FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990
Division of Insurance and Research

July 1, 2014

MEMORANDUM TO: The Board of Directors

FROM: Diane Ellis *Diane Ellis*
Director, Division of Insurance and Research

SUBJECT: Revisions to the Deposit Insurance Assessment System

RECOMMENDATION

Staff recommends that the FDIC Board of Directors (the Board) authorize publication of the attached notice of proposed rulemaking (NPR or proposal) with a 60-day comment period. The NPR would: 1) revise the ratios and ratio thresholds for the capital evaluations used in the FDIC's deposit insurance assessment system to conform to the prompt corrective action (PCA) capital ratios and ratio thresholds adopted by the Board, the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency (the Federal banking agencies); 2) revise the assessment base calculation for custodial banks to conform to the revised asset risk weights adopted by the Board under the same final rule; and 3) require that all highly complex institutions measure counterparty exposure for deposit insurance assessment purposes consistent with the Basel III standardized approach.

The NPR would incorporate the new PCA capital ratios and ratio thresholds—the new common equity tier 1 capital ratio and revised thresholds for the tier 1 risk-based capital ratio (for all institutions) and the new supplementary leverage ratio (for certain institutions)—into the deposit insurance assessment system. The proposal would maintain the consistency between capital evaluations for risk-based assessment purposes and capital ratios and ratio thresholds for PCA purposes that has existed since the creation of the risk-based assessment system over 20 years ago. The adoption of these changes will prevent unnecessary complexity and inconsistency between the ratios and thresholds used to determine an insured depository institution's (IDI or bank) capital evaluation for deposit insurance assessment purposes and for PCA purposes.

The NPR would conform the assessment base calculation for custodial banks under the FDIC's deposit insurance assessment system to the new standardized approach asset risk weights. This revision would ensure consistency between the new standardized approach asset risk weights for regulatory capital purposes and the risk weights used for the assessment base deduction applicable to custodial banks.

Concur:

for Roberta K. McInerney
Richard J. Osterman, Jr.
Acting General Counsel

The NPR would also revise the calculation of counterparty exposure amounts by requiring that highly complex institutions use the standardized approach implemented under the Basel III capital rules to measure counterparty credit exposure for deposit insurance assessment purposes. The proposed approach is broadly consistent with the way banks have traditionally measured counterparty exposure.

Staff believes that the proposed amendments will prevent confusion and reduce regulatory burden on banks.

RATIOS AND RATIO THRESHOLDS RELATING TO CAPITAL EVALUATIONS

Background

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)[1] required that the FDIC establish a risk-based deposit insurance assessment system. To implement this requirement, the FDIC adopted by regulation a system that placed all insured depository institutions (IDIs or banks) into nine risk classifications based on two criteria: capital evaluations and supervisory ratings.[2] Each bank was assigned one of three capital evaluations based on data reported in its Consolidated Report of Condition and Income (Call Report): well capitalized, adequately capitalized, or undercapitalized. The capital ratios and ratio thresholds used to determine each capital evaluation were based on the capital ratios and ratio thresholds adopted by the FDIC, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), and the Office of Thrift Supervision (OTS)—the Federal banking agencies at that time—for PCA purposes.[3] In 1993, the ratios and ratio thresholds used to determine each capital evaluation for assessment purposes were as shown in Table 1.

[1] 12 U.S.C. § 1817(b), Pub. L. No. 102-242, 105 Stat. 2236 (1991).

[2] The FDIC first published a transitional rule that provided the industry guidance during the period of transition from a uniform rate to a risk-based assessment system. 57 FR 45263 (Oct. 1, 1992). The FDIC established the new risk-based assessment system, which became effective on January 1, 1994, to replace the transitional rule. 58 FR 34357 (June 25, 1993). 12 CFR § 327.3 (1993).

[3] This final rule, issued by the FDIC, OCC, Federal Reserve, and OTS, in part, established capital ratios and ratio thresholds for the five capital categories for purposes of the PCA rules: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. 57 FR 44866 (Sept. 29, 1992). The risk-based assessment system does not use the two lowest capital categories (significantly undercapitalized and critically undercapitalized) under the PCA rules. For assessment purposes, banks that would be in one of these capital categories are treated as undercapitalized.

Table 1 – Capital ratios used to determine capital evaluations for assessment purposes

Capital Evaluations	Total risk-based ratio	Tier 1 risk-based ratio	Tier 1 leverage ratio
Well Capitalized	≥10%	≥ 6%	≥ 5%
Adequately Capitalized*	≥ 8%	≥ 4%	≥ 4%
Undercapitalized	Does not qualify as either Well Capitalized or Adequately Capitalized		

*An institution is Adequately Capitalized if it is not Well Capitalized, but satisfies each of the listed capital ratio standards for Adequately Capitalized.

