Supervisory Insights

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Inside

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Supervisory Insights

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Issue at a Glance

Volume 10, Issue 2 Winter 2013

Articles

During the recent sustained low interest rate environment, the banking industry's asset mix and funding profile have shifted. This article looks at how these changes appear to have resulted in increased interest-rate risk (IRR) exposure. The article also highlights supervisory expectations for IRR management and suggests strategies financial institutions can use to assess and mitigate this exposure.

Completed by FDIC examiners at the conclusion of each risk management examination, the Credit and Consumer Products/Services Survey gathers examiner insights on underwriting practices, new and evolving banking activities and products, commercial real estate market conditions, and funding practices. This article shares recent Survey results with a focus on lending activity including trends in underwriting, factors influencing banks' ability and willingness to lend, use of loan workouts, and loan growth trends across the country.

The new regulatory capital rules require a deduction from capital, under certain circumstances, for a portion of a bank's investments in the capital of unconsolidated financial institutions. This article, which is part of the FDIC's ongoing efforts to assist banks in understanding the new rule, provides examples that show the mechanics of the calculation.

Regular Features

This feature provides an overview of recently released regulations and supervisory guidance.

Letter from the Director

The banking industry continues to recover gradually from the effects of the financial crisis and subsequent recession, showing gains in profitability, improvements in asset quality, and an uptick in lending activity. However, other challenges are now facing bankers and regulators. This issue of ***Supervisory Insights*** features articles that address three diverse areas of banking that are relevant to both community banks and larger banking institutions.

The recent environment of sustained low interest rates has led some banks to alter balance sheets in a reach for higher yields. "Industry Trends Highlight Importance of Effective Interest-Rate Risk Management" describes how these changes in the banking industry's asset mix and funding profiles have resulted in increased interest-rate risk (IRR) exposure. The article discusses supervisory expectations for IRR management and describes strategies banks can use to evaluate and mitigate this exposure.

FDIC risk management examiners have completed the Credit and Consumer Products/Services Survey since October 2009 to assess the level of risk and quality of underwriting on various types of credit. "Lending Trends: Results from the FDIC's Credit and Consumer Products/Services Survey" summarizes recent Survey results related to loan growth, credit underwriting practices, concentration risk, and the use of loan workouts.

The FDIC approved its new capital rule in July 2013. The rule, which takes effect January 1, 2015, includes a new set of deductions and adjustments from capital. As part of the FDIC's outreach efforts to explain the rule, "The New Basel III Definition of Capital: Understanding the Deductions for Investments in Unconsolidated Financial Institutions" describes one of the more complex aspects of the rule dealing with holdings of capital instruments of other institutions. The article also provides examples to show the mechanics of the related calculations.

We hope you read all the articles in this issue and find them to be a valuable resource going forward. We welcome your feedback and ideas for topics in future issues. Please e-mail your comments and suggestions to SupervisoryJournal@fdic.gov.

Doreen R. Eberley
Director
Division of Risk Management Supervision

Industry Trends Highlight Importance of Effective Interest-Rate Risk Management

Over the past five years, banks have operated in an environment of historically low interest rates. During this time, banks' balance sheets have evolved in a way that appears to have increased their exposure to rising rates.[1] Although it is difficult to predict when interest rates will increase, prudence suggests—and supervisory guidance emphasizes the importance of—that banks prepare for a period of rising interest rates.

This article describes the changes in the banking industry's asset mix and funding profile during the sustained low-rate environment and outlines how those changes appear to have resulted in increased interest-rate risk (IRR) exposure. As described in more detail below, concerns center around lengthened asset maturities and a potentially more rate-sensitive mix of liabilities that may expose some banks to securities depreciation and pressures on the net interest margin (NIM) in a rising-rate environment. These trends highlight the importance to banks of proactively managing and addressing IRR. In this regard, the article includes some common pitfalls identified by examiners and recommends strategies that banks can use to better assess and mitigate IRR exposure.

Banking Industry Response to Low-Rate Environment

Banks have faced many challenges since the financial crisis. Along with addressing asset quality issues, raising additional capital, and navigating a shifting financial services landscape, institutions have contended with a persistent and exceptionally low interest rate environment. These conditions have influenced changes in asset and funding compositions at many institutions and presented challenges to maintaining profitability. As interest rates have declined, the yield curve has steepened and the availability of retail deposit funding has increased. Banks have benefited from lower interest expense that, in the short term, improved NIMs and buoyed profitability, which was being adversely affected by poor credit quality. However, sustained low rates caused persistent downward pressure on asset yields. Low short-term interest rates also made it difficult to achieve further reductions in interest expense, resulting in deteriorating NIMs. Nevertheless,

[1] Unless otherwise noted, "bank" and "institution" refer to insured depository institutions.

Interest-Rate Risk Management

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as shown in Table 1, banks have been able to increase profitability in recent quarters as a result of improved credit quality, reduced noninterest expense, and increased noninterest income. Steps taken to improve earnings performance have overcome declining NIMs and contributed to higher return-on-asset and return-on-equity ratios.

Asset expansion over the past five years has primarily been the result of growth in bank securities portfolios. Securities balances grew by a larger dollar volume and at a considerably faster rate than loans during the five years ending second quarter 2013 (see Table 2).[2] During this period the annualized growth rate of securities

Table 1 – Bank profitability has improved in recent quarters despite declining net interest margins.

	2008Q2	2009Q2	2010Q2	2011Q2	2012Q2	2013Q2
Yield on Earning Assets	5.76%	4.81%	4.72%	4.38%	4.00%	3.69%
Cost of Funding Earning Assets	2.38%	1.34%	0.96%	0.77%	0.56%	0.43%
Net Interest Margin	3.37%	3.47%	3.76%	3.61%	3.45%	3.26%
Noninterest Income to Total Assets	1.83%	2.04%	1.80%	1.73%	1.72%	1.86%
Noninterest Expense to Total Assets	2.93%	3.22%	2.95%	3.07%	2.96%	2.96%
Loss Provisions to Net Operating Revenue*	31.96%	40.19%	24.13%	11.70%	8.52%	4.99%
Return on Assets	0.14%	-0.38%	0.63%	0.85%	0.99%	1.06%
Return on Equity	1.40%	-3.68%	5.75%	7.50%	8.73%	9.44%

Includes all insured depository institutions.

Source: FDIC Call Report data.

*Net Operating Revenue = Net Interest Income + Noninterest Income.

Table 2 – Banks have increased assets primarily through growth in securities portfolios.

