



May 8, 2020

MEMORANDUM TO: The Board of Directors

FROM: Diane Ellis
Director, Division of Insurance and Research

SUBJECT: Notice of Proposed Rulemaking Re: Mitigating the Deposit Insurance Assessment Effect of Participation in the Paycheck Protection Program (PPP), the PPP Lending Facility, and the Money Market Mutual Fund Liquidity Facility

RECOMMENDATION

Staff recommends that the FDIC Board of Directors (the Board) adopt and authorize publication of the attached notice of proposed rulemaking (NPR or proposal) with a 7-day comment period. The NPR would mitigate the deposit insurance assessment effects of participating in the Paycheck Protection Program (PPP) established by the Small Business Administration (SBA), and the Paycheck Protection Program Lending Facility (PPPLF), and Money Market Mutual Fund Liquidity Facility (MMLF) established by the Board of Governors of the Federal Reserve System (Board of Governors).

The proposed changes would: (1) remove the effect of participation in the PPP and PPPLF on various risk measures used to calculate an insured depository institution's (IDI's) assessment rate; (2) remove the effect of participation in the PPPLF and MMLF programs on certain adjustments to an IDI's assessment rate; (3) provide an offset to an insured depository institution's assessment for the increase to its assessment base attributable to participation in the MMLF and PPPLF; and (4) remove the effect of participation in the PPPLF and MMLF programs when classifying insured depository institutions as small, large, or highly complex for assessment purposes.

BACKGROUND

On March 18, 2020, the Board of Governors, with approval of the Secretary of the Treasury, authorized the Federal Reserve Bank of Boston (FRBB) to establish the MMLF, pursuant to section 13(3) of the Federal Reserve Act.¹ Under the MMLF, the FRBB is extending non-recourse loans to eligible borrowers to purchase assets from money market mutual funds

¹ The MMLF is scheduled to terminate on September 30, 2020, unless extended by the Board of Governors.

Concur:

Nicholas J. Podsiadly
General Counsel

(MMFs). Assets purchased from MMFs will be posted as collateral to the FRBB (eligible collateral). Eligible borrowers under the MMLF include IDIs. Eligible collateral under the MMLF includes U.S. Treasuries and fully guaranteed agency securities, securities issued by government-sponsored enterprises, and certain types of commercial paper.

As part of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) and in recognition of the exigent circumstances faced by small businesses, Congress created the PPP.² PPP loans are fully guaranteed as to principal and accrued interest by the Small Business Administration (SBA), the amount of each being determined at the time the guarantee is exercised.³

In order to provide liquidity to small business lenders and the broader credit markets, and to help stabilize the financial system, on April 8, 2020, the Board of Governors, with approval of the Secretary of the Treasury, authorized each of the Federal Reserve Banks to extend credit under the PPPLF, pursuant to section 13(3) of the Federal Reserve Act. Under the PPPLF, Federal Reserve Banks are extending non-recourse loans to institutions that are eligible to make PPP loans, including IDIs. Under the PPPLF, only PPP loans that are guaranteed by the SBA with respect to both principal and interest and that are originated by an eligible institution may be pledged as collateral to the Federal Reserve Banks (loans pledged to the PPPLF).⁴

Pursuant to Section 7 of the Federal Deposit Insurance Act (FDI Act), the FDIC has established a risk-based assessment system through which it charges all IDIs an assessment amount for deposit insurance. Under the FDIC's regulations, an IDI's assessment is equal to its assessment base multiplied by its risk-based assessment rate. An IDI's assessment base and assessment rate are determined each quarter based on supervisory ratings and information collected on the Consolidated Reports of Condition and Income (Call Report) or the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002), as appropriate. Generally, an IDI's assessment base equals its average consolidated total assets minus its average tangible equity. An IDI's assessment rate is calculated using different methods based on whether the IDI is a small, large, or highly complex institution.⁵ All IDIs are subject to adjustments to their assessment rates for certain liabilities that can increase or reduce loss to the DIF in the event the bank fails.⁶

² Pub. L. 116-136 (Mar. 27, 2020).