In 2007, the nine risk classifications were consolidated into four risk categories, which continued to be based on capital evaluations and supervisory ratings;[4] the capital ratios and the thresholds used to determine capital evaluations remained unchanged.[5]

In 2011, the FDIC adopted a revised assessment system for large banks—generally, those with at least $10 billion in total assets (Assessments final rule).[6] This system eliminated risk categories for these banks, but the capital evaluations continue to be used to determine whether an assessment rate is subject to adjustment for significant amounts of brokered deposits.[7]

The assessment system for small banks, generally those with less than $10 billion in total assets, continues to use risk categories based on capital evaluations and supervisory ratings; the capital ratios and the thresholds used to determine capital evaluations have remained unchanged.

On September 7, 2013, the FDIC adopted an interim final rule.[8] On April 14, 2014, the FDIC published a final rule that, in part, revises the definition of regulatory capital.[9] The OCC and the Federal Reserve adopted a final rule in October 2013 that is substantially identical to the

[4] The four risk categories are I, II, III, and IV. Banks posing the least risk are assigned to risk category I. 71 FR 69282 (Nov. 30, 2006).

[5] To the extent that the definitions of components of the ratios—such as tier 1 capital, total capital, and risk-weighted assets—have changed over time for PCA purposes, the assessment system has reflected these changes.

[6] 76 FR 10672 (Feb. 25, 2011). The FDIC amended Part 327 in a subsequent final rule by revising some of the definitions used to determine assessment rates for large and highly complex IDIs. 77 FR 66000 (Oct. 31, 2012). The term "Assessments final rule" includes the October 2012 final rule.

[7] In 2009, the FDIC added adjustments to its risk-based pricing methods to improve the way the assessment system differentiates risk among insured institutions. The brokered deposit adjustment (one of the adjustments added in 2009) is applicable only to small institutions in risk categories II, III, and IV, and large institutions that are either less than well capitalized or have a composite CAMELS rating of 3, 4 or 5 (under the Uniform Financial Institution Rating System). The adjustment increases assessment rates for significant amounts of brokered deposits. 75 FR 9525 (Mar. 4, 2009).

[8] 78 FR 55340 (Sept. 10, 2013).

[9] 79 FR 20754 (Apr. 14, 2014).

FDIC's interim final rule and final rule.[10] (The FDIC's interim final rule and final rule and the OCC and Federal Reserve's final rule are referred to collectively hereafter as the Basel III capital rules.) The Basel III capital rules revise the thresholds for the tier 1 risk-based capital ratio used to determine a bank's capital category under the PCA rules (that is, whether the bank is well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized). The Basel III capital rules also add a new ratio, the common equity tier 1 capital ratio, and new thresholds for that ratio to determine a bank's capital category under the PCA rules.[11] The new ratio and ratio thresholds will take effect on January 1, 2015.

The Basel III capital rules also adopt changes to the regulatory capital requirements for banking organizations consistent with section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), often referred to as the "Collins Amendment." Under section 171 of the Dodd-Frank Act, the generally applicable capital requirements serve as a risk-based capital floor for banking organizations subject to the advanced approaches risk-based capital rules[12] (advanced approaches banks[13]). Under the Basel III capital rules effective January 1, 2015, the minimum capital requirements as determined by the regulatory capital ratios based on the standardized approach[14] become the "generally applicable" capital requirements under section 171 of the Dodd-Frank Act.

All banks, including advanced approaches banks, must calculate risk-weighted assets under the standardized approach and report these risk-weighted assets, for capital purposes, in Schedule RC-R of the Call Report effective January 1, 2015. Advanced approaches banks also must calculate risk weights using the advanced approaches and report risk-weighted assets in the Risk-Based Capital Reporting for Institutions Subject to the Advanced Capital Adequacy Framework (FFIEC 101). Revisions to the advanced approaches risk-weight calculations became effective January 1, 2014. An advanced approaches bank that has successfully completed the parallel run process[15] must determine whether it meets its minimum risk-based

---

[10] 78 FR 62018 (Oct. 11, 2013).

[11] 78 FR at 62027 and 62283 (OCC and Federal Reserve) and 78 FR 55592 (FDIC), codified, in part, at 12 CFR part 6 (OCC); 12 CFR part 208 (Regulation H), subpart D (Federal Reserve); and 12 CFR part 324, subpart H (FDIC).

[12] The FDIC's advanced approaches rule is at 12 CFR part 324, subpart E. The advanced approaches rule is also supplemented by the FDIC's risk-based capital requirements for banks subject to significant exposure to market risk (market risk rule) in 12 CFR part 324, subpart F.

[13] As used herein, an advanced approaches bank means an IDI that is an advanced approaches national bank or Federal savings association under 12 CFR § 3.100(b)(1), an advanced approaches Board-regulated institution under 12 CFR § 217.100(b)(1), or an advanced approaches FDIC-supervised institution under 12 CFR § 324.100(b)(1). In general, an IDI is an advanced approaches bank if it has total consolidated assets of $250 billion or more, has total consolidated on-balance sheet foreign exposures of $10 billion or more, or elects to use or is a subsidiary of an IDI, bank holding company, or savings and loan holding company that uses the advanced approaches to calculate risk-weighted assets.