($ billions)	Banks Less Than $1 Billion at 2Q13		Banks Over $1 Billion at 2Q13		All Banks at 2Q13	
	Total Change 2Q08 to 2Q13	Annual Percent-age Change	Total Change 2Q08 to 2Q13	Annual Percent-age Change	Total Change 2Q08 to 2Q13	Annual Percent-age Change
Total Loans	$28.5	0.7%	($182.8)	-0.5%	($154.2)	-0.4%
Total Securities	$91.3	7.0%	$864.2	8.3%	$955.5	8.2%
Total Assets	$186.2	2.9%	$1,103.2	1.8%	$1,289.4	1.9%

Includes all insured depository institutions. Data are merger-adjusted.

Source: FDIC Call Report data.

[2] Data used for asset size category growth rate comparisons are merger-adjusted. In merger-adjusting, balances reported in the current period are compared with previous periods after taking into account any acquisitions.

held by all banks far exceeded (8.2 percent vs. -0.4 percent) the growth rate in loans.

As a result, banks have held increasingly more securities during this time. Total securities as a percentage of total assets increased from 14.7 percent to 20.2 percent for institutions with total assets over $1 billion and from 18.5 percent to 23.1 percent for institutions with total assets less than $1 billion. By comparison, total loans as a percent of total assets declined from 58.8 percent to 52.7 percent for institutions with total assets over $1 billion, and 70.3 percent to 62.5 percent for institutions with total assets under $1 billion.[3] Muted loan growth and a shift in the asset mix toward securities may have resulted from modest loan demand and a reluctance to ease credit terms, given the asset quality problems experienced in the aftermath of the crisis.

While securities balances increased, the quarterly annualized yield on securities held by all institutions fell 280 basis points to 2.21 percent from second quarter 2008 to second quarter 2013. This compares to the quarterly annualized yield on loans which fell 134 basis points to 4.94 percent over the same time period.[4] Some of this difference can be attributed to the taxable status of investment portfolios, particularly due to a shift to municipal securities that often pay lower yields because of their preferential tax status. During this time, banks with total assets less than $1 billion shifted securities portfolios toward municipal securities. Municipal securities for these institutions represented more than 28 percent of aggregate securities balances at June 30, 2013, after increasing steadily from 19 percent in the same period of 2008. Mortgage-backed securities (MBS) holdings, on the other hand, have not experienced similar growth. MBS comprised almost

[3] Unless otherwise noted, the term "total loans" in this article refers to gross loans and leases, net of unearned income.

[4] Yield on securities is calculated as total quarterly annualized securities interest and dividend income as a percent of average total securities. Yield on loans is calculated as total quarterly annualized interest and fee income on loans and leases as a percent of average gross loans and leases.

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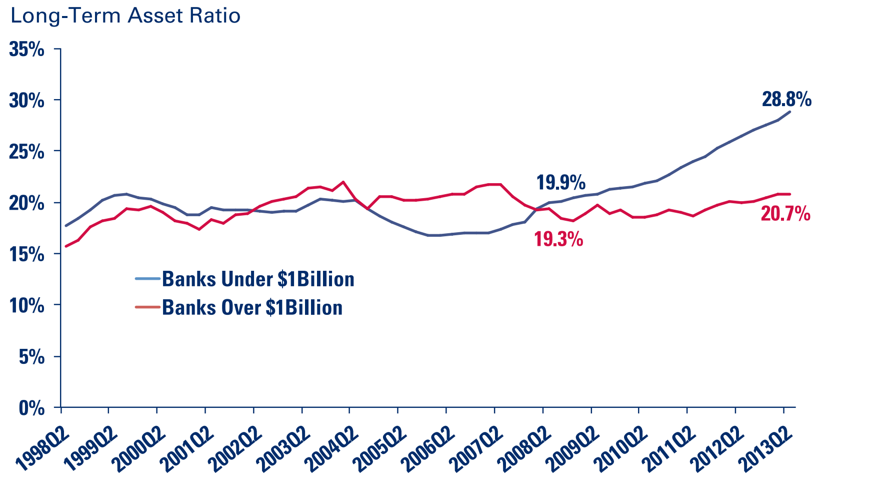
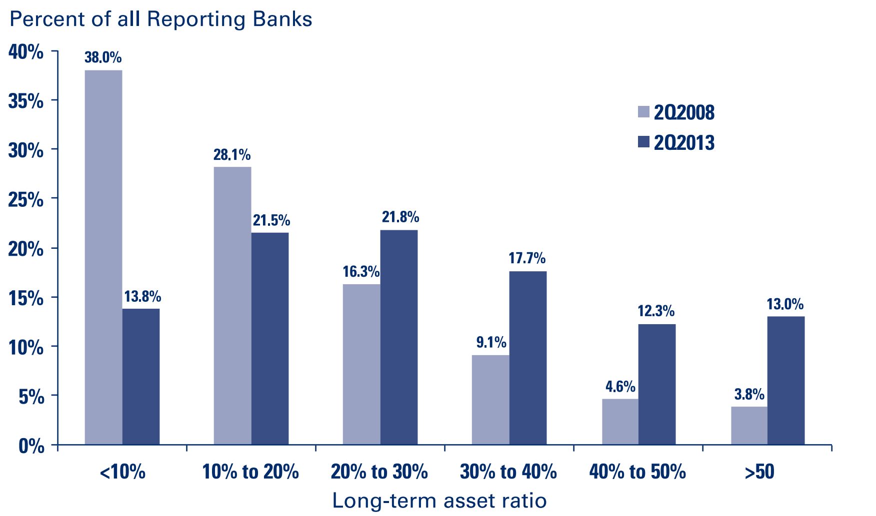
Chart 1: The long-term asset ratio for smaller banks has increased significantly since 2008.[5]



Note: Excludes former Thrift Financial Report filers. The long-term asset ratio for all banks, including former TFR filers, at June 30, 2013 was 29.8% for banks under $1 billion and 21.1% for banks over $1 billion.
Source: FDIC Call Report data.

Chart 2: Long-term asset ratios have increased for many banks since 2008.



Note: Excludes former TFR filers.
Source: FDIC Call Report data.

40 percent of total securities at June 30, 2013, compared to roughly 43 percent at second quarter 2008.

Even as smaller banks (defined in this paper as banks with total assets under $1 billion) have increased securities holdings, they also have shifted to securities and loans with longer maturities (see Chart 1). Since second quarter 2008, longer-term assets (defined as loans and securities with remaining maturities or next repricing dates greater than five years) held by smaller banks have increased substantially (from 19.9 percent to 28.8 percent of asset holdings).[6] Of these longer-term assets, longer-term securities represent 13.0 percent of assets (up from 9.0 percent at second quarter 2008) and more than half of all securities held by smaller banks. Longer-term loans for these banks represent 15.8 percent of assets (up from 10.9 percent at second quarter 2008). Meanwhile, larger banks with assets over $1 billion have only slightly increased longer-term assets, from 19.3 percent to 20.7 percent at second quarter 2013.