³ As a general matter, SBA guarantees are backed by the full faith and credit of the U.S. Government. PPP loans also afford borrowers forgiveness up to the principal amount of the PPP loan, if the proceeds of the PPP loan are used for certain expenses. The SBA reimburses PPP lenders for any amount of a PPP loan that is forgiven. PPP lenders are not held liable for any representations made by PPP borrowers in connection with a borrower's request for PPP loan forgiveness.

⁴ The maturity date of the extension of credit under the PPPLF equals the maturity date of the PPP loans pledged to secure the extension of credit. No new extensions of credit will be made under the PPPLF after September 30, 2020, unless extended by the Board of Governors and the Department of the Treasury.

⁵ For assessment purposes, a large bank is generally defined as an institution with \$10 billion or more in total assets, a small bank is generally defined as an institution with less than \$10 billion in total assets, and a highly complex bank is generally defined as an institution that has \$50 billion or more in total assets and is controlled by a parent holding company that has \$500 billion or more in total assets, or is a processing bank or trust company. *See generally* 12 CFR 327.8.

⁶ For certain IDIs, adjustments include the unsecured debt adjustment and the depository institution debt adjustment (DIDA). The unsecured debt adjustment decreases an IDI's total assessment rate based on the ratio of its long-term

Absent a change to the assessment rules, an IDI that participates in the PPP, PPPLF, or MMLF programs could be subject to increased deposit insurance assessments.

DISCUSSION OF THE PROPOSAL

Summary

Staff recommends that the FDIC, under its general rulemaking authority in Section 9 (Tenth) of the FDI Act, and its specific authority under Section 7 of the FDI Act to establish a risk-based assessment system and set assessments, issue this proposal that would mitigate the deposit insurance assessment effects of holding PPP loans, pledging loans to the PPPLF, and purchasing assets under the MMLF. Under the proposal, an IDI generally would not be subject to a higher deposit insurance assessment rate solely due to its participation in the PPP, PPPLF, or MMLF. In addition, the FDIC would provide an offset against an IDI's assessment amount for the increase to its assessment base attributable to participation in the MMLF and PPPLF.

Changes to reporting requirements applicable to the Call Report, the FFIEC 002, and their respective instructions, would be required in order to make the proposed adjustments to the assessment system. These changes are concurrently being effectuated in coordination with the other member entities of the Federal Financial Institutions Examination Council.⁷

Mitigating the Effects of Loans Pledged to the PPPLF and of PPP Loans Held by an IDI on an IDI's Assessment Rate

Staff recommends that the FDIC exclude PPP loans held by an IDI from its loan portfolio for purposes of calculating the IDI's deposit insurance assessment rate.⁸ Staff also recommends

unsecured debt to its assessment base. The DIDA increases an IDI's total assessment rate if it holds long-term, unsecured debt issued by another IDI. In addition, large banks that meet certain criteria and new small banks are subject to the brokered deposit adjustment. The brokered deposit adjustment increases the total assessment rate of large IDIs that hold significant concentrations of brokered deposits and that are less than well capitalized, not CAMELS composite 1- or 2-rated, as well as new, small IDIs that are not assigned to Risk Category I. See 12 CFR 327.16(e).

⁷ The FDIC, Board of Governors, and the Comptroller of the Currency (together, the agencies) have submitted requests for seven additional items on the Call Report (FFIEC 031, FFIEC 041, and FFIEC 051): (1) the outstanding balance of PPP loans; (2) the outstanding balance of loans pledged to the PPPLF as of quarter-end; (3) the quarterly average amount of loans pledged to the PPPLF; (4) the outstanding balance of borrowings from the Federal Reserve Banks under the PPPLF with a remaining maturity of one year or less, as of quarter-end; (5) the outstanding balance of borrowings from the Federal Reserve Banks under the PPPLF with a remaining maturity of greater than one year, as of quarter-end; (6) the outstanding amount of assets purchased from MMFs under the MMLF as of quarter-end; and (7) the quarterly average amount of assets purchased from the MMFs under the MMLF. In addition, the agencies have submitted requests for two additional items on the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002): the quarterly average amount of loans pledged to the PPPLF and the quarterly average amount of assets purchased from MMFs under the MMLF. The FDIC is requesting these items in order to make the proposed adjustments described below.