[14] The FDIC's standardized approach risk-based capital rule is at 12 CFR part 324, subpart D. The standardized-approach risk-based capital rule is supplemented by the FDIC's market risk rule in 12 CFR part 324, subpart F.

[15] Before determining its risk-weighted assets under advanced approaches, a bank must conduct a satisfactory parallel run. A satisfactory parallel run is a period of no less than four consecutive calendar quarters during which

capital requirements by calculating the three risk-based capital ratios using total risk-weighted assets under the generally applicable risk-based capital rules and, separately, total risk-weighted assets under the advanced approaches.[16] The lower ratio for each risk-based capital requirement is the ratio that will be used to determine an advanced approaches bank's compliance with the minimum capital requirements[17] and, beginning on January 1, 2015, for purposes of determining compliance with the new PCA requirements.[18]

For advanced approaches banks, the Basel III capital rules also introduce the supplementary leverage ratio and a threshold for that ratio that advanced approaches banks must meet to be deemed adequately capitalized.[19] (The supplementary leverage ratio as adopted in the Basel III capital rules does not, however, establish a ratio that advanced approaches banks must meet to be deemed well capitalized.) While all advanced approaches banks must calculate and begin reporting the supplementary leverage ratio beginning in the first quarter of 2015, the supplementary leverage ratio does not become effective for PCA purposes until January 1, 2018.[20]

On May 1, 2014, the Federal banking agencies published a final rule (the Enhanced Supplementary Leverage Ratio final rule) that strengthens the supplementary leverage ratio standards for the largest advanced approaches banks.[21] The Enhanced Supplementary Leverage Ratio final rule provides that an IDI that is a subsidiary of a covered bank holding company (BHC) must maintain a supplementary leverage ratio of at least 6 percent to be well capitalized under the Federal banking agencies' PCA framework.[22] Again, the supplementary leverage ratio does not become effective for PCA purposes until January 1, 2018.

---

the bank complies with the qualification requirements to the satisfaction of its primary Federal regulator. Following completion of a satisfactory parallel run, a bank must receive approval from its primary Federal regulator to calculate risk-based capital requirements under the advanced approaches. See 12 CFR § 324.121 (FDIC); 12 CFR § 3.121 (OCC); and 12 CFR § 217.121 (Federal Reserve).

[16] Currently, the generally applicable risk-based capital rules are found at 12 CFR part 325, appendix A (as supplemented by the risk-based capital requirements for banks subject to the market risk rule in appendix C). Effective January 1, 2015, the generally applicable risk-based capital rules will be based on the standardized approach for calculating risk-weighted assets under the Basel III capital rules, 12 CFR part 324, subpart D (as supplemented by the risk-based capital requirements for banks subject to the market risk rule in subpart F).

[17] See 12 CFR § 324.10(c) (FDIC); 12 CFR § 3.10(c) (OCC); and 12 CFR § 217.10(c) (Federal Reserve).

[18] See 12 CFR part 324, subpart H.

[19] The supplementary leverage ratio includes many off-balance sheet exposures in its denominator, while the generally applicable leverage ratio does not.

[20] 78 FR at 62277 (OCC and Federal Reserve); 78 FR at 55592 (FDIC).

[21] 79 FR 24528 (May 1, 2014).

[22] 79 FR at 24530. IDI subsidiaries of a "covered BHC" are a subset of IDIs subject to advanced approaches requirements. A covered BHC is any U.S. top-tier U.S. BHC with more than $700 billion in total consolidated assets or more than $10 trillion in assets under custody. 79 FR at 24530. The list of "covered BHCs" is consistent with the list of banking organizations that meet the Basel Committee on Banking Supervision (BCBS) definition of a Global Systemically Important Bank (G-SIB), based on year-end 2011 data, and consistent with the revised list,

Proposed Capital Evaluations

The NPR recommended by staff proposes to revise the ratios and ratio thresholds relating to capital evaluations for deposit insurance assessment purposes to conform to the new PCA capital rules. This proposed revision would maintain the consistency between capital evaluations for deposit insurance assessment purposes and capital ratios and ratio thresholds for PCA purposes that has existed since the creation of the risk-based assessment system over 20 years ago. Ensuring that the same ratios, ratio thresholds, and terminology used for PCA purposes also are used for deposit insurance assessment purposes will avoid differing capital definitions and potential confusion, and will decrease regulatory burden for banks because they will be subject to only a single set of capital category definitions.