Increasing reliance on longer-term loans and securities has occurred across a significant number of banks as well. As of second quarter 2013, nearly 43 percent of all banks had a long-term asset ratio of at least 30 percent compared to almost 18 percent of all banks at second quarter 2008 (see Chart 2).[7]

[5] Long-term asset ratio is calculated as total loans and securities with maturities or repricing dates greater than five years, as a percent of total assets. This ratio does not include "Other mortgage-backed securities" reported in Call Report Schedule RC-B as having an expected average life over three years.

[6] Unless otherwise noted, maturity analysis in this article excludes former Thrift Financial Report (TFR) filers, which were not required to report maturity data. Current trends toward longer-term asset holdings are more significant when considering former TFR filers.

[7] For this analysis, a long-term asset ratio of 30 percent or greater was considered to be an elevated level of long-term asset holdings.

On the liability side of the balance sheet, the banking industry has experienced a surge in deposits since the financial crisis. Domestic deposits held by all banks increased roughly $2.5 trillion from second quarter 2008 through second quarter 2013. This represented an annualized growth rate of 6.4 percent, one percentage point higher than the annual growth rate of domestic deposits for the banking industry over the 15 years prior to second quarter 2008 (see Table 3).

Table 3 – Banks have experienced a significant increase in non-maturity deposits since 2008.

($ billions)	Banks Less Than $1 Billion at 2Q13		Banks Over $1 Billion at 2Q13		All Banks at 2Q13	
	Total Change 2Q08 to 2Q13	Annual Percentage Change	Total Change 2Q08 to 2Q13	Annual Percentage Change	Total Change 2Q08 to 2Q13	Annual Percentage Change
Time Deposits[8]	($60.3)	-2.6%	($768.9)	-9.1%	($829.2)	-7.7%
Other Savings[9]	$81.2	10.2%	$902.5	17.6%	$983.7	16.6%
MMDA	$87.8	9.8%	$1,516.0	9.5%	$1,603.8	9.5%
Demand Deposits	$64.1	10.2%	$574.4	18.0%	$638.5	16.7%
NOW Deposits	$42.8	8.9%	$55.3	7.0%	$98.0	7.7%
Total Domestic Deposits	$215.5	4.2%	$2,279.4	6.7%	$2,494.9	6.4%

Includes all insured depository institutions.
Source: FDIC Call Report data. Data are merger-adjusted.

[8] Includes time deposits of all sizes.

[9] Comprises all savings deposits other than MMDAs, and includes regular passbook accounts.

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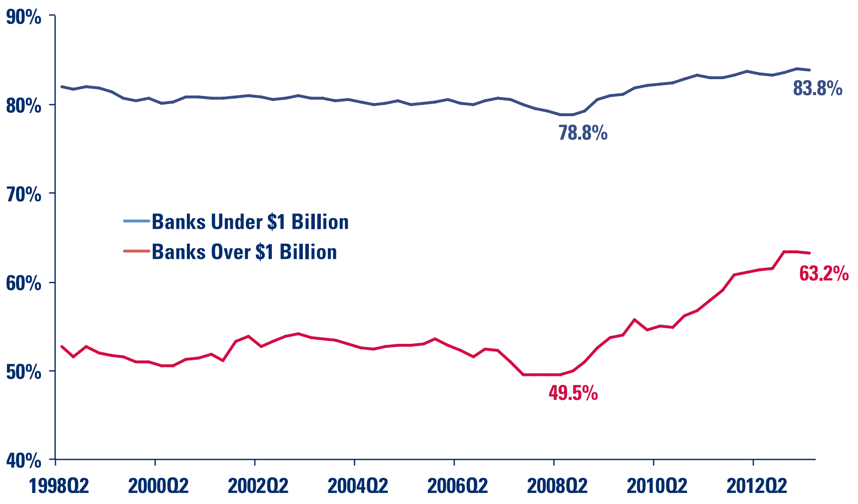
Chart 3: The proportion of assets funded by deposits has increased to the highest levels in the past 15 years for both large and small banks.



Source: FDIC Call Report data.

Growth in deposits during the past five years was driven by larger banks, which garnered the majority of deposit volume and saw deposits grow at a faster rate than at smaller banks. Domestic deposits as a percent of total assets also increased substantially for larger banks (see Chart 3). Although growth in domestic deposits for smaller banks may not have been as substantial as it was for larger banks in terms of volume, smaller banks did experience a significant increase in deposits as a percent of total assets. The ratio of domestic deposits to total assets for smaller banks is now at the highest levels in the past 15 years.

The composition of smaller-bank deposits has also changed considerably since 2008. The proportion of noninterest-bearing domestic deposits to total domestic deposits at smaller banks increased from 13.4 percent at second quarter 2008 to 17.7 percent at June 30, 2013. representing the highest levels seen in the past 15 years. Similarly, ratios of money market demand accounts (MMDA), demand deposits, and other savings deposits to total deposits at second quarter 2013 were at their highest levels of the past 15 years. Conversely, smaller-bank time deposits have fallen to 36.5 percent of total deposits as of second quarter 2013, the lowest level recorded in 15 years. Although time deposit balances declined, the duration has increased; time deposit balances at smaller banks currently have longer average maturities than during 2008. The proportion of total time deposits with remaining maturities or next repricing dates over one year increased from 19.6 percent in second quarter 2008 to 35.8 percent in second quarter 2013.[10] This shift toward longer-term time deposits was largely driven by higher-balance time deposits as depositors with larger balances sought higher rates through longer-term instruments. Time deposits over $100,000 with remaining maturities over one year increased to 17.2 percent of total time deposits at second quarter 2013 from 6.7 percent five years earlier.[11]

Meanwhile, the use of brokered deposits and Federal Home Loan Bank (FHLB) advances by smaller banks has declined. Brokered deposits as a percentage of total assets decreased to 2.5 percent at June 30, 2013, from 4.3 percent five years earlier. Similarly, FHLB advances as a percentage of total assets declined from 7.0 percent to 3.2 percent.

[10] Excludes former TFR filers.

[11] A shift toward higher-balance time deposits has been influenced, in part, by changes in deposit insurance coverage limits. The FDIC insurance coverage limit was temporarily increased from $100,000 to $250,000 on October 10, 2008, and the coverage limit was made permanent by the enactment of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Public Law 111-203. See http://www.fdic.gov/news/news/press/2008/pr08093.html and http://www.fdic.gov/deposit/deposits/changes.html.