⁸ The FDIC is not proposing to modify its assessment pricing system with respect to the Tier 1 leverage ratio, which is one of the measures used to determine the assessment rate for both large and small IDIs. In accordance with the agencies' April 13, 2020 interim final rule, banking organizations are required to neutralize the regulatory capital effects of assets pledged to the PPPLF on leverage capital ratios. See 85 FR 20387 (April 13, 2020). Therefore, the

that the FDIC modify various risk measures to exclude loans pledged to the PPPLF from total assets and to exclude borrowings from the Federal Reserve Banks under the PPPLF from total liabilities when calculating an IDI's deposit insurance assessment rate.

To minimize reporting burden, staff recommends excluding outstanding PPP loans, which includes loans pledged to the PPPLF, from an IDI's loan portfolio using assumptions under a waterfall approach.⁹ Under this approach, the FDIC would assume that all PPP loans are C&I Loans, and to the extent that the balance of PPP loans exceed the balance of C&I Loans, any excess loan amounts are assumed to be categorized as either All Other Loans or Agricultural Loans, as applicable for the calculation of the loan mix index (LMI), growth-adjusted portfolio concentration measure, and loss severity measure, as described below.

1. Established Small Institutions

a. Exclusion of Loans Pledged to the PPPLF in Various Risk Measures

For established small banks, staff recommends that the outstanding balance of loans pledged to the PPPLF be excluded from total assets in the calculation of six risk measures: the net income before taxes to total assets ratio,¹⁰ the nonperforming loans and leases to gross assets ratio, the other real estate owned to gross assets ratio, the brokered deposit ratio, the one-year asset growth measure, and the LMI.

b. Exclusion of PPP Loans and Loans Pledged to the PPPLF in the LMI

The LMI is a measure of the extent to which a bank's total assets include higher-risk categories of loans. In the calculation of the LMI, staff recommends that the FDIC exclude PPP loans, which include loans pledged to the PPPLF, from an institution's loan portfolio based on the waterfall approach described above. Under the proposed rule, the FDIC would therefore exclude outstanding PPP loans, which includes loans pledged to the PPPLF, from the balance of C&I Loans in the calculation of the LMI. In the unlikely event that the outstanding balance of PPP loans exceeds the balance of C&I Loans, the FDIC would exclude any remaining balance of these loans from the balance of Agricultural Loans, up to the total amount of Agricultural Loans, in the calculation of the LMI.¹¹ As discussed above, staff also recommends that the FDIC exclude loans pledged to the PPPLF from total assets in the LMI.

effects of participation in the PPPLF will be automatically incorporated in an IDI's regulatory capital reporting and the FDIC does not need to make any adjustments to an IDI's deposit insurance assessment.

⁹ Based on data from the SBA, staff expects that most PPP loans will be categorized as Commercial & Industrial (C&I) Loans. PPP loans may also be reported in other loan types, including Agricultural Loans and All Other Loans.

¹⁰ Staff expects that IDIs that participate in the PPP, PPPLF, and MMLF will earn additional income from participation in these programs. To minimize additional reporting burden, however, staff is not recommending that the FDIC exclude income related to participation in these programs from the net income before taxes to total assets ratio in the calculation of an IDI's deposit insurance assessment rate.

¹¹ All Other Loans are not included in the LMI; therefore, the FDIC proposes to exclude the outstanding balance of PPP loans, which include loans pledged to the PPPLF, first from the balance of C&I Loans, followed by Agricultural Loans.