Specifically, the NPR proposes to revise the definitions of well capitalized and adequately capitalized for deposit insurance assessment purposes to reflect the threshold changes for the tier 1 risk-based capital ratio, to incorporate the common equity tier 1 capital ratio and its thresholds and, for those banks subject to the supplementary leverage ratio for PCA purposes, to incorporate the supplementary leverage ratio and its thresholds.[23] The definition of undercapitalized will remain unchanged. The NPR proposes to make the revisions to the definitions of well capitalized and adequately capitalized for deposit insurance assessment purposes effective when the new PCA capital rules become effective. Therefore, some of the revisions for deposit insurance assessment purposes would become effective January 1, 2015 and the remaining revisions would become effective January 1, 2018.

Effective January 1, 2015, staff proposes that for deposit insurance assessment purposes:

1. An institution would be well capitalized if it satisfies each of the following capital ratio standards: total risk-based capital ratio, 10.0 percent or greater; tier 1 risk-based capital ratio, 8.0 percent or greater (as opposed to the current 6.0 percent or greater); leverage ratio, 5.0 percent or greater; and common equity tier 1 capital ratio, 6.5 percent or greater.

2. An institution would be adequately capitalized if it is not well capitalized but satisfied each of the following capital ratio standards: total risk-based capital ratio, 8.0 percent or greater; tier 1 risk-based capital ratio, 6.0 percent or greater (as opposed to the current 4.0 percent or greater); leverage ratio, 4.0 percent or greater; and common equity tier 1 capital ratio, 4.5 percent or greater.

---

based on year-end 2012 data. The revised list is available at http://www.financialstabilityboard.org/publications/r_131111.pdf).

[23] To the extent that the definitions of components of the ratios—such as tier 1 capital, total capital, and risk-weighted assets—change in the future for PCA purposes, the assessment system will automatically incorporate these changes as implemented under the Basel III capital rules. Thus, for example, if the Federal banking agencies adopt a final rule redefining the denominator of the supplementary leverage ratio, as they have proposed, 79 FR 24596 (May 1, 2014), the new definition will automatically become applicable to the assessment system.

The definition of an undercapitalized institution would remain the same: an institution would be undercapitalized if it does not qualify as either well capitalized or adequately capitalized.

The NPR also proposes a technical amendment to Part 327 to replace the terms “Total risk-based ratio,” “Tier 1 risk-based ratio,” and “Tier 1 leverage ratio,” with “total risk-based capital ratio,” “tier 1 risk-based capital ratio,” and “leverage ratio,” respectively, wherever such terms appear.[24]

Table 2 summarizes the proposed ratios and ratio thresholds for determining capital evaluations for deposit insurance assessment purposes, to be effective January 1, 2015.

Table 2 – Proposed capital ratios used to determine capital evaluations for assessment purposes, effective January 1, 2015

Capital Evaluations	Total risk-based capital ratio	Tier 1 risk-based capital ratio	Common equity tier 1 capital ratio	Leverage ratio
Well Capitalized	≥10%	≥ 8%	≥ 6.5%	≥ 5%
Adequately Capitalized*	≥ 8%	≥ 6%	≥ 4.5%	≥ 4%
Undercapitalized	Does not qualify as either Well Capitalized or Adequately Capitalized			
*An institution is Adequately Capitalized if it is not Well Capitalized, but satisfies each of the listed capital ratio standards for Adequately Capitalized.				

Effective January 1, 2018, the NPR proposes to add the supplementary leverage ratio to its capital evaluations for deposit insurance assessment purposes to conform to the PCA capital rules. For assessment purposes, an advanced approaches bank, including an IDI subsidiary of a covered BHC, must have at least a 3.0 percent supplementary leverage ratio to be adequately capitalized, and an IDI subsidiary of a covered BHC must have at least a 6.0 percent supplementary leverage ratio to be well capitalized.

Table 3 summarizes the proposed ratios and ratio thresholds for determining capital evaluations for deposit insurance assessment purposes, to be effective January 1, 2018.

[24] The FDIC has identified a slight inconsistency in terminology between the PCA capital rules of Parts 324 and 325 and the deposit insurance assessment system of Part 327. Currently, the risk-based assessment system under Part 327 uses the terms “Total risk-based ratio,” “Tier 1 risk-based ratio,” and “*Tier 1* leverage ratio.” The PCA capital rules use the terms “total risk-based *capital* ratio,” “tier 1 risk-based *capital* ratio,” and “leverage ratio” (emphasis added). Despite this minor difference in nomenclature, the underlying calculations for each of these three ratios are the same under Parts 324, 325 and 327 of the FDIC regulations.