Although traditionally stable non-maturity deposit categories have grown in recent years and replaced many traditionally volatile funding sources, such as brokered deposits and FHLB advances, the rapid growth in non-maturity deposit balances may have been exaggerated by persistently low rates. In this regard, traditionally stable deposit categories may have higher rate sensitivity than historical behavior may indicate, especially if persistently low deposit rates have encouraged bank customers to invest in non-maturity products rather than more rate-sensitive products, such as term certificates of deposit. Moreover, some of the increase in deposits could be due to customers' lack of alternative investments or to non-permanent shifts in customers' risk profiles, which may change in a rising-rate environment.

We highlight these shifts in the mix and duration of assets and the composition of deposits because they appear to have increased the IRR profile of many banks. Generally, and for reasons discussed further below, the asset side is more exposed to reductions in value in a rising interest rate environment, while the cost of liabilities may be becoming more sensitive to rising rates. These considerations lend added weight to the importance of effective management of IRR exposure.

Sound Practices for Managing IRR Exposure

As discussed above, the sustained low-rate environment has influenced bank balance sheets since the financial crisis and, in many cases, changes to asset and funding structures have increased the need to actively manage IRR exposure. A robust IRR management framework with appropriate policies and procedures that serve to control risk, as well as the capability to quantify and evaluate IRR exposure, remains an integral part of a bank's risk management framework. However, when assessing their IRR frameworks, banks should keep in mind that effective IRR management need not be overly complex, nor should it rely exclusively on third parties. An understanding of risk exposures and limits by senior bank management and the Board of Directors should play a large role in driving a successful risk management framework.

Banks should measure their IRR exposure in a variety of interest-rate scenarios, including parallel and non-parallel changes, such as flattening or steepening of the yield curve. As highlighted in the 2010 *Interagency Advisory on Interest Rate Risk Management*, exposures should be tested for substantial rate increases (e.g., 300 and 400 basis points) and

Regulations, Guidance and Resources for Managing IRR

- "Managing Sensitivity to Market Risk in a Challenging Interest Rate Environment": FIL-46-2013 (October 8, 2013) - http://www.fdic.gov/news/news/financial/2013/fil13046.html.
- FDIC Directors' video on IRR (2013) - http://www.fdic.gov/regulations/resources/director/virtual/irr.html.
- Interagency "Advisory on Interest Rate Risk Management" (January 6, 2010) – FIL-2-2010 - http://www.fdic.gov/news/news/press/2010/pr1002.pdf) and Frequently Asked Questions (January 12, 2012) - FIL-2-2012 - http://www.fdic.gov/news/news/finan-cial/2012/fil12002a.pdf.
- "Joint Agency Policy Statement on Interest Rate Risk" (May 14, 1996) - https://www.fdic.gov/regulations/laws/rules/fdic-interagency-statements.html.
- Interagency Guidelines Establishing Standards for Safety and Soundness (July 10, 1995) - https://www.ecfr.gov/current/title-12/chapter-III/subchapter-B/part-364/appendix-Appendix%20A%20to%20Part%20364.

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Examination Insights – Examiner Focus and Review

The issues described below highlight certain elements of an IRR framework commonly reviewed by examiners during an IRR examination, along with common pitfalls. Importantly, the focus of IRR reviews may vary depending on the unique characteristics of a particular institution. The issues highlighted below are meant only to be illustrative and are not inclusive of all items that may be reviewed or all potential findings. For additional information on expectations for managing IRR, refer to the regulations, guidance, and resources provided above.

Areas Reviewed by Examiner:	Common Pitfalls
The adequacy and reasonableness of policies, procedures, risk limits, and strategies governing an IRR framework and the involvement of the Board and senior management in actively reviewing and approving these items.	▪ The Board and senior management do not regularly review or approve policies, procedures, risk limits, or strategies. ▪ Risk limits are not defined or not appropriate for risk tolerance of the institution. ▪ Policies and procedures do not specify oversight responsibilities for measuring, monitoring, or controlling IRR.
The capabilities and accuracy of internal measurement systems and the appropriateness of assumptions and stress-testing scenarios.	▪ Assumptions are not regularly updated or are not reasonable for a given interest rate shock scenario (e.g., specified asset prepayments or non-maturity deposit price sensitivity and decay rates) or do not take into account specific characteristics of certain assets and liabilities (e.g., influence of loan floors and caps on rate exposure). ▪ Stress tests do not incorporate significant rate shocks (for example, 300- and 400-basis point shocks) and other severe but plausible scenarios specific to the particular risks of the bank. Results of stress tests are not compared to internal risk limits. ▪ Models used to measure and manage IRR are not adequate given the complexity of the institution's balance sheet (i.e., the model cannot accurately measure embedded options).
Characteristics and duration of assets, funding sources, and off-balance sheet exposures and their contribution to the overall IRR profile.	▪ An imbalance in the duration of assets and liabilities presents a marked exposure to changes in interest rates. ▪ The potential exists for significant securities portfolio depreciation in relation to capital in the event of a significant increase in interest rates.

incorporate severe but plausible scenarios. Moreover, scenario testing should incorporate assumptions that consider a departure from historical norms, in particular when considering future deposit behavior.

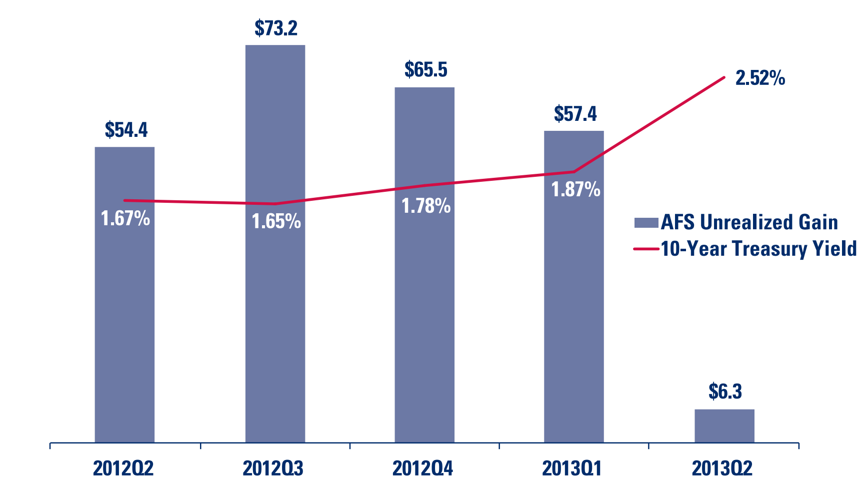
Banks that have experienced significant changes to their asset or funding mix during the past several years also should consider implementing risk mitigation strategies now to reduce IRR exposure. Such strategies are easier and more cost-effective to implement before a substantial rate movement occurs. In general, mitigation strategies could include shifting the asset and funding mix; diversifying income sources; ensuring capital is adequate to absorb losses should depreciated securities have to be sold; and, for institutions with sufficient understanding and expertise, engaging in hedging activities.[12] Banks should

[12] Hedging with interest rate derivatives is a potentially complex activity that can have unintended consequences, including compounding losses, if used incorrectly.

establish prudent risk limits that include measurable triggers to help determine when risk mitigation strategies may need to be executed.