2. Large and Highly Complex Institutions

For IDIs defined as large or highly complex for deposit insurance assessment purposes, staff recommends that the FDIC exclude the outstanding balance of loans pledged to the PPPLF and borrowings from the Federal Reserve Banks under the PPPLF from five risk measures used in the scorecard method: the core earnings ratio, the core deposit ratio, the balance sheet liquidity ratio, the average short-term funding ratio and the loss severity measure. For four risk measures – the growth-adjusted portfolio concentration measure, the balance sheet liquidity ratio, the trading asset ratio, and the loss severity measure – staff recommends that the FDIC treat the outstanding balance of PPP loans, which includes loans pledged to the PPPLF, as riskless. These measures are described in more detail below.

a. Core Earnings Ratio

For the core earnings ratio, the FDIC divides the four-quarter sum of merger-adjusted core earnings by the average of five quarter-end total assets (most recent and four prior quarters). Staff recommends that the FDIC exclude the outstanding balance of loans pledged to the PPPLF at quarter-end from total assets for the applicable quarter-end periods prior to averaging.¹²

b. Core Deposit Ratio

The core deposit ratio is defined as total domestic deposits excluding brokered deposits and uninsured non-brokered time deposits divided by total liabilities. For purposes of this calculation, staff recommends that the FDIC exclude from total liabilities borrowings from Federal Reserve Banks under the PPPLF.

c. Balance Sheet Liquidity Ratio

The balance sheet liquidity ratio measures the amount of highly liquid assets needed to cover potential cash outflows in the event of stress. In calculating this ratio, staff recommends that the FDIC treat the outstanding balance of PPP loans as of quarter-end that exceed borrowings from the Federal Reserve Banks under the PPPLF as riskless and to treat them as highly liquid assets. Staff also recommends that the FDIC exclude from the ratio an IDI's reported borrowings from the Federal Reserve Banks under the PPPLF with a remaining maturity of one year or less.

d. Average Short-term Funding Ratio

The ratio of average short-term funding to average total assets is one of the measures used to determine the assessment rate for a highly complex IDI. In calculating the average short-term funding ratio, staff recommends that the FDIC reduce the quarterly average of total assets by the quarterly average amount of loans pledged to the PPPLF.

¹² Staff expects that IDIs that participate in the PPP, PPPLF, and MMLF will earn additional income from participation in these programs. To minimize additional reporting burden, staff is not recommending that the FDIC exclude earnings related to participation in these programs from the core earnings ratio in the calculation of an IDI's deposit insurance assessment rate.

e. Growth-adjusted Portfolio Concentrations

The growth-adjusted portfolio concentration measure is one of the measures used to determine a large IDI's overall concentration measure. Staff recommends that the FDIC apply a waterfall approach as described above and assume that all outstanding PPP loans, which include loans pledged to the PPPLF, are categorized as C&I Loans and exclude these loans from C&I Loans in the calculation of the portfolio growth rate calculations for this measure.¹³

f. Trading Asset Ratio

For highly complex IDIs, the trading asset ratio is used to determine the relative weights assigned to the credit quality measure and the market risk measure. In calculating this ratio, staff recommends that the FDIC reduce the balance of loans by the outstanding balance as of quarter-end of PPP loans, which includes loans pledged to the PPPLF.¹⁴

g. Loss Severity Measure

The loss severity measure estimates the relative magnitude of potential losses to the DIF in the event of an IDI's failure. In calculating the loss severity score, staff recommends that the FDIC remove the total amount of borrowings from the Federal Reserve Banks under the PPPLF from short- and long-term secured borrowings, as appropriate. Staff also recommends that the FDIC exclude PPP loans, which include loans pledged to the PPPLF, using a waterfall approach, described above. Under this approach, the FDIC would exclude PPP loans, which include loans pledged to the PPPLF, from an IDI's balance of C&I Loans. In the unlikely event that the outstanding balance of PPP loans exceeds the balance of C&I Loans, the FDIC would exclude any remaining balance from All Other Loans, up to the total amount of All Other Loans, followed by Agricultural Loans, up to the total amount of Agricultural Loans. To the extent that an IDI's outstanding PPP loans exceeds its borrowings under the PPPLF, and consistent with the treatment of these loans as riskless, the FDIC would then add outstanding PPP loans in excess of borrowings under the PPPLF to cash.

