May 13, 2020

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director

SUBJECT: Regulatory Capital Rule: Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks from the Supplementary Leverage Ratio

SUMMARY: In light of recent disruptions in economic conditions caused by the coronavirus disease 2019 ("COVID-19") and strains in U.S. financial markets, staff is presenting for approval of the Federal Deposit Insurance Corporation ("FDIC") Board of Directors ("FDIC Board") a request to adopt and publish the attached interagency interim final rule ("interim final rule") that temporarily revises the supplementary leverage ratio calculation in the capital rule of the FDIC, the Board of Governors of the Federal Reserve System ("Federal Reserve"), and the Office of the Comptroller of the Currency ("OCC") (together, the "agencies"). The interim final rule would temporarily exclude the on-balance sheet amounts of U.S. Treasury securities and deposits at Federal Reserve Banks from the denominator of the supplementary leverage ratio. This exclusion would be effective as of publication of the interim final rule in the *Federal Register* and would remain in effect through March 31, 2021. The interim final rule would provide banking organizations subject to the supplementary leverage ratio increased flexibility to continue to act as financial intermediaries.

Recommendation: Staff requests that the FDIC Board approve this interim final rule and authorize its publication in the *Federal Register* with an effective date as of publication of the

Concur:

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interim final rule in the *Federal Register* and with a comment period deadline of 45 days after the date of *Federal Register* publication.

Discussion:

I. Introduction

Under the capital rule, a global systemically important bank holding company ("GSIB"), an insured depository institution ("IDI") subsidiary of a GSIB, and a banking organization subject to Category II or Category III capital standards are required to meet a minimum supplementary leverage ratio of 3 percent, measured as the ratio of a banking organization's tier 1 capital to its total leverage exposure.[1] The denominator of the supplementary leverage ratio is total leverage exposure, which includes certain off-balance sheet exposures in addition to on-balance sheet assets.

GSIB depository institution subsidiaries also are subject to enhanced supplementary leverage ratio ("eSLR") standards established by the agencies in 2014.[2] Under the eSLR standards, GSIB depository institution subsidiaries must maintain a 6 percent supplementary leverage ratio to be considered "well capitalized" under the prompt corrective action ("PCA") framework of each agency.

In contrast to the risk-based capital requirements, a leverage ratio does not differentiate the amount of capital required by exposure type. Rather, a leverage ratio places an upper bound on banking organization leverage. A leverage ratio protects against underestimation of risk both

[1] See 84 FR 59230 (Nov. 1, 2019). Firms that are subject to Category II standards include those with (1) at least $700 billion in total consolidated assets or (2) at least $75 billion in cross-jurisdictional activity and at least $100 billion in total consolidated assets. Firms that are subject to Category III standards include those with (1) at least $250 billion in average total consolidated assets or (2) at least $100 billion in average total consolidated assets and at least $75 billion in average total nonbank assets, average weighted short-term wholesale funding; or average off-balance sheet exposure.

by banking organizations and by risk-based capital requirements and serves as a complement to risk-based capital requirements. Under the supplementary leverage ratio, banking organizations include all their on-balance sheet assets, including U.S. Treasury Securities ("Treasuries") and deposits in their accounts at Federal Reserve Banks ("deposits at Federal Reserve Banks"), in total leverage exposure.

The ability of depository institutions to hold certain assets, most notably deposits at a Federal Reserve Bank and Treasuries, is essential to market functioning, financial intermediation, and funding market activity, particularly in periods of financial uncertainty. In response to volatility and market strains, the Federal Reserve has taken a number of actions to support market functioning and the flow of credit to the economy. The response to COVID-19 has notably increased the size of the Federal Reserve's balance sheet and resulted in a large increase in the amount of reserves in the banking system. The agencies anticipate that the Federal Reserve's balance sheet may continue to expand in the near term, as customer deposits continue to expand, and recently announced facilities to support the flow of credit to households and businesses begin or continue operations. In addition, market participants have liquidated a high volume of assets and customers have drawn down credit lines, and both have deposited the cash proceeds with depository institutions in recent weeks, further increasing the size of depository institutions' balance sheets.

Absent any adjustments to the supplementary leverage ratio, the resulting increase in the size of depository institutions' balance sheets may cause a sudden and significant increase in the regulatory capital needed to meet a depository institution's leverage ratio requirement.[2] This is

[2] The Federal Reserve recently issued an interim final rule to revise, on a temporary basis for bank holding companies, savings and loan holding companies, and U.S. intermediate holding companies of foreign banking organizations, the calculation of total leverage exposure, the denominator of the supplementary leverage ratio in the

particularly the case for many of the depository institutions subject to the supplementary leverage ratio, which are significant participants in financial intermediation services, including as clearing banks for dealers in the open market operations of the Federal Open Market Committee and as major custodians of securities.

II. The Interim Final Rule

In order to facilitate depository institutions' significant increase in reserve balances resulting from the Federal Reserve's asset purchases and the establishment of various programs to support the flow of credit to the economy, as well as the need to continue to accept exceptionally high levels of customer deposits, the agencies would issue this interim final rule to provide certain depository institutions subject to the supplementary leverage ratio ("qualifying depository institutions") the ability to exclude temporarily Treasuries and deposits at Federal Reserve Banks from total leverage exposure through March 31, 2021. For example, depository institutions would be able to exclude temporarily on-balance sheet Treasuries that they hold, including Treasuries that they have borrowed and re-pledged in a repo-style transaction, provided such Treasuries are included in the depository institution's total leverage exposure prior to the effect of the exclusion.[3]

Under the interim final rule, a depository institution that opts into this treatment would be required to obtain prior approval of distributions from its primary Federal banking regulator.