Banks with longer-maturity securities portfolios should prepare for the risk of declining fair values that may come as a result of higher interest rates. Unrealized gains can quickly decline or be transformed into unrealized losses because of increasing rates, as experienced in second quarter 2013 (see Chart 4). Banks should test securities portfolio exposure to rising rates under significant rising-rate scenarios (e.g., 300 and 400 basis points). As highlighted in Financial Institution Letter (FIL) 46-2013, *Managing Sensitivity to Market Risk in a Challenging Interest Rate Environment*, although net unrealized losses on securities may not flow through to regulatory capital for most banks, examiners do consider the amount of unrealized losses in the investment portfolio and an institution's exposure to the possibility of further unrealized losses when qualitatively assessing capital adequacy and liquidity and assigning examination ratings.[13] In the event depreciated securities have to be sold, unrealized losses become realized losses, reducing the institution's regulatory capital position. Furthermore, unrealized losses on available-for-sale and held-to-maturity securities may also reduce equity capital under U.S. generally accepted accounting principles (GAAP). In extreme cases,

Chart 4: Unrealized gains on available-for-sale securities declined significantly in the second quarter.



Note: Includes all insured depository institutions. Unrealized gains calculated as difference between reported fair value and reported book value of AFS securities.
Source: FDIC Call Report data, U.S. Treasury.

securities depreciation could exceed equity capital, resulting in a negative GAAP equity position. A significant decline in an institution's GAAP equity can have negative market perception and liquidity implications. For all of these reasons, significant securities depreciation is an important risk for banks regardless of the regulatory capital treatment, as it can adversely affect earnings, liquidity, and public confidence in the institution.

To alleviate pressure from fair value losses for banks with sizable long-term fixed-rate holdings, management may consider locking in profits in longer-term securities through investment

[13] Under the current general risk-based capital rules, most components of accumulated other comprehensive income (AOCI) are not reflected in a banking organization's regulatory capital. Under the Basel III capital rules, all banking organizations must recognize in regulatory capital all components of AOCI, excluding accumulated net gains and losses on cash-flow hedges that relate to the hedging of items that are not recognized at fair value on the balance sheet. Banking organizations, other than advanced approaches banking organizations, will be able to make a one-time election to opt out of this treatment and continue to neutralize changes in AOCI, as is done under the current capital rules. The one-time election provided to non-advanced approaches banking organizations must be made with the filing of the March 31, 2015 Call Report. Recognition of changes to AOCI within capital calculations will start in 2014 for advanced approaches banking organizations and 2015 for non-advanced approaches banking organizations that did not opt out of the Basel III treatment.

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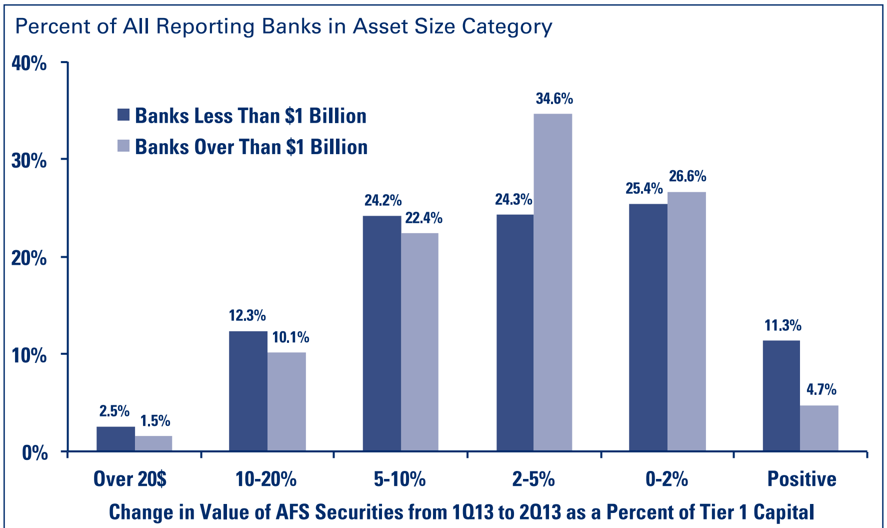
sales and shifts in the investment portfolio's composition toward shorter-maturity or variable-rate securities. Similarly, banks that have extended asset portfolio duration to capture higher yields may consider shorter-term or variable-rate products, which are more effective in managing sensitivity and mitigating potential depreciation in the portfolio.

When assessing the IRR exposure of loan portfolios or considering new loan products, it is also important to consider how rate floors or caps may either improve or exacerbate exposure in a rising-rate scenario. If a bank's variable-rate loans have contractual rate floors that are currently well above prevailing rates, increases in interest rates will not immediately be reflected in those loans – possibly for several hundred basis points – and could potentially increase the bank's liability sensitivity. Similarly, variable-rate loans that are at or close to their contractual rate caps will not fully benefit from significant increases in interest rates as rates will be held at respective caps regardless of the increase in prevailing rates.

Additionally, banks should consider the impact rising rates will have on cash flow for variable-rate customers, as well as for those customers with near-term maturities, when loans may reprice at higher rates. The IRR management framework and quantitative exposure models should consider the potential for increased losses through credit deterioration stemming from the strain on cash flows of marginal borrowers.

Chart 5: The change in value of available-for-sale securities during the second quarter represented a substantial percentage of Tier 1 Capital for many banks.



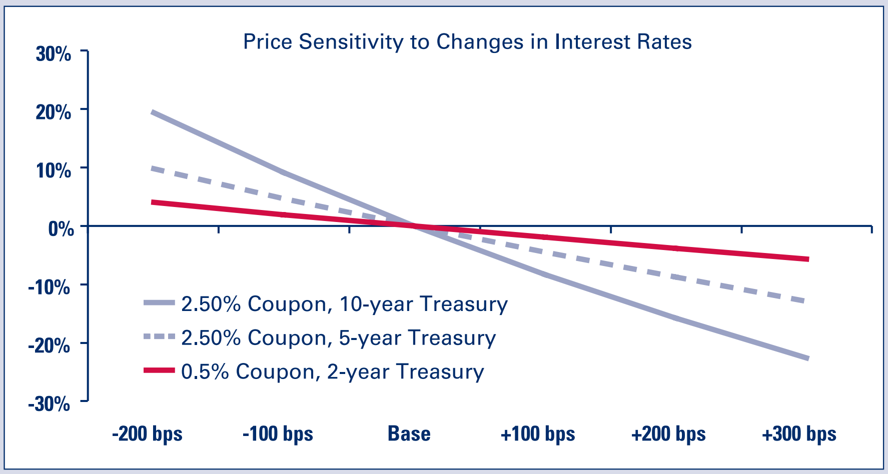
Source: FDIC Call Report data.

