FDIC
Federal Deposit Insurance Corporation
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Division of Insurance and Research

December 7, 2018

MEMORANDUM TO: The Board of Directors

FROM: 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 amend the FDIC's deposit insurance assessment regulations to apply the community bank leverage ratio (CBLR) framework to the deposit insurance assessment system.[1]

The primary objective of this proposal is to incorporate the alternative measure of capital adequacy established under the CBLR framework into the current risk-based deposit insurance assessment system in a manner that: (1) maximizes regulatory relief for small institutions that use the CBLR framework; and (2) minimizes increases in deposit insurance assessments that may arise without a change in risk. The rulemaking would maintain the fair and appropriate pricing of deposit insurance for institutions that use the CBLR.

Specifically, the NPR proposes to amend the FDIC's assessment regulations to provide that a CBLR bank would be priced under the small bank assessment methodology. Also the NPR would amend the assessment regulations to allow for the option to calculate: (1) the assessment base of qualifying community banking organizations that elect to use the CBLR framework (CBLR banks) using tangible equity capital as defined by the CBLR framework (CBLR tangible equity)[2] instead of tier 1 capital; and (2) the assessment rate of such banks using

[1] In this proposal, the term "CBLR framework" refers to the simplified measure of capital adequacy provided in the interagency proposal published by the FDIC, the Board of Governors of the Federal Reserve System (Federal Reserve) and the Office of the Comptroller of the Currency (OCC) (collectively, the Federal banking agencies) in the Federal Register on December __, 2018 (CBLR NPR), as well as any subsequent changes to that proposal that are adopted during the rulemaking process. Staff expects that this rule would be effective on the same date as the CBLR NPR, with all definitions and references aligned accordingly.

[2] In the CBLR NPR, CBLR tangible equity would equal total bank equity capital, prior to including minority interests, and excluding accumulated other comprehensive income (AOCI), deferred tax assets arising from net operating loss and tax credit carryforwards, goodwill, and certain other intangible assets, calculated in accordance with a qualifying community bank organization's regulatory reports. *See* [insert cite to CBLR NPR].

Concur:

Charles Yi
General Counsel

the CBLR (defined as the ratio of tangible equity capital to average total consolidated assets) instead of the tier 1 leverage ratio. For a minority of small banks, the use of the CBLR to calculate the assessment rate or CBLR tangible equity to calculate the assessment base may result in a higher assessment. Therefore, in addition to reporting CBLR tangible equity and the CBLR for capital purposes under the CBLR framework, the proposal would give a CBLR bank the option to use tier 1 capital for purposes of the assessment base calculation, and report the tier 1 leverage ratio for purposes of the assessment rate calculation.[3]

The proposal also would clarify that a CBLR bank that meets the definition of a custodial bank[4] would have no change to its custodial bank deduction or reporting items required to calculate the deduction. A CBLR bank that meets the definition of a custodial bank would continue to report the items related to the custodial bank deduction on its Call Report for assessment purposes, one of which is calculated based on the risk weighting of qualifying low-risk liquid assets; however, to utilize the deduction the bank would not be required to report the more detailed schedule of risk-weighted assets for regulatory capital purposes consistent with adoption of the CBLR framework.

In addition, the proposal clarifies that the assessment regulations would continue to reference the prompt corrective action (PCA) regulations for the definitions of capital categories used in the deposit insurance assessment system, with technical amendments to align with the CBLR NPR. To assist banks in understanding the effects of the NPR, staff plans to provide on the FDIC website a spreadsheet calculator that estimates deposit insurance assessment amounts under the proposal.

Staff believes that this proposal would extend the regulatory relief for small institutions under the CBLR framework while minimizing or potentially eliminating increases in deposit insurance assessments that are unrelated to a change in risk.

BACKGROUND

The CBLR framework, including the anticipated reporting changes, would allow qualifying community banking organizations (defined as a depository institution or depository institution holding company with total consolidated assets of less than $10 billion and a limited risk profile[5]) to report their CBLR and other relevant information on a simpler regulatory capital schedule in their Call Report.