Table 3 - Proposed capital ratios used to determine capital evaluations for assessment purposes, effective January 1, 2018

Capital Evaluations	Total risk-based capital ratio	Tier 1 risk-based capital ratio	Common equity tier 1 capital ratio	Leverage ratio	Supplementary leverage ratio (advanced approaches banking organizations)	Supplementary leverage ratio (subsidiary IDIs of covered BHCs)
Well Capitalized	≥10%	≥ 8%	≥ 6.5%	≥ 5%	Not applicable	≥ 6%
Adequately Capitalized*	≥ 8%	≥ 6%	≥ 4.5%	≥ 4%	≥ 3%	≥ 3%
Undercapitalized	Does not qualify as either Well Capitalized or Adequately Capitalized					
*An institution is Adequately Capitalized if it is not Well Capitalized, but satisfies each of the listed capital ratio standards for Adequately Capitalized.						

ASSESSMENT BASE CALCULATION FOR CUSTODIAL BANKS

Background

The FDIC charges IDIs an amount for deposit insurance equal to the IDI's deposit insurance assessment base multiplied by its risk-based assessment rate. The Dodd-Frank Act directed the FDIC to amend its regulatory definition of "assessment base" for purposes of setting assessments for IDIs. Specifically, the Dodd-Frank Act required the FDIC to define the term "assessment base" with respect to a depository institution:

> as an amount equal to –
> (1) the average consolidated total assets of the insured depository institution during the assessment period; minus
> (2) the sum of –
> (A) the average tangible equity of the insured depository institution during the assessment period, and
> (B) in the case of an insured depository institution that is a custodial bank (as defined by the Corporation, based on factors including the percentage of total revenues generated by custodial businesses and the level of assets under custody) …, an amount that the Corporation determines is necessary to establish assessments consistent with the definition under section 7(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1817(b)(1)) for a custodial bank …[25]

In February 2011, the FDIC implemented this requirement in the Assessments final rule.[26] The Assessments final rule defines a custodial bank and specifies the additional amount to be deducted from a custodial bank's average consolidated total assets for purposes of determining its assessment base. The assessment base deduction for custodial banks is defined

[25] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203 (Dodd-Frank Act), § 331(b), 124 Stat. 1376, 1538 (codified at 12 U.S.C. § 1817(nt)).

[26] 76 FR at 10706.

as the daily or weekly average (depending upon the way the bank reports its average consolidated total assets) of a specified amount of certain low-risk, liquid assets, subject to the limitation that the daily or weekly average value of such assets not exceed the average value of deposits that are classified as transaction accounts and are identified by the bank as being directly linked to a fiduciary or custodial and safekeeping account.

Under the Assessments final rule, a custodial bank may deduct all asset types described in the instructions to lines 34, 35, 36, and 37 of Schedule RC–R of the Call Report as of December 31, 2010 with a Basel risk weight of 0 percent, regardless of maturity, and 50 percent of those asset types described in the instructions to those same lines with a Basel risk weight of 20 percent, again regardless of maturity.[27] These assets include cash and balances due from depository institutions, securities, federal funds sold, and securities purchased under agreements to resell.

Under the Basel III capital rules, the standardized approach introduces 2 percent and 4 percent risk weights for cleared transactions with Qualified Central Counterparties (QCCPs), as defined in the regulatory capital rules, subject to certain collateral requirements.[28] The lower risk weights reflect the Federal banking agencies' support for "incentives designed to encourage clearing of derivative and repo-style transactions through a CCP [central counterparty] wherever possible in order to promote transparency, multilateral netting, and robust risk-management practices."[29] Nonetheless, the new 2 percent and 4 percent risk weights (being greater than 0) recognize that, while clearing transactions through a CPP significantly reduces counterparty credit risk, the clearing process does not eliminate risk altogether and that some degree of residual risk is retained.

Section 939A of the Dodd-Frank Act requires the removal of any regulatory reference to or requirement of reliance on credit ratings for assessing the credit-worthiness of a security or money market instrument and the substitution of new standards of credit-worthiness.[30] Consequently, the Basel III capital rules remove references to credit ratings for purposes of determining risk weights for risk-based capital calculations, and the standardized approach introduces a formula-based methodology for calculating risk-weighted assets for many securitization exposures. Risk weights under the standardized approach for certain other assets, including but not limited to exposures to foreign sovereigns, foreign banks, and foreign public sector entities, have also changed.

---

[27] Risk-weighted assets are generally determined by assigning assets to broad risk-weight categories. The amount of an asset is multiplied by its risk weight (for example, 0 percent or 20 percent) to calculate the risk-weighted asset amount.

[28] See 78 FR 62184-85 (OCC and Federal Reserve); 78 FR at 55502 (FDIC).

[29] See 78 FR at 62096 (OCC and Federal Reserve); 78 FR at 55414 (FDIC).

[30] See 15 U.S.C. § 78o–7 note.