The text box on page 13 depicts the price sensitivity of selected securities to changes in interest rates. The value of long-duration securities can be materially reduced in an environment of substantially rising interest rates. For example, a 10-year Treasury note with a 2.5 percent coupon would lose approximately 23 percent of its value if interest rates increased 300 basis points.

As indicated in Chart 5, market experience in second quarter 2013 illustrated the sensitivity of the values of investment portfolios to rising interest rates across many banks. An increase in rates in the second quarter was accompanied by widespread reductions

Understanding price sensitivity across security types

Understanding how price behavior is influenced by changes in interest rates for current securities holdings as well as prospective purchases is a critical component of managing IRR exposure. Banks should fully understand the relationship between rate movements and price sensitivity for securities holdings, in particular for securities with embedded options that may affect price behavior. In general, price sensitivity for an option-free bond is greater for low-coupon, longer-maturity securities compared to high-coupon, shorter-maturity securities. This is because the sooner cash flows are received, the less time they would be subjected to the disparity between their original yield and current market rates, should rates change. Generally, the effects of a longer maturity outweigh the effects of a larger coupon. The example below illustrates price behavior for option-free Treasury securities of varying terms and coupons.



Price behavior of securities with embedded options varies depending on how the underlying option influences cash flows of the particular security. For example, expected cash flows of a mortgage-backed security (MBS) may change as borrowers exercise options to prepay mortgage balances. Similarly, cash flows of a callable bond may be affected if the bond is called at the option of the issuer. Price behavior, total return, and life of these security types will change across interest rate scenarios as a result of the embedded options. The example below compares price behavior across various security types.

Price Change*	-200 bps	-100 bps	+100 bps	+200 bps	+300 bps	+400 bps
Treasury 2.5%, 10-year	19%	9%	-8%	-16%	-23%	-29%
Treasury 0.5%, 2-year	4%	2%	-2%	-4%	-6%	-8%
FNMA 3.5% 30-yr MBS	6%	5%	-8%	-15%	-21%	-26%
FNMA 3.0% 15-yr MBS	3%	3%	-4%	-9%	-13%	-19%
FNMA Callable 5-yr Note	0.9%	0.5%	-4%	-8%	-12%	-15%
FNMA Callable Step Coupon 5-yr Note	0.4%	0.2%	-2%	-5%	-8%	-11%

*Price changes are approximate and intended only to illustrate differences in price behavior across security types. Forecasted price behavior may vary depending on assumptions. Actual price behavior of securities may not precisely reflect those shown above.
Source: Bloomberg.

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in the fair values of banks' investment portfolios, by amounts that exceeded 10 percent of tier 1 capital for nearly 15 percent of all reporting institutions.

With respect to liabilities, banks should objectively examine funding and deposit structures. Changes in the level and composition of deposits in recent years should be examined with an understanding of how a sustained low-rate environment may have influenced deposit trends. Deposit products may not behave in the same manner going forward. For example, longer-term time deposits that lock in low rates generally improve a bank's IRR profile. However, banks should consider the risk that penalties for early termination of time deposits—regardless of maturity—may not be sufficient to deter customers from taking advantage of higher rates if broader interest rates increase. This is a particular concern if the customer only forfeits interest (which can be minimal in the current environment). Additionally, traditionally stable deposit categories may now reflect greater rate sensitivity than previously thought. To the extent that persistently low deposit interest rates have encouraged bank customers to invest in non-maturity products rather than more rate-sensitive products, such as term certificates of deposit, the pricing power that banks have over these deposit categories may be diminished. Moreover, some of the increase in deposits could be due to customers' lack of alternative investments or non-permanent shifts in customers' risk profiles, which could reduce the natural ability of some banks' funding structures to offset rate risk taken via long-term assets. Another factor that could increase the rate sensitivity of non-maturity deposits compared to previous experience is the elimination under the *Dodd-Frank Wall Street Reform and Consumer Protection Act* of the prohibition of payment of interest on demand deposits.[14] This statutory change has had little effect to date because of near-0 percent short-term interest rates. However, in a rising-rate environment, the fact that demand deposits can require interest payments should be considered as part of banks' planning. Similarly, as noted above, time deposit balances have experienced a shift in composition towards larger balance accounts. Although this shift may have been influenced in part by statutory changes to insurance coverage limits, banks should still be conscious of how a shift towards larger—and potentially more sophisticated—accounts may increase rate sensitivity relative to historical experience if time deposit balances previously consisted primarily of smaller accounts.

As shown in Chart 3 (see page 8), deposits are currently funding the highest percentage of assets than at any other time during the past 15 years. Accordingly, the effect on NIMs could be more pronounced if deposit products prove more rate sensitive than historical experience may suggest. Banks should create scenarios that take into consideration how funding mix and interest expense would change if deposit balances shift toward higher rate products, or deposit balances leave the bank altogether and need to be replaced by alternative funding sources. Banks that have

[14] Section 627(a) of *Dodd Frank Wall Street Reform and Consumer Protection Act*. See https://federalregister.gov/documents/2011/07/18/2011-17886/prohibition-against-payment-of-interest-on-demand-deposits

experienced a significant increase in deposit balances or a shift in funding mix should consider the potential for reduced pricing power of their deposit products.[15] This is particularly important for banks that have extended maturities on the asset side of their balance sheet and depend on these deposits for longer-term funding.

To some extent, banks can use experiences from prior rate cycles to develop appropriate modeling assumptions for assets and liabilities and stress-testing scenarios. However, banks should be mindful of how differences between current and previous interest rate environments may influence outcomes. For example, during the previous rate cycle, prevailing interest rates began to decline in early 2001 before reaching a bottom in 2003, and subsequently rising through 2006 (see Chart 6). The environment in 2003, however, was far different from the current low-rate environment in that rates were not as low, had not dropped as far, and did not stay as low for as long. In the current rate environment, rates began to decline in 2007 before hitting current lows that have been maintained since 2008. As a result of this difference, banks using experiences from the previous rate cycle as a basis for developing assumptions and stress-testing scenarios going forward may not be adequately capturing the risk for a more severe impact of rising rates. Assumptions should be updated to account for the current interest rate environment.

