Financial Services Management

Risk-Based Premium Adjustments

Cite

FDIC
Final Rule
Assessments

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Website

https://www.fdic.gov/news/news/financial/2014/fil14057a.pdf

Impact Assessment

- RBPs for the largest banks will rise significantly due to the recalculation of counterparty credit risk. This should offset premium increases for smaller banks otherwise necessary to replenish the DIF.

- While not as significant a cost as higher capital or exposure limits, RBP hikes will still affect strategy with regard to the use of counterparties in securities financing, derivatives exposures, and similar transactions. RBPs based on CCP exposures will create an additional disincentive for banks despite broader policy demands for central clearing.

Overview

The FDIC has finalized its proposed revisions to the way exposures at the largest banks are calculated for purposes of determining counterparty credit risk (CCR) in its current risk-based premium (RBP) assessment rules.[1] CCR now will be judged by the standardized credit-exposure measurement in the new U.S. Basel III rules,[2] not the internal-model method allowed under its

[1] See **DEPOSITINSURANCE102**, Financial Services *Management,* July 29, 2014.

[2] See **CAPITAL200**, *Financial Services Management*, July 15, 2013.

advanced approach.[3] This approach has been liberalized somewhat from the proposed rule, but does not go as far in recognizing netting as some commenters had urged. It does not, however, go as far as others suggested and wholly reject collateral, margin, and other backstops in favor of a simple total leverage measure of CCR. The rule also updates the capital evaluations used for setting RBPs and revises calculations used by custodial banks to conform them to the Basel III risk weightings, not those included in the current rule.

Impact

The final rule largely tracks the NPR with regard to the revised way the FDIC calculates counterparty credit risk for the largest, most complex insured depository institutions. As these U.S. BHCs transition to the Basel III advanced option[4], they were previously allowed to use the internal models method (IMM) to calculate CCR. As this occurred during the second quarter of 2014, RBPs dropped significantly due to the new calculation method even though, in the FDIC's opinion, the risk remained unchanged and the nine very large banks apply the IMM in sharply different ways. Large banks countered that RBPs dropped because the IMM measures risk better than the standardized approach, but the FDIC believes that a simpler, consistent approach best protects the Deposit Insurance Fund (DIF).

The higher RBPs resulting from this rule derive from the use of the credit-equivalent method (CEM), which in part does not permit as much collateral recognition and netting as the IMM. The FDIC approach here for CEM generally tracks that used for purposes of determining the leverage-capital requirements both for all large banks under Basel III and the G-SIBs under the enhanced supplementary leverage ratio.[5] The final rule indicates that the FDIC may at some future point consider eliminating virtually all netting and use simple total leverage ratios for CCR, but no timeline for doing so is proposed.

The "total" approach to leverage is favored by those who, like FDIC Vice Chairman Hoenig believe that netting under accounting rules is no guide to risk. However, a total-leverage approach would not only have significant RBP ramifications, but also far-reaching and costly capital consequences. It is thus not likely quickly to advance in the U.S.

The FDIC does not calculate just how high RBPs may rise, but a guide to them can be derived from the response to a newly-finalized Basel rule on credit exposures[6] and the FRB's proposed single-counterparty credit limits

[3] See **CAPITAL201**, *Financial Services Management*, July 19, 2013.

[4] See **CAPITAL201**, *Financial Services Management*, July 19, 2013.

[5] See **LEVERAGE8**, *Financial Services Management*, October 1, 2014.

[6] See **CONCENTRATIONS5**, *Financial Services Management*, April 23, 2014.

(SCCLs).[7] Basel decided largely to rely on IMM, not CEM, in its standards, reflecting strong protests to the CEM approach from large banks. The SCCL proposal was similarly opposed, with quantitative studies from the industry showing that the CEM measures very large exposures that, if limited, they believe would disrupt capital markets and credit availability.

