September 15, 2020

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director

SUBJECT: Treatment of Certain Emergency Facilities in the Regulatory Capital Rule and the Liquidity Coverage Ratio Rule

SUMMARY: Staff is presenting for approval of the Federal Deposit Insurance Corporation (FDIC) Board (FDIC Board) the attached interagency final rule (final rule) that would adopt as final the revisions to the regulatory capital rule (capital rule) and the liquidity coverage ratio (LCR) rule made under three interim final rules published in the *Federal Register* on March 23, April 13, and May 6, 2020 (interim final rules). The final rule would adopt these interim final rules as final with no changes. Under the final rule, banking organizations may continue to neutralize the regulatory capital effects of participating in the Money Market Mutual Fund Liquidity Facility (MMLF) and the Paycheck Protection Program Liquidity Facility (PPPLF), and would be required to continue to neutralize the LCR effects of participating in the MMLF and the PPPLF. In addition, Paycheck Protection Program (PPP) covered loans would receive a zero percent risk weight under the capital rule.

Recommendation: Staff requests that the FDIC Board approve this interagency final rule and authorize its publication in the *Federal Register* with an effective date 60 days after the date of publication in the *Federal Register*.

Concur:

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Nicholas J. Podsiadly
General Counsel

Discussion:

I. Background

In light of recent disruptions in economic conditions caused by the outbreak of the coronavirus disease 2019 and the strains in U.S. financial markets, the Board of Governors of the Federal Reserve System (FRB), with the approval of the U.S. Secretary of the Treasury, established certain liquidity facilities pursuant to section 13(3) of the Federal Reserve Act.[1] In order to prevent disruptions in the money markets from destabilizing the financial system, the FRB authorized the Federal Reserve Bank of Boston to establish the MMLF. Under the MMLF, the Federal Reserve Bank of Boston may extend non-recourse loans to eligible borrowers to purchase assets from money market mutual funds. Assets purchased from money market mutual funds are posted as collateral to the Federal Reserve Bank of Boston.

In order to provide liquidity to small business lenders and the broader credit markets, and to help stabilize the financial system, the FRB authorized each of the Federal Reserve Banks to extend credit under the PPPLF. Under the PPPLF, each of the Federal Reserve Banks may extend non-recourse loans to institutions that are eligible to make PPP covered loans as defined in section 7(a)(36) of the Small Business Act.[2] Under the PPPLF, only PPP covered loans that are guaranteed by SBA with respect to both principal and accrued interest and that are originated by an eligible institution may be pledged as collateral to the Federal Reserve Banks.

[1] 12 U.S.C. 343(3).

[2] Congress created the PPP as part of the Coronavirus Aid, Relief, and Economic Security (CARES) Act and in recognition of the exigent circumstances faced by small businesses. PPP covered loans are fully guaranteed as to principal and accrued interest by the Small Business Administration (SBA)and also afford borrower forgiveness up to the principal amount and accrued interest of the PPP covered loan, if the proceeds of the PPP covered loan are used for certain expenses. Under the PPP, eligible borrowers generally include businesses with fewer than 500 employees or that are otherwise considered to be small by the SBA. The SBA reimburses PPP lenders for any amount of a PPP covered loan that is forgiven.

Eligible borrowers from the MMLF and PPPLF and holders of PPP covered loans include banking organizations supervised by the Office of the Comptroller of the Currency (OCC), the FRB, and the FDIC (together, the agencies) that are subject to the capital rule[3] and that may be subject to the LCR rule.[4] To facilitate the use of the MMLF and the PPPLF, the agencies adopted three interim final rules to address the capital treatment of participation in the MMLF (MMLF capital interim final rule)[5] and the PPPLF (PPPLF capital interim final rule),[6] and the LCR treatment of participation in the MMLF and the PPPLF (LCR interim final rule),[7] respectively.