Chart 6: The 2-Year Treasury yield has remained at historically low levels for an extended period.

Source: U.S. Treasury.

[15] Pricing power, in this context, should consider the ability to retain deposit levels while simultaneously increasing their yield more slowly and by a lower amount than other market rates.

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Conclusion

The sustained low-rate environment since 2008 has increased the need to actively manage IRR exposure as a result of shifting asset and liability structures for many banks. Effective policies and procedures that quantify and evaluate IRR exposure remain an integral part of the risk management framework given the challenges presented by the current and prospective environments. On the asset side of the balance sheet, industry data show expanding securities holdings and extending maturities of loan and securities portfolios. This has increased the risk of substantial unrealized losses and extended periods of below-market yields on these assets in a rising-rate environment. On the liability side, a significant surge in deposits since 2008 has pushed reliance on deposit funding to the highest level in the past 15 years, while the deposit mix has shifted toward non-interest and other non-maturity deposit balances. This has added uncertainty to the pricing power banks have over these funding sources. Banks should be prepared for some customers to respond to a rising-rate environment by moving investments into higher-yielding products which may or may not be offered by the bank. Banks should address such adverse scenarios in the assumptions used to gauge asset and liability IRR exposure to ensure they are adequately prepared for a period of rising interest rates. Through proactive steps to manage and mitigate IRR exposure, bank management should implement effective strategies that will preserve earnings and capital when faced with rising rates.

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Lending Trends: Results from the FDIC's Credit and Consumer Products/Services Survey

FDIC examiners have completed the Credit and Consumer Products/Services Survey (Survey) at the conclusion of all risk management examinations since October 2009. The Survey solicits examiner assessments on the level of risk and quality of underwriting on nine credit products and information on new and evolving banking activities and products, local commercial real estate (CRE) market conditions, and funding practices.

Survey results for 2011 were presented most recently in the Summer 2012 issue of *Supervisory Insights* with a discussion of how banks were responding to ongoing economic and competitive challenges, including an assessment of general underwriting and loan growth trends.[1] As noted in the article, the FDIC continues to review and analyze data from this Survey. This article summarizes recent Survey results and provides insights on lending trends and the changing risk profiles of insured institutions.

During the eighteen months ending June 30, 2013, more than 3,700 surveys were completed by FDIC examiners based on risk management examination findings. On average, approximately 1,200 surveys are generated every six months at insured institutions across the country. Since the Survey was revised in October 2009,[2] many banks have had multiple surveys completed by FDIC examiners. Since implementation of the Survey, almost all 4,375 institutions supervised by the FDIC have a completed survey with 64 percent having multiple surveys.

In addition to sharing Survey results with the industry through articles in the *Supervisory Insights* journal, this information is available to the FDIC's supervisory staff across the country. By combining Survey results with other information such as financial, economic, and examination data, supervisory staff can better identify trends, conduct enhanced forward-looking analyses, and make more informed decisions regarding supervisory policies, examination scheduling, and examination risk scoping.

General Underwriting and Credit Trends

Recent Survey results generally indicate continued improvement in overall credit risk profiles and underwriting practices, which supports the trend of gradual strengthening in asset quality at many institutions as they recover from the most recent financial crisis. For the eighteen months ending June 30, 2013,[3] the percentage of respondents designating one or more loan portfolios as "high" risk declined for all portfolios except Agricultural loans, which evidenced a slight uptick during

[1] Jeffrey A. Forbes; Margaret M. Hanrahan; Andrea N. Plante; and Paul S. Vigil, "Results from the FDIC's Credit and Consumer Products/Services Survey: Focus on Lending Trends," ***Supervisory Insights***, Summer 2012. https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum12/sisummer12-article3.pdf.

[2] Jeffrey A. Forbes; David P. Lafleur; Paul S. Vigil; and Kenneth A. Weber, "Insights from the FDIC's Credit and Consumer Products/Services Survey," ***Supervisory Insights***, Winter 2010. https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin10/siwinter10-article2.pdf.

[3] This article focuses on surveys completed between January 1, 2012, and June 30, 2013.

Credit and Consumer Products/Services Survey

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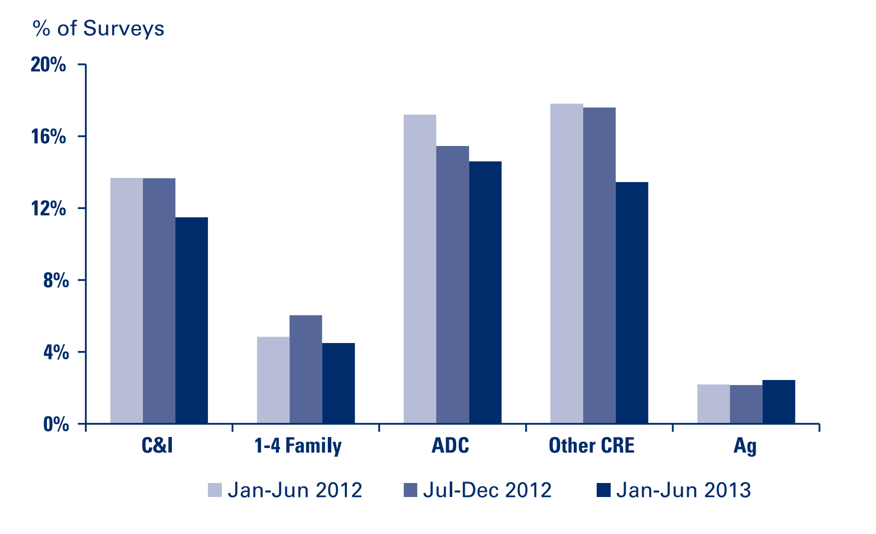
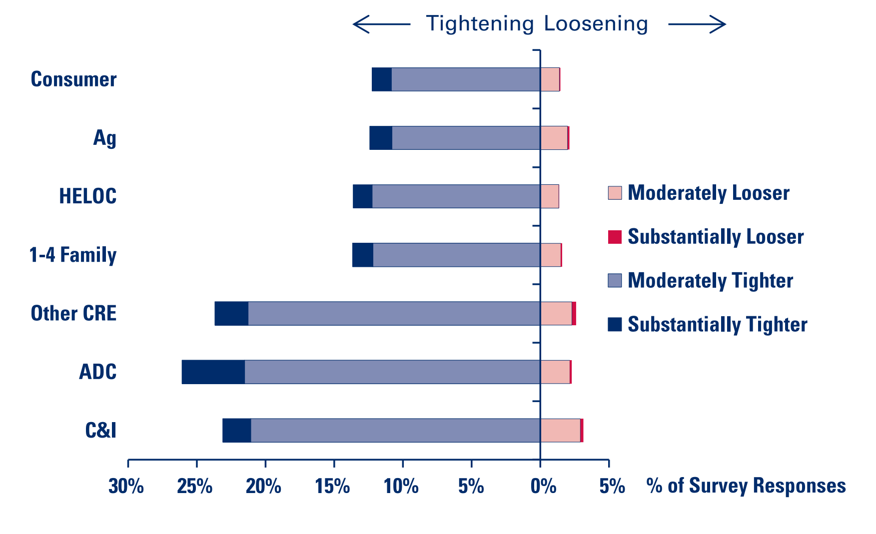
Chart 1: General Underwriting Trends Continue to Show Declines in "High" Risk Designations