An electing depository institution must notify its primary Federal banking regulator of its election within 30 days after the interim final rule is effective. Under the FDIC Board

Federal Reserve's capital rule, to exclude Treasuries and deposits at Federal Reserve Banks. The exclusion will remain in effect until March 31, 2021. 85 FR 20578 (April 14, 2020).

[3] This scope is consistent with the Federal Reserve's recent interim final rule to revise the supplementary leverage ratio. (See footnote 2).

Resolution accompanying this Board Memorandum, the FDIC Board would delegate to the appropriate regional director of the Division of Risk Management Supervision the authority to receive an opt-in notice within thirty days after the effective date of the interim final rule. Further, the primary Federal banking regulator will consider an opt-in notice received from a qualifying depository institution more than 30 days after the effective date of the interim final rule on a case-by-case basis. The election will not affect the electing depository institution's ability to pay distributions already declared or to declare distributions for payment in the second quarter of 2020. The prior approval requirement applies to distributions to be paid beginning in the third quarter of 2020. The interim final rule will terminate after March 31, 2021.

For purposes of reporting the supplementary leverage ratio as of June 30, 2020, an electing depository institution may reflect the exclusion of Treasuries and deposits at Federal Reserve Banks from total leverage exposure, as if this interim final rule had been in effect for the entire second quarter of 2020. Because the supplementary leverage ratio is calculated as an average over the quarter, this will have the effect of maximizing the effect of the exclusion starting in the second quarter of 2020. The agencies are not making similar adjustments to risk-based capital ratios because Treasuries and deposits at Federal Reserve Banks are risk-weighted at zero percent.

Under the interim final rule, beginning in the third quarter of 2020, an electing depository institution will be required to obtain approval from its primary Federal banking regulator before making a distribution[4] or creating an obligation to make such a distribution so long as the temporary exclusion is in effect. The primary Federal banking regulator will endeavor to respond within 14 days to the request with an approval, disapproval, or request for additional

[4] *See* 12 CFR 3.2 (defining "distribution") (OCC); 12 CFR 217.2 (defining "distribution") (Federal Reserve); 12 CFR 324.2 (defining "distribution" (FDIC).

information. This prior approval requirement will help support the objective of the interim final rule to strengthen the ability of electing depository institutions to continue taking deposits, lending and conducting other financial intermediation activities during this period of stress. Under the FDIC Board Resolution accompanying this Board Memorandum, the FDIC Board would delegate to staff of the Division of Risk Management Supervision authority to approve such distribution requests under the interim final rule.

When evaluating any such request, the primary Federal banking regulator will consider all relevant factors, including whether any distribution would be contrary to safety and soundness and limitations on distributions in the existing rules applicable to the electing depository institution.[5] Factors that the primary Federal banking regulator will take into account include the depository institution's current earnings and forecasts, the nature, purpose, and extent of the request, and the particular circumstances giving rise to the request.[6] Also, the primary Federal banking regulator may consider the expected future capital needs of the depository institution and its ability to meet capital requirements after the temporary relief provided under this interim final rule expires.

The requirement in the interim final rule that a depository institution request approval for distributions is not intended to prohibit electing depository institutions from paying dividends or repurchasing capital instruments in all cases. Rather, the primary Federal banking regulator will

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[5] Additional limitations on distributions may apply under 12 CFR part 3, subparts H and I; 12 CFR 5.46, 12 CFR part 5, subpart E; 12 CFR part 6; 12 CFR part 208, subparts A and D; 12 CFR part 303, subparts K and M. The restrictions set forth in this interim final rule are in addition to, and therefore do not supersede, any existing statutory or regulatory limitations on making capital distributions. For purposes of the FDIC's PCA rules, regarding capital distribution restrictions for undercapitalized FDIC-supervised institutions, see 12 CFR 324.405.

[6] Holding companies use dividends from their subsidiaries for various purposes. For example, dividends to the holding company can support the efficient internal allocation of capital within a holding company, allowing excess capital from one subsidiary, such as the depository institution, to be redeployed to other subsidiaries. As such, an effective dividend strategy can both ensure the safety and soundness of the depository institution and promote the safety and soundness of the entire banking organization.

evaluate each request to ensure that the electing depository institution will be able to continue supporting the economy by taking deposits, lending, and accepting deposits consistent with the goal of this interim final rule.

The agencies expect that the interim final rule would temporarily decrease binding tier 1 capital requirements by approximately $55 billion for depository institutions if all depository institutions subject to the supplementary leverage ratio elect to opt-in.[7] In light of the exclusions under this interim final rule, this temporary reduction in capital requirements is expected to increase leverage exposure capacity at depository institutions by around $1.2 trillion.

III. Technical Amendments

The agencies are making technical corrections and clarifications to the Prompt Corrective Action regulations. In their respective PCA regulations, the agencies are correcting an unintentional omission of "Category III" to clarify that depository institutions subject to Category III standards must meet their minimum supplementary leverage ratio requirement of 3 percent in order to be considered "adequately capitalized."

Conclusion:

Staff requests that the FDIC Board approve this interim final rule and authorize its publication in the *Federal Register* with an effective date as of the publication of the interim

[7] This analysis accounts for the exclusion of qualifying central bank deposits for custodial banking organizations as provided under the capital rule. As of April 1, 2020, custodial banking organizations may exclude deposits with qualifying foreign central banks, in addition to the exclusions provided under this interim final rule. See footnote 3. In addition, the analysis uses balances due from banks in foreign countries and foreign central banks, as reported under line item 3 of Schedule RC-A of the Call Report. Line item 3 of Schedule RC-A may slightly overstate amounts eligible for exclusion by custodial banking organizations because it includes some balances due from banks in foreign countries and foreign central banks that are not eligible for exclusion.

final rule in the *Federal Register* and with a comment period deadline of 45 days after the date of *Federal Register* publication.

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