarding Central Counterparty Resolution (PR-16-2022, February 8, 2022)	Senior officials from the Bank of England, FDIC, Commodity Futures Trading Commission, SEC, and the Federal Reserve Board convened a virtual meeting to discuss certain issues relating to the resolution of a central counterparty (CCP). The meeting was an opportunity to review recent joint work undertaken by the agencies, in particular the development of detailed operational planning to support prototype resolution strategies for U.S. and UK CCPs. See https://www.fdic.gov/news/press-releases/2022/pr22016.html

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Acting Chairman Martin J. Gruenberg Announces FDIC Priorities for 2022 (PR-15-2022, February 7, 2022)	FDIC Acting Chairman Gruenberg released a summary of the FDIC's priorities for the coming year. The key priorities include the Community Reinvestment Act, climate change, the Bank Merger Act, crypto-assets, and the Basel III capital rule. See https://www.fdic.gov/news/press-releases/2022/pr22015.html
FDIC Expands #GetBanked Campaign in Los Angeles, Dallas, and Detroit (PR-11-2022, February 2, 2022)	The FDIC announced it will expand its #GetBanked public awareness campaign into the Los Angeles, Dallas, and Detroit metropolitan areas. See https://www.fdic.gov/news/press-releases/2022/pr22011.html
FDIC and FinCEN Open Registration for Digital Identify Tech Sprint (PR-9-2022, February 1, 2022)	The FDIC and FinCEN opened the registration period for interested parties to participate in a Tech Sprint to help measure the effectiveness of digital identity proofing. See https://www.fdic.gov/news/press-releases/2022/pr22009.html
FDIC Names Three New Members to Its Systemic Resolution Advisory Committee (PR-8-2022, January 28, 2022)	The FDIC named three new members to its Systemic Resolution Advisory Committee. The three individuals were all invited to join the Committee in December, 2021. See https://www.fdic.gov/news/press-releases/2022/pr22008.html
FDIC Announces Collaboration with Operation HOPE, Inc. to Expand Financial Education and Minority/Women-Owned Business Opportunities (PR-5-2022, January 24, 2022)	The FDIC announced a collaboration with Operation HOPE, Inc., to promote financial education using the FDIC's Money Smart curriculum and other resources to help educate minority- and/or women-owned businesses on how to do business with the agency. See https://www.fdic.gov/news/press-releases/2022/pr22005.html
Final Rulemaking on Simplification of Deposit Insurance Rules for Trust and Mortgage Servicing Accounts (FIL-7-2022, PR-4-2022, January 21, 2022)	The FDIC published a final rule to amend the deposit insurance regulations for trust accounts and mortgage servicing accounts. The changes are intended to make the deposit insurance rules easier to understand for depositors and bankers, facilitate more timely insurance determinations for trust accounts in the event of bank failure, and enhance consistency of insurance coverage for mortgage servicing account deposits. The final rule will take effect on April 1, 2024. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22007.html
FDIC and FinCEN Launch Digital Identity Tech Sprint (FIL-4-2022, PR-3-2022, January 11, 2022)	The FDIC and FinCEN announced a Tech Sprint to develop solutions for financial institutions and regulators to help measure the effectiveness of digital identity proofing – the process used to collect, validate, and verify information about a person. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22004.html

Subject	Summary
Consolidated Reports of Condition and Income for Fourth Quarter 2021 (FIL-3-2022, January 7, 2022)	The federal bank regulatory agencies released materials pertaining to the Consolidated Reports of Condition and Income (Call Report) for the December 31, 2021, report date. The new Call Report data item on Schedule RC-R related to the Standard Approach for Counterparty Credit Risk is effective as of this report date for all three versions of the Call Report. See https://www.fdic.gov/news/financial-institution-letters/2022/fil22003.html

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