For this reason, commenters on this rule pushed for CCR exemptions, including for those to qualifying CCPs, arguing in part that CCPs have been selected as the policy response to derivatives-market risk and thus should be favored in the RBP rule. The FDIC rejected this on grounds that CCPs still pose risk that must be assessed to protect the DIF. The risks cited here include those of risk concentrations in CCPs and the systemic consequences of their failure, risks several large banks have pressed regulators to address directly at CCPs, not by charging banks extra for using them as required under an array of post-crisis rules.

U.S. large banks have hoped that the SCCLs, like the Basel credit exposure limits, would depart from CEM, but the FDIC's action may put pressure on the FRB to take a more conservative approach. The FRB is, however, free to do as it likes with the SCCLs.

The revised prompt corrective action (PCA) framework resulting from the updated capital references is unlikely to have significant impact on insured depositories, according to the FDIC. The custodial-bank changes should similarly have limited impact on these institutions, although reliance on standardized risk weightings could offset some RBP reductions these banks expected from use of the advanced approach.

What's Next

The FDIC unanimously approved this rule on November 24, although it has yet to be published in the *Federal Register*. The new CCR premium method would go into effect on January 1, 2015. The new PCA thresholds also go into effect in tandem with the Basel III rules – that is, January 1, 2015, taking into account relevant transition periods in the rule that run until 2018 in some cases.

The RBP scoring system now needs to change to reflect the new CCR approach. The FDIC will do so in a notice for public comment, not on its own as initially proposed.

[7] See **SYSTEMIC54**, *Financial Services Management*, January 3, 2012.

Analysis

A. Capital Evaluation

As noted, PCA thresholds for the purposes of determining where an insured depository falls in the capital scale dictating prompt corrective action setting RBPs are now to be measured in accordance with the Basel III rules, changing as these change in the U.S. The thresholds apply to both risk-based and leverage capital, including the enhanced supplementary standards governing U.S. G-SIBs.[8]

B. Custodial Banks

RBP scorecards include a special asset criterion reflecting the large volumes of low-risk assets held by custodial banks. The rule revises the definition of eligible assets that may be deemed low risk to conform to the new risk weightings in the Basel III standardized regulation referenced above, now also including preferential treatment for certain securitization exposures with a twenty percent risk weighting. The FDIC rejected comments seeking greater exclusions from RBP assessments for exposures related to qualifying central counterparties on grounds of undue risk. The largest custodial banks are advanced-approaches institutions, but the FDIC believes use of the standardized model provides a comparable framework for all such banks.

C. CCR

As noted, these provisions affect only large banks that are also highly-complex institutions – i.e., those that are found to be of such size and complexity due to the scope of their operations as to warrant additional RBPs. One RBP criterion for these highly-complex institutions is the ratio of exposures to the largest twenty counterparties to capital, along with a similar criterion for the ratio of the largest exposures to capital.

Under this rule, exposures to a counterparty are 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 securities-financing transactions (SFTs) subject to risk weighting without deductions for collateral other than qualifying cash that is effectively a pre-settlement payment. Recognition of cash collateral is a change in the final rule from the NPR, but the FDIC rejected comments that pushed for still broader recognition of other financial collateral.

Counterparty exposure amounts include derivatives, SFTs and gross-lending exposures (including all unfunded commitments). SFTs include repurchase agreements, reverse repurchase agreements, security lending and borrowing, and margin-lending transactions where the value of the transaction depends on market valuations.

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[8] See **LEVERAGE5**, *Financial Services Management*, January 21, 2014.

A cleared transaction with a central counterparty, (CCP) would be included in the counterparty exposure measures. For both derivative and SFT exposures, the amount of counterparty exposure to CCPs would also include default-fund contributions.

The final rule also continues to include affiliate exposures. Commenters had sought this on grounds that Federal Reserve rules limit these inter-affiliate exposures.[9] The FDIC rejected these because it does not think these limits eliminate risk.

The final rule also includes non-U.S. sovereign exposures within the CCR measurement, even if the exposure receives a zero risk weight under the U.S. Basel III rules. Counterparty exposure continues to exclude all counterparty exposures to the U.S. Government and departments or agencies unconditionally guaranteed by the full faith and credit of the United States.

[9] See Client Reports in the **REGW** series.

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