A. Treatment of MMLF and PPPLF Participation under the Capital Rule

The capital rule requires banking organizations to comply with risk-based and leverage capital requirements, which are expressed as a ratio of regulatory capital to assets and certain other exposures. Risk-based capital requirements are based on risk-weighted assets, whereas leverage capital requirements are based on a measure of average total consolidated assets or total leverage exposure. Participation in the MMLF or the PPPLF affects the balance sheet of a banking organization. To participate in the MMLF, a banking organization must acquire and hold assets (that is, eligible collateral pledged to the Federal Reserve Bank of Boston) on its balance sheet. Similarly, to participate in the PPPLF, a banking organization must hold PPP covered loans on its balance sheet. As a result, a banking organization that participates in either facility could have been required to maintain increased regulatory capital.

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[3] *See* 12 CFR part 3 (OCC); 12 CFR part 217 (FRB); and 12 CFR part 324 (FDIC).

[4] *See* 12 CFR part 50 (OCC); 12 CFR part 249 (FRB); and 12 CFR part 329 (FDIC).

[5] 85 FR 16232 (Mar. 23, 2020).

[6] 85 FR 20387 (Apr. 13, 2020).

[7] 85 FR 26835 (May 6, 2020).

B. Treatment of MMLF and PPPLF Participation under the LCR Rule

The LCR rule requires covered companies[8] to calculate and maintain an amount of high-quality liquid assets (HQLA) sufficient to cover their total net cash outflows over a 30-day stress period. A covered company's LCR is the ratio of its HQLA amount divided by its total net cash outflow amount. The total net cash outflow amount is calculated as the difference between outflow and inflow amounts, which are determined by applying a standardized set of outflow and inflow rates to the cash flows of various assets and liabilities, together with off-balance sheet items, as specified in sections 32 and 33 of the LCR rule.[9]

Absent changes to the LCR rule, covered companies would have been required to recognize outflows for MMLF and PPPLF advances with a remaining maturity of 30 days or less and inflows for certain assets securing the MMLF and PPPLF advances. As a result, a covered company's participation in the MMLF or PPPLF could have affected its total net cash outflow amount, which potentially could have resulted in an inconsistent, unpredictable, and more volatile calculation of LCR requirements across covered companies.

II. Interim Final Rules

A. MMLF Capital Interim Final Rule

The MMLF capital interim final rule neutralizes the regulatory capital effect of participation in the MMLF, and permits a banking organization to exclude exposures acquired as

[8] The applicability of the LCR rule is described in 12 CFR 50.1 (OCC); 12 CFR 249.1 (FRB); and 12 CFR 329.1 (FDIC).

[9] *See* 12 CFR 50.32 and 50.33 (OCC); 12 CFR 249.32 and 249.33 (FRB); and 12 CFR 329.32 and 329.33 (FDIC). Section 30 of the LCR rule also requires a covered company, as applicable, to include in its total net cash outflow amount a maturity mismatch add-on, which is calculated as the difference (if greater than zero) between the covered company's largest net cumulative maturity outflow amount for any of the 30 calendar days following the calculation date and the net day 30 cumulative maturity outflow amount. *See* 12 CFR 50.30 (OCC); 12 CFR 249.30 (FRB); and 12 CFR 329.30 (FDIC).

part of the MMLF from the banking organization's total leverage exposure, average total consolidated assets, advanced approaches total risk-weighted assets, and standardized total risk-weighted assets, as applicable. Because of the non-recourse nature of the Federal Reserve Bank of Boston's extension of credit to the banking organization, the organization is not exposed to credit or market risk from the assets purchased by the banking organization and pledged to the Federal Reserve Bank of Boston.

B. PPPLF Capital Interim Final Rule

The PPPLF capital interim final rule neutralizes the regulatory capital effect of participation in the PPPLF. The PPPLF capital interim final rule permits a banking organization to exclude exposures pledged as collateral to the PPPLF from the banking organization's total leverage exposure, average total consolidated assets, advanced approaches total risk-weighted assets, and standardized total risk-weighted assets, as applicable. Because of the non-recourse nature of each Federal Reserve Bank’s extension of credit to the banking organization, the banking organization is not exposed to credit or market risk from the pledged PPP covered loans.