Proposed Assessment Base Calculation

The NPR recommended by staff proposes to revise the assessment base deduction for custodial banks to conform to the new standardized approach for risk-weighted assets adopted in the Basel III capital rules. For deposit insurance assessment purposes, the NPR proposes to continue using the generally applicable risk weights (as revised under the standardized approach, effective January 1, 2015), even for advanced approaches banks. Using a single set of risk weights assures that all custodial banks will be treated consistently for purposes of determining the assessment base deduction, whether or not they are advanced approaches banks. In addition, as described above, all banks, including advanced approaches banks, must calculate standardized approach risk weights to determine compliance with minimum capital requirements and the PCA standards. Thus, the NPR's proposal should not increase reporting burden for advanced approaches banks.

The NPR proposes to continue to define the assessment base deduction for custodial banks as the daily or weekly average of a certain amount of specified low-risk, liquid assets, subject to the limitation that the daily or weekly average value of these assets cannot exceed the daily or weekly average value of deposits that are classified as transaction accounts and are identified by the bank as being directly linked to a fiduciary or custodial and safekeeping account asset. Subject to this limitation, effective January 1, 2015, the NPR proposes that the assessment base deduction be the daily or weekly average of:

1. 100 percent of those asset types described in the instructions to lines 1, 2, and 3 of Schedule RC of the Consolidated Report of Condition and Income with a standardized approach risk weight of 0 percent, regardless of maturity, excluding any asset that qualifies as a securitization exposure; plus

2. 50 percent of those asset types described in the instructions to lines 1, 2, and 3 of Schedule RC of the Consolidated Report of Condition and Income with a standardized approach risk weight greater than 0 and up to and including 20 percent, regardless of maturity, excluding any asset that qualifies as a securitization exposure.

In general, the assets described in lines 1, 2, and 3 of Schedule RC of the Call Report include cash and balances due from depository institutions, securities (both held-to-maturity and available-for-sale), federal funds sold, and securities under agreements to resell. The inclusion of these asset types in the assessment base deduction for custodial banks is consistent with the asset types included in the current adjustment.

The assessment base of a custodial bank is adjusted because of the custodial bank's need to hold low-risk, liquid assets to facilitate the payments and processing function associated with its custody and safekeeping accounts. For this reason, the NPR proposes to exclude from the assessment base deduction those asset types described in lines 1, 2, and 3 of Schedule RC of the Call Report that qualify as a securitization exposure as defined in the regulatory capital rules,[31]

[31] 78 FR at 55482.

since these assets are often not liquid. Under the Basel III capital rules, a securitization exposure generally includes credit exposures with more than one underlying exposure where the credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority.[32] Traditional collateralized mortgage obligations issued or guaranteed by the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, or Government National Mortgage Association that do not have credit tranches generally do not meet this definition of a securitization exposure, and thus will generally continue to be included in the assessment base deduction for custodial banks.

In addition, 50 percent of assets described in line 3 of Schedule RC of the Call Report that are assigned a 2 or 4 percent risk weight may be included in the assessment base deduction for custodial banks. While these assets are generally liquid and low-risk, they are not risk-free and consequently, staff believes, do not merit a 100 percent inclusion in the assessment base deduction for custodial banks.

The NPR also proposes a technical amendment to the definition of "custodial bank." This amendment removes any reference to the Call Report date of December 31, 2010 and ensures conformity with the Basel III capital rules.

CALCULATION OF COUNTERPARTY EXPOSURES IN THE HIGHLY COMPLEX INSTITUTION SCORECARD

Background

Under section 7 of the Federal Deposit Insurance Act, the FDIC may establish a separate risk-based assessment system for large members of the Deposit Insurance Fund (DIF). In setting assessments for IDIs, the FDIC must consider certain enumerated factors, including the probability that the DIF will incur a loss with respect to an institution, taking into consideration the risks attributable to different categories and concentrations of assets and liabilities.[33] In the Assessments final rule, the FDIC adopted a revised assessment system for large banks—generally, those with at least $10 billion in total assets. This system, which went into effect in the second quarter of 2011, uses scorecards that combine CAMELS ratings and certain financial measures to assess the risk a large institution poses to the DIF. One scorecard applies to most large institutions and another applies to highly complex institutions, those that are structurally and operationally complex or that pose unique challenges and risks to the DIF in the event of failure.[34]

---

[32] Securitization exposure is defined as an on- or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arises from a traditional securitization or a synthetic securitization (including a re-securitization), or an exposure that directly or indirectly references a securitization exposure. See 78 FR at 62168 (OCC and Federal Reserve); 78 FR at 55482 (FDIC).

[33] 12 U.S.C. § 1817(b).

[34] A ''highly complex institution'' is defined as: (1) An IDI (excluding a credit card bank) that has had $50 billion or more in total assets for at least four consecutive quarters that either is controlled by a U.S. parent holding company

The scorecards for both large and highly complex institutions use quantitative measures that are useful in predicting a large institution's long-term performance. Most of the measures used in the highly complex institution scorecard are similar to the measures used in the large bank scorecard. The scorecard for highly complex institutions, however, includes additional measures, such as the ratio of top 20 counterparty exposures to Tier 1 capital and reserves and the ratio of the largest counterparty exposure to Tier 1 capital and reserves (collectively, the counterparty exposure measures). Both ratios are defined in the Assessments final rule.