Mitigating the Effects of Loans Pledged to the PPPLF and Assets Purchased under the MMLF on Certain Adjustments to an IDI's Assessment Rate

Staff recommends that the FDIC exclude the quarterly average amount of loans pledged to the PPPLF and the quarterly average amount of assets purchased under the MMLF from the calculation of the unsecured debt adjustment, depository institution debt adjustment, and the brokered deposit adjustment, which are applied when calculating an IDI's assessment rate.

¹³ All Other Loans and Agricultural Loans are not included in the growth-adjusted portfolio concentration measure; therefore, the FDIC proposes to exclude the outstanding balance of PPP loans, which include loans pledged to the PPPLF, from the balance of C&I Loans.

¹⁴ To minimize reporting burden, staff recommends that the FDIC reduce average loans by the outstanding balance of PPP loans, which includes loans pledged to the PPPLF, as of quarter-end, rather than requiring institutions to additionally report the average balance of PPP loans.

Offset to Deposit Insurance Assessment Due to Increase in the Assessment Base Attributable to Assets Pledged to the PPPLF and Assets Purchased under the MMLF

Staff is recommending that the FDIC provide an offset to an IDI's total assessment amount due for the increase to its assessment base attributable to participation in the PPPLF and MMLF. To determine this offset amount, the FDIC would calculate the total of the quarterly average amount of assets pledged to the PPPLF and the quarterly average amount of assets purchased under the MMLF, multiply that amount by an IDI's total base assessment rate (after excluding the effect of participation in the MMLF and PPPLF, as proposed), and subtract the resulting amount from an IDI's total assessment amount.¹⁵

Classification of IDIs as Small, Large, or Highly Complex for Assessment Purposes

In defining IDIs for assessment purposes, staff recommends that the FDIC exclude from an IDI's total assets the amount of loans pledged to the PPPLF and assets purchased under the MMLF. As a result, the FDIC would not reclassify a small institution as large or a large institution as a highly complex institution solely due to participation in the PPPLF and MMLF programs, which would otherwise have the effect of expanding an IDI's balance sheet.¹⁶

EXPECTED EFFECTS

The proposed rule would mitigate the deposit insurance assessment effects of holding PPP loans, pledging loans to the PPPLF, and purchasing assets under the MMLF. Because IDIs are not yet reporting the necessary data, staff does not have sufficient data on the distribution of loans among IDIs and other non-bank financial institutions made under the PPP, loans pledged to the PPPLF, and dollar volume of assets purchased under the MMLF by IDIs, nor on the loan categories of PPP loans held. Although this estimate is subject to considerable uncertainty, staff estimates that quarterly deposit insurance assessments across all IDIs would increase by approximately \$90 million, absent the proposed rule, after applying certain assumptions.¹⁷ The actual effect of these programs on deposit insurance assessments will vary depending on participation in the programs by IDIs and non-IDIs, the maturity of borrowings from the Federal Reserve Banks under these programs, and the types of loans held under the PPP.

¹⁵ Currently, an IDI's total assessment amount on its quarterly certified statement invoice is equal to the product of the institution's assessment base (calculated in accordance with 12 CFR 327.5) multiplied by the institution's assessment rate (calculated in accordance with 12 CFR 327.4 and 12 CFR 327.16). See 12 CFR 327.3(b)(1).

¹⁶ In addition, staff recommends that an institution with total assets between \$5 billion and \$10 billion, excluding the amount of loans pledged to the PPPLF and assets purchased under the MMLF, may request that the FDIC determine its assessment rate as a large institution.