Source: FDIC Credit and Consumer Products/Services Survey

Chart 2: More Portfolios Continue to Indicate Tightened vs. Loosened Underwriting Practices



Source: FDIC Credit and Consumer Products/Services Survey – responses from January 1, 2012 to June 30, 2013

the first six months of 2013 (see Chart 1).[4] When characterizing loan underwriting practices, respondents reported a similar positive trend. The percentage of respondents describing an institution's underwriting as "generally liberal" declined in all portfolios except Commercial and Industrial, while there was an increase in the percentage of institutions considered to have "generally conservative" underwriting practices.

For those institutions captured in the Survey during the eighteen-month period, roughly 76 percent of respondents indicated no material change in loan underwriting practices since the last examination. However, when examiners did observe a change in practices, they reported that a greater percentage of institutions are tightening rather than loosening underwriting standards (see Chart 2 for changes in underwriting for seven loan types). Furthermore, examiners indicated that banks that are experiencing loan growth have not been loosening standards as the Survey results reflect "low" risk in these portfolios. Similar to results published in the Summer 2012 issue of *Supervisory Insights*, examiners are reporting that institutions have been more likely to tighten rather than loosen loan underwriting, most notably in the commercial-related portfolios (Commercial/Industrial (C&I), Acquisition, Development, and Construction (ADC), and Other CRE).

The primary factors that continue to influence changes in underwriting

[4] The Survey asks examiners to assess the risk in nine loan portfolios as "low," "moderate," or "high."

practices are changes in economic conditions, changes in condition of the institution, and responses to regulatory findings/actions. An institution that is distressed or operating in a depressed market often responds by tightening credit standards. A similar response is common when a bank is faced with unfavorable regulatory findings, ratings, and enforcement actions.

Higher-Risk Practices

The Survey also includes questions that focus on higher-risk lending practices. Although less common in 2012 and 2013 compared to previous years, such practices continue to exist most frequently in ADC lending. As reflected in Table 1, five higher-risk practices associated with construction lending were characterized by examiners as "frequently enough to warrant notice" or "as a standard practice" in more than one quarter of the institutions captured in the survey during 2011. However, the frequency of these practices continues to drop with fewer than 20 percent of institutions with responses for this question engaging in four of these practices in 2012, and with further declines during the first half of 2013. Among these risky practices, the most frequently observed practice is a failure to verify the quality of alternative repayment sources when market conditions are strong, projects are completed, and loans are paid as agreed. However, as was evident during the latest economic downturn, ADC loans across the country became nonperforming as developers could not generate sales, and alternative repayment sources were nonexistent.

Out-of-area lending grew dramatically in the years before the crisis as more institutions extended credit in areas of the country with particularly strong economies. These loans often were purchased whole or in participations underwritten by other financial institutions. Many failed banks had relatively large portfolios of out-of-area loans that deteriorated quickly and were exacerbated by weak due diligence at origination, lack of knowledge of the area

Table 1: Frequency of Risky ADC Practices Continues to Decline

Higher-Risk Acquisition, Development, and Construction Practices	2010	2011	2012	Jan-Jun 2013
Funding projects on a speculative basis (i.e. without meaningful pre-sale, pre-lease, or take-out commitments)	35%	25%	16%	9%
Funding loans without consideration of repayment sources other than sale of the collateral	33%	27%	16%	11%
Failing to verify the quality of alternative repayment sources	38%	31%	23%	17%
Use of unrealistic appraisal values relative to the current economic conditions and/or the performance observed in similar credits	30%	25%	16%	10%
Liberal use of interest reserves or deferral of interest payments to an extent that may mask rising delinquency levels	19%	12%	6%	3%

Source: FDIC Credit and Consumer Products/Services Survey.

Note: Surveys are completed at the end of each examination; therefore, percentages may not reflect the same group of institutions over time.

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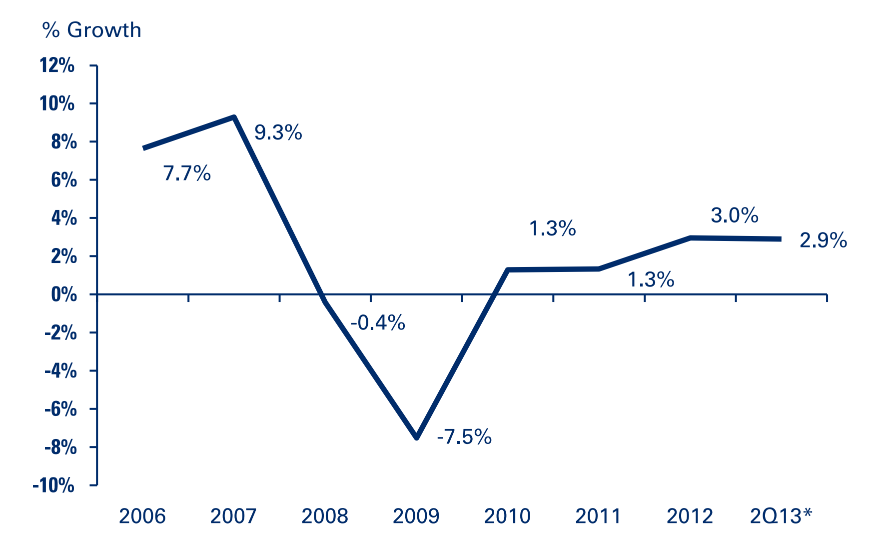
where the loan was made, and reliance on a third party that poorly managed the credit. Survey results suggest insured institutions are implementing lessons learned from the crisis, with fewer banks making out-of-area loans. Survey results show that the extent banks have been engaged in out-of-area lending continues to decline for ADC and Other CRE, while the frequency of out-of-area 1-4 family residential lending remains stable (see Chart 3 for historical trends).

Chart 4: Outstanding Loan Balances Continue Growing Modestly



Source: FDIC Call Reports; 2Q13 growth represents 12-month's growth

Growth in Concentrated Loan Portfolios and Unfunded Commitments[5]