The Assessments final rule defines counterparty exposure as the sum of exposure at default (EAD) associated with derivatives trading[35] and securities financing transactions (SFTs) and the gross lending exposure for each counterparty or borrower.[36] Generally, since June 30, 2011, when highly complex institutions began reporting for scorecard purposes, they have determined and reported their counterparty exposures for assessment purposes using certain methods permitted under the Assessments final rule.[37] The Assessments final rule allows use of an approach based on internal models (the Internal Models Method, or IMM) to calculate counterparty exposures subject to approval by primary federal regulators, but until recently no highly complex institution has been permitted to use the IMM.

The IMM is one component of the advanced approaches risk-based capital framework. Banking organizations that have received approval to use the advanced approaches do not automatically have approval to use the IMM, which requires a separate approval. Seven of the nine highly complex institutions recently received approval from their primary regulators to use the advanced approaches for regulatory capital beginning in the first quarter of 2014. Of these seven banks, some, but not all, have received approval from their primary regulator to use the IMM for calculating part of their counterparty credit risk beginning in the second quarter of 2014. Thus, some of the nine banks using the highly complex institution scorecard began calculating their counterparty exposure in the second quarter of 2014 using the IMM, while the others will use non-IMM methods.

Based on preliminary assessments data, the adoption of the IMM by itself will cause a significant reduction in counterparty exposure amounts and change the scorecard results in a way that significantly reduces deposit insurance assessments for the banks using the IMM. This significant reduction in assessments does not appear to be driven primarily by a change in risk

---

that has had $500 billion or more in total assets for four consecutive quarters, or is controlled by one or more intermediate U.S. parent holding companies that are controlled by a U.S. holding company that has had $500 billion or more in assets for four consecutive quarters; or (2) a processing bank or trust company. 12 CFR § 327.8(g).

[35] Derivatives trading exposures include both over-the-counter (OTC) derivatives and derivative contracts that an IDI has entered into with a central counterparty.

[36] Counterparty exposure excludes all counterparty exposure to the U.S. government and departments or agencies of the U.S. government that is unconditionally guaranteed by the full faith and credit of the United States.

[37] For example, permitted methods for derivatives exposures have included the credit equivalent amount as calculated under the Federal banking agencies' general risk-based capital rules and the current exposure method (CEM) under the BCBS Basel II framework.

exposure, but rather by a change in measurement methodology. Moreover, since the second quarter of 2014, the nine banks currently subject to the highly complex institution scorecard have been measuring counterparty risk in different ways, and the differences in assessments are driven primarily by the different methodologies these banks are using.

General Description and Rationale for Proposed Counterparty Exposure Calculation

Consequently, the NPR proposes that all banks using the highly complex institution scorecard calculate their counterparty exposure using standardized approach measures from the Basel III capital rules starting in the first quarter of 2015. Using the standardized approach has four primary advantages. First, all banks employing the highly complex institution scorecard would calculate their counterparty exposure using a common measurement framework. Using a common, consistent methodology for measuring counterparty exposure would ensure that methodological differences do not determine a bank's exposure relative to its peers. This advantage is an important consideration in a risk-based assessment system that in part functions by comparing banks according to specified risk metrics. Second, this approach would ensure a consistent measurement of counterparty exposure even among advanced approaches banks approved for the use of IMM. Third, as compared to allowing the IMM to determine the counterparty exposure measure for the scorecard, the proposal is generally more consistent with the approach taken in the Federal banking agencies' regulatory capital framework, because most advanced approaches banks will be bound by the floor set by the standardized approach risk-based capital rules. Finally, all nine institutions currently using the highly complex institution scorecard would be using counterparty exposure measures they will compute for the standardized approach, so that the proposal would not impose additional reporting burdens.

The proposed approach – using the standardized approach – is intended to be broadly consistent with the way banks have measured their counterparty exposure under the Assessments final rule (before adopting IMM). Under the NPR, exposure to a counterparty would be the sum of gross loans, the credit equivalent amount of all derivatives exposures as reported in the revised Basel III regulatory reporting instructions for the standardized approach, and the amount of SFTs subject to risk weighting. The proposal is described in more detail directly below.

Specifics of the Proposed Counterparty Exposure Calculation

For deposit insurance assessment purposes, the NPR proposes that, effective January 1, 2015, all highly complex institutions calculate counterparty exposure amounts for the counterparty exposure measures based upon the standardized approach implemented under the Basel III capital rules. Counterparty exposure amounts would continue to include derivatives, SFTs and gross lending exposures (including all unfunded commitments). SFTs would include repurchase agreements, reverse repurchase agreements, security lending and borrowing, and margin lending transactions, where the value of the transactions depends on market valuations and the transactions are often subject to margin agreements. A cleared transaction, which is an exposure associated with an outstanding derivative contract or repo-style transaction that an IDI has entered into with a central counterparty, would be included in the counterparty exposure measures. Counterparty exposure would continue to exclude all counterparty exposure to the

U.S. government and departments or agencies of the U.S. government that is unconditionally guaranteed by the full faith and credit of the United States.