¹⁷ In estimating the deposit insurance assessment effects of participation in the PPP, PPPLF, and MMLF, staff assumed that (1) \$600 billion of PPP loans are held by IDIs, (2) the PPP loans that are held by IDIs are evenly distributed across all IDIs that have C&I loans, which results in a 27 percent increase in those loans, (3) 25 percent of PPP loans held by IDIs are pledged to the PPPLF, (4) 100 percent of loans pledged to the PPPLF are matched by borrowings from the Federal Reserve Banks with maturities greater than one year, and (5) large and highly complex banks hold approximately \$50 billion in assets pledged under the MMLF. Based on Call Report data as of December 31, 2019 and Federal Reserve data as of April 1, 2020.

ALTERNATIVES CONSIDERED

Staff considered the reasonable and possible alternatives described below but rejected these alternatives because they would not accomplish the policy objective of mitigating the deposit insurance assessment effects of an IDI's participation in the PPP, PPPLF, and MMLF, or would impose additional reporting burden on IDIs.

Staff considered leaving in place the current assessment regulations, but rejected this alternative because an IDI's participation in the PPP, PPPLF, and MMLF could potentially lead to sharp increases in assessments for an individual IDI solely due to its participation in programs intended to provide liquidity to small businesses and stabilize the financial system.

A second alternative staff considered was to require that institutions report PPP loans as a separate loan category instead of including them in C&I Loans or other loan categories, thus providing data that would reduce the need for the FDIC to rely on certain assumptions, reduce the amount of necessary changes to specific risk measures and other factors, and potentially more accurately mitigate the deposit insurance assessment effects of an IDI's participation in the program. This alternative, however, would likely shift additional reporting burden onto IDIs in comparison to the proposal, which would achieve a similar result with less burden.

Finally, staff considered excluding the effects of participation in the MMLF from measures used to determine an IDI's deposit insurance assessment rate. Given the minimal expected effect of participation in the MMLF on an IDI's assessment rate and the short duration of the program, and to minimize the additional reporting burden associated with the variety of potential assets in the program, staff does not recommend this alternative. An IDI that is priced as large or highly complex may request an adjustment to its total score, used in determining an institution's assessment rate, based on supporting data reflecting its participation in the MMLF.¹⁸

On balance, staff believes the current proposal would mitigate the deposit insurance effects of participation in the PPP, PPPLF, and MMLF in the most appropriate and straightforward manner.

COMMENT PERIOD, APPLICATION DATE, AND EFFECTIVE DATE

Staff recommends issuing this proposal with a 7-day comment period. This would allow sufficient time for the FDIC to consider comments and ensure publication of a final rule before June 30, 2020 (the end of the second quarterly assessment period).

Since the implementation of the PPP, PPPLF, and MMLF, the FDIC observed uncertainty from the public and the banking industry and wants to provide clarity on how, if at all, these programs would affect the assessments of IDIs which participate in these programs. Because PPP loans must be issued by June 30, 2020, the full assessment impact of these programs will first occur in the second quarterly assessment period. It is therefore staff's view that rapid administrative action is critical and warrants an abbreviated comment period.

¹⁸ See *Assessment Rate Adjustment Guidelines for Large and Highly Complex Institutions*, 76 FR 57992 (Sept. 19, 2011).

The 7-day comment period will afford the public and affected institutions with an opportunity to review and comment on the proposal, and will allow the FDIC sufficient time to consider and respond to comments received. In addition, a proposed effective date by June 30, 2020 and a proposed application date of April 1, 2020 will enable the FDIC to provide the relief contemplated in this rulemaking as soon as practicable, starting with the second quarter of 2020, and provide certainty to IDIs regarding the assessment effects of participating in the PPP, PPPLF, or MMLF for the second quarter of 2020, which is the first assessment quarter in which the assessments will be affected.

Under the Administrative Procedure Act (APA), “[t]he required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except as otherwise provided by the agency for good cause found and published with the rule.” Under this proposal, the amendments to the FDIC’s deposit insurance assessment regulations would be effective upon publication of a final rule in the *Federal Register*. It is anticipated that the FDIC would find good cause that the publication of a final rule implementing the proposal can be less than 30 days before its effective date in order to fully effectuate the intent of ensuring that IDIs benefit from the mitigation effects to their deposit insurance assessments as soon as practicable.

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