Additionally, the PPPLF capital interim final rule clarifies that a banking organization must apply a zero percent risk weight to PPP covered loans, regardless of whether they are pledged under the PPPLF, as required by Section 1102 of the CARES Act.

C. LCR Interim Final Rule

The LCR interim final rule requires a banking organization subject to the LCR rule to neutralize the effect on its LCR of participation in the MMLF and PPPLF. Specifically, the LCR interim final rule adds a new definition to the LCR rule for “Covered Federal Reserve Facility Funding” to identify MMLF and PPPLF advances separately from other secured funding transactions under the LCR rule. The LCR interim final rule requires outflow amounts associated with Covered Federal Reserve Facility Funding and inflow amounts associated with the assets securing this funding to be excluded from a covered company's total net cash outflow amount under the LCR rule.[10]

Advances from the MMLF and PPPLF facilities are non-recourse and the maturity of the advance generally aligns with the maturity of the collateral. Accordingly, a covered company is not exposed to credit or market risk from the collateral securing the MMLF or PPPLF advance that could otherwise affect the banking organization's ability to settle the loan and generally can use the value of cash received from the collateral to repay the advances at maturity. For these reasons, the agencies issued the LCR interim final rule to better align the treatment of these advances and collateral under the LCR rule with the liquidity risk associated with funding exposures through these facilities, and to ensure consistent and predictable treatment of covered companies' participation in the facilities under the LCR rule.

III. Public Comments and the Final Rule

The agencies received two comment letters, from a trade association and an advocacy organization, addressing the MMLF capital interim final rule. These commenters supported the agencies' actions to encourage banking organizations' participation in the emergency lending facility. One commenter recommended broader considerations for money market mutual fund reform that are outside the scope of this rulemaking.

The agencies received 14 comment letters from industry participants, advocacy groups, trade associations, and individuals addressing the PPPLF interim final rule. Several commenters expressed support for the agencies' actions under the PPPLF capital interim final rule, and two of

[10] *See* 12 CFR 50.34 (OCC); 12 CFR 249.34 (FRB); and 12 CFR 329.34 (FDIC). Section 329.34 does not apply to the extent the covered company secures Covered Federal Reserve Facility Funding with securities, debt obligations, or other instruments issued by the covered company or its consolidated entity.

these commenters further supported the agencies' determination that good cause existed to issue the interim final rules without notice and comment. Several commenters suggested that the agencies extend the zero percent risk weight to PPP covered loans purchased in secondary markets. Under the PPPLF capital interim final rule, the risk weight for all PPP covered loans is zero percent.

Several commenters asserted that the PPPLF capital interim final rule should extend the leverage exclusion to PPP loans that are not pledged to the PPPLF, arguing that the treatment could discourage banking organizations that are not using the PPPLF from making PPP covered loans. The final rule would adopt the PPPLF capital interim final rule without changes. The CARES Act sets the risk weight of these loans at zero percent, and did not exclude these loans from the leverage capital requirements. The favorable leverage capital treatment in the PPPLF capital interim final rule reflects the non-recourse nature of the relevant Federal Reserve Bank's extension of credit to a banking organization only for PPP covered loans pledged by a banking organization to a Federal Reserve Bank.

The agencies received one comment letter, from a trade association, on the LCR interim final rule. The commenter supported the requirements under the LCR interim final rule, arguing that the requirements encourage participation in the facilities, which ultimately provides benefits to small businesses, households, and investors.

For the reasons discussed above, the final rule would adopt the interim final rules as final without change.

Conclusion:

Staff requests that the FDIC Board approve this final rule and authorize its publication in the *Federal Register* with an effective 60 days after the date of publication in the *Federal Register*.

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