Specifically, the NPR proposes that, for deposit insurance assessment purposes, the counterparty exposure amount associated with derivatives, including OTC derivatives, a cleared transaction that is a derivative contract, or a netting set of derivative contracts,[38] would be calculated as the credit equivalent amount under the standardized approach. The credit equivalent amount under the standardized approach is the exposure amount set forth in 12 CFR 324.34(a) and is the sum of current credit exposure and potential future exposure without reduction for collateral.[39] This approach is generally consistent with the manner in which highly complex institutions have been measuring derivatives exposure for the counterparty exposure measures before their approval to use IMM.

The NPR proposes that, for deposit insurance assessment purposes, the counterparty exposure amount associated with SFTs, including SFTs that are cleared transactions, would be calculated using either the simple approach or the collateral haircut approach contained in 12 CFR 324.37(b) and (c), respectively. This treatment is generally consistent with the manner in which highly complex institutions have been measuring counterparty exposure under the Assessments final rule.

For both derivative and SFT exposures, the amount of counterparty exposure to central counterparties would also include the default fund contribution, which is the funds contributed or commitments made by a clearing member to a central counterparty's mutualized loss sharing arrangement.

These proposals are likely to change the amounts that highly complex institutions report in their counterparty exposure measures. For banks that have begun reporting counterparty exposure using the IMM, the amounts reported under the proposals are likely to increase total scores and assessment rates compared to amounts reported under the IMM; however, staff lacks sufficient data to determine the magnitude of the increases at this time. The proposals also may change the counterparty exposure amounts reported by banks that do not use the IMM because the standardized approach in the Basel III capital rules changes the generally applicable risk-based capital rules. Because banks will not begin reporting under the Basel III standardized approach until March 2015, staff lacks sufficient data at this time to determine whether the proposals would increase or decrease total scores and assessment rates for these banks.

To ensure that scores for the counterparty exposure measures appropriately differentiate for risk, the FDIC may need to revise the conversion of the counterparty exposures measures to

[38] A "netting set" is a group of transactions with a single counterparty that are subject to a qualifying master netting agreement or a qualifying cross-product master netting agreement. 12 CFR § 324.2.

[39] For multiple OTC derivative contracts subject to a qualifying master netting agreement, however, the exposure amount equals the sum of the net current credit exposure and the adjusted sum of potential future exposure OTC derivative contracts subject to the qualifying master netting agreement, also without reduction for collateral.

scores (that is, recalibrate the conversion) after reviewing data reported for some or all of 2015. The FDIC's Board would continue to reserve the right to make such a revision without further notice-and-comment rulemaking.[40] From time to time, the FDIC could add new data for subsequent reporting periods to its analysis and exclude some earlier reporting periods from its analysis. Updating the conversion of the counterparty exposure measures to scores would allow the FDIC to use the most recent data, thereby improving the accuracy of the scorecard method. The NPR also proposes that FDIC give banks at least one quarter notice before any revision takes effect.

Alternatives

Staff considered alternatives to this proposal and the NPR requests comment on three alternatives. The first alternative would be to recalibrate the conversion of counterparty exposure measures into scores using exposures calculated under the IMM approach. The second alternative would recognize collateral posted in derivatives transactions; specifically, this alternative would allow collateral to reduce the credit equivalent amount of derivatives. The third alternative would be to measure counterparty exposure using "total leverage exposure," which is the exposure measure in the denominator of the supplementary leverage ratio.

EFFECTIVE DATES

Ratios and Thresholds Relating to Capital Evaluations

The NPR proposes two effective dates for the ratios and ratio thresholds relating to the capital evaluation used in the FDIC's risk-based assessment system: January 1, 2015, and January 1, 2018, the effective dates for the changes to the PCA regulatory capital rules.

Assessment Base Calculation for Custodial Banks

The NPR proposes an effective date for the assessment base calculation for custodial banks of January 1, 2015.

Calculation of Counterparty Exposures in the Highly Complex Institution Scorecard

The NPR proposes an effective date for the calculation of counterparty exposure in the highly complex institution scorecard of January 1, 2015.

[40] See 76 FR at 10700; 77 FR at 66016.

Staff contacts:

DIR

Munsell St. Clair, Chief, Banking and Regulatory Policy Section, (202) 898-8967
Ashley M. Mihalik, Senior Financial Economist, Banking and Regulatory Policy Section, (202) 898-3793

Legal Division

Nefretete Smith, Senior Attorney, (202) 898-6851
Tanya Otsuka, Attorney, (202) 898-6816