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[3] In order to effectuate the FDIC's intent to provide CBLR banks with these options, the FDIC, in coordination with the Federal Financial Institution Examination Council (FFIEC), would seek comment on proposed changes, including a new line item to report the tier 1 leverage ratio and revised instructions for reporting items related to the assessment base calculation, to Schedule RC-O and its instructions in the Consolidated Reports of Condition and Income (Call Report) in a separate Paperwork Reduction Act notice.

[4] Generally, a custodial bank is defined as an insured depository institution (IDI) with previous calendar year-end trust assets of at least $50 billion or those insured depository institutions that derived more than 50 percent of their revenue from trust activity over the previous calendar year. *See* 12 CFR 327.5(c)(1). The assessment regulations also provide an adjustment to the assessment base for banker's banks under 12 CFR 327.5(b); however, that adjustment would not be affected by this proposal.

[5] The CBLR NPR would exclude organizations with amounts of off-balance sheet exposures, trading assets and liabilities, mortgage servicing assets, and certain deferred tax assets above certain levels. An advanced approaches

The simpler regulatory capital schedule would not include items required to calculate deposit insurance assessments under the current system, such as tier 1 capital, the tier 1 leverage ratio, and components used to calculate risk-weighted assets. Tier 1 capital is used in the calculation of a bank's assessment base, as well as in the depository institution debt adjustment (DIDA) applicable to a bank's assessment rate. The tier 1 leverage ratio is one of seven financial measures, in addition to a weighted average of supervisory ratings (CAMELS), used to calculate an established small bank's assessment rate.[6] Finally, current regulations allow for an adjustment to the assessment base for custodial banks equal to a certain amount of low risk-weighted assets.

ASSESSMENT BASE AND ASSESSMENT RATE ADJUSTMENTS

A bank's assessment base equals its average total consolidated assets minus average tangible equity.[7] The NPR proposes to amend the definition of tangible equity for purposes of calculating the assessment base to mean either CBLR tangible equity, or tier 1 capital, as appropriate. For most, but not all, CBLR banks, CBLR tangible equity would equal or exceed tier 1 capital. However, in the event that a bank's CBLR tangible equity is less than tier 1 capital, its assessment base and assessment amount could increase. Therefore, through this NPR and upcoming corresponding Call Report changes, CBLR banks would have the option to use either tier 1 capital or CBLR tangible equity when calculating and reporting "average tangible equity" for purposes of calculating the bank's assessment base. Staff believes that the proposed change would minimize increases in deposit insurance assessments that may arise without a change in risk.

The change to tangible equity and the resulting change to a bank's assessment base also would affect adjustments that could apply to a CBLR bank's assessment rate because the assessment base is used in the denominator of each adjustment.[8] Finally, the NPR also proposes to amend the DIDA to substitute CBLR tangible equity in place of tier 1 capital for CBLR banks.[9] Under the proposal, the FDIC would exclude an amount equal to no more than 3 percent of CBLR tangible equity in calculating the DIDA of a CBLR bank. All other banks would continue to be able to exclude an amount equal to no more than 3 percent of tier 1 capital and thus would see no change.

Staff believes that the proposed changes maximize regulatory relief for CBLR banks. A CBLR bank would experience a decrease in reporting burden as a result of this proposal. If the

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banking organization also would not be a qualifying community banking organization. *See* [insert cite to CBLR NPR].

[6] *See* 12 CFR 327.16(a). Generally, an "established small institution" is an institution with less than $10 billion in total assets that has been federally insured for at least five years. *See* 12 CFR 327.8(v).

[7] *See* 12 CFR 327.5(a). Tangible equity is defined as tier 1 capital. *See* 12 CFR 327.5(a)(2).

[8] These adjustments are the DIDA, the unsecured debt adjustment, and the brokered deposit adjustment. *See* 12 CFR 327.16(e).

[9] Under the current assessment system, a bank may exclude no more than 3 percent of its end-of-quarter tier 1 capital when calculating the DIDA. *See* 12 CFR 327.16(e)(2)(i).

bank chooses the option to use tier 1 capital for assessment purposes, it would experience an increase in its reporting burden relative to other CBLR banks by having to calculate tier 1 capital when reporting its average tangible equity. Compared to current reporting, however, this would still result in an overall reduction in reporting. Staff expects that a CBLR bank only would elect the option to use tier 1 capital if it would result in a lower assessment.

ASSESSMENT RATES FOR ESTABLISHED SMALL INSTITUTIONS

The NPR recommended by staff proposes to amend the definition of the Leverage Ratio (defined as tier 1 capital divided by adjusted average assets, also referred to in this document as the tier 1 leverage ratio) in the small bank pricing methodology, which is used to calculate an established small bank's assessment rate, to mean the higher of either the CBLR or tier 1 leverage ratio for CBLR banks.

The goal of the proposed change is to minimize increases in deposit insurance assessments that may arise without a change in risk. Staff estimates that for most, but not all, qualifying community banking organizations under the CBLR framework, the CBLR would equal or exceed the tier 1 leverage ratio and, therefore, would reduce or have no effect on an established small bank's deposit insurance assessment rate. However, in the event that an established small bank's CBLR is less than its tier 1 leverage ratio, its assessment rate could increase. Therefore, through corresponding changes to the Call Report, CBLR banks would have the option to separately report the tier 1 leverage ratio, in addition to the CBLR, for purposes of calculating the bank's assessment rate. As reflected in the proposed amendments to the definition of "Leverage Ratio," the FDIC would then use the value that results in the lowest assessment when calculating the bank's assessment rate (i.e., the higher value).

Staff further believes that the proposed change maximizes regulatory relief for CBLR banks. A CBLR bank would experience a decrease in its reporting burden under this proposal. If the bank chooses the option to report its tier 1 leverage ratio for assessment purposes, it would experience an increase in its reporting burden relative to other CBLR banks by having to calculate and report the ratio. However, reporting the tier 1 leverage ratio would be optional and staff expects that a CBLR bank would only calculate and report this additional line item it would result in a lower assessment. Compared with current reporting, the proposal would result in an overall reduction in reporting.

PRICING CBLR BANKS AS SMALL INSTITUTIONS

The NPR proposes to amend the definition of a small institution so that a CBLR bank must be priced under the small bank assessment methodology. Otherwise, the different eligibility thresholds used to define a small bank in the assessment regulations and a CBLR bank under the CBLR framework could result in a CBLR bank that is classified and priced as a large bank.[10] Furthermore, under the proposal, a bank that opts into the CBLR framework and has

[10] Under the current assessment regulations, a large bank is reclassified as small once it has reported less than $10 billion in total assets for four consecutive quarters, and a small bank is reclassified as large once it has reported $10 billion or more in total assets for four consecutive quarters. Under the CBLR NPR, a qualifying community banking

assets of between $5 billion and $10 billion cannot request to be priced as a large bank.[11] Staff believes these changes are warranted because the CBLR framework was intended to provide regulatory relief to small, community banks; whereas, the pricing methodology for large banks is meant to measure the risk of banks with more complex operations and organizational structures. Further, under the CBLR NPR, CBLR banks would no longer be required to report the tier 1 leverage ratio or tier 1 capital, which are used for multiple measures in the large bank pricing methodology. The FDIC requires large banks to report both items to ensure that risk is priced appropriately.

CLARIFICATIONS NOT REQUIRING A SUBSTANTIVE CHANGE TO REGULATIONS

The NPR clarifies that for any CBLR bank that meets the definition of a custodial bank there is no change in the reporting that is necessary to calculate and receive the custodial bank deduction under the assessment regulations. The NPR would not change the custodial bank deduction. A CBLR bank that receives the custodial bank deduction would continue to report the items related to the custodial bank deduction for assessments purposes, one of which is calculated based on the risk weighting of qualifying low-risk liquid assets. However, consistent with the CBLR framework, CBLR banks that meet the definition of a custodial bank would not be required to report the more detailed schedule of its risk-weighted assets for regulatory capital purposes in order to utilize the deduction.

The proposal also clarifies that the assessment regulations would continue to reference the PCA regulations for the definitions of capital categories used in the deposit insurance assessment system.[12] Any changes to the PCA capital categories that are made as a result of the CBLR rulemaking process would be automatically incorporated into the assessment regulations. The FDIC also proposes to make technical amendments to the assessment regulations to align with the changes in the CBLR NPR.

EXPECTED EFFECTS

Based on Call Report data as of September 30, 2018, the FDIC does not expect that the proposed changes to the assessment regulations would have a material impact on aggregate assessment revenue or on rates paid by individual institutions. The FDIC estimates that 81 percent (4,450 out of 5,477) of banks would meet the proposed qualifying community banking organization criteria[13] for the CBLR framework and would have a CBLR greater than 9 percent. Under the proposal, of the 5,477 banks:

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organization is defined as a depository institution or depository institution holding company with less than $10 billion in total consolidated assets as of the end of the most recent calendar quarter and that meet certain qualifying criteria. Therefore, it is possible that a bank could be eligible to report under the proposed CBLR framework in a given quarter, but under existing assessment regulations would not be reclassified as small until it reported total assets below $10 billion for four consecutive quarters.

[11] Under current regulations, a bank with between $5 billion and $10 billion may request treatment as a large bank for deposit insurance assessments. *See* 12 CFR 327.8(f).
[12] *See* 12 CFR 327.8(z).

[13] *See* [insert cite to CBLR NPR].

- 4,479 (81.8 percent) would see no change in their deposit insurance assessment;

- 560 (10.2 percent) would see a decrease in their assessment, of which, 458 (8.4 percent) would experience a decrease of less than 1 percent, and only 40 (0.7 percent) would experience a decrease greater than 5 percent; and

- 438 (8.0 percent) could, depending on the reporting elections that these banks made, see an increase in their assessment, of which, 347 (6.3 percent) would experience an increase of less than 1 percent, and only 22 (0.4 percent) would experience an increase greater than 5 percent.

CBLR banks facing an increase in assessments would have the option of avoiding that increase, however, either by using tier 1 capital, or reporting the tier 1 leverage ratio, or both, for assessments purposes. Therefore, the number of banks that would experience an increase in assessments as the result of this proposal is likely to be less than 438, depending on the number of banks that utilize the options.

If all CBLR banks that would experience an increase in assessments by opting into the CBLR framework choose to use tier 1 capital and report the tier 1 leverage ratio (in order to prevent any increase in assessments), staff estimates that aggregate revenue to the DIF would decline by $4.3 million annually (0.08% of annual assessments), based on Call Report data as of September 30, 2018. Custodial banks would see no changes in their assessments.

ALTERNATIVES

Staff considered several reasonable and possible alternatives to this proposal.

- One alternative would be to leave in place the current assessment regulations and require CBLR banks to report all of the necessary data related to tier 1 capital and the tier 1 leverage ratio, to determine an institution's assessment base and rate. This option, however, would not maximize regulatory relief for CBLR banks.

- A second alternative would be to require all CBLR banks to use CBLR tangible equity capital and the CBLR, as appropriate, for determining deposit insurance assessments, without the option to use tier 1 capital or to report the tier 1 leverage ratio (or with a time limit on a bank's ability to choose that option) if it resulted in a lower deposit insurance assessment. This option, however, would result in higher deposit insurance assessments for some banks with no corresponding change in their risk profile.

- Under a third alternative, a bank's assessment would be reduced by the historical difference between its estimated assessment based on the CBLR framework and its assessment based on tier 1 capital and the tier 1 leverage ratio. This option, however, would be operationally complex and would become inaccurate over time.

On balance, staff believes that the current proposal would meet its stated policy objectives in the most appropriate and straightforward manner.

EFFECTIVE DATES

The effective date of amendments to assessment regulations would coincide with the effective date of final rule establishing the CBLR framework, but is not expected to occur prior to September 30, 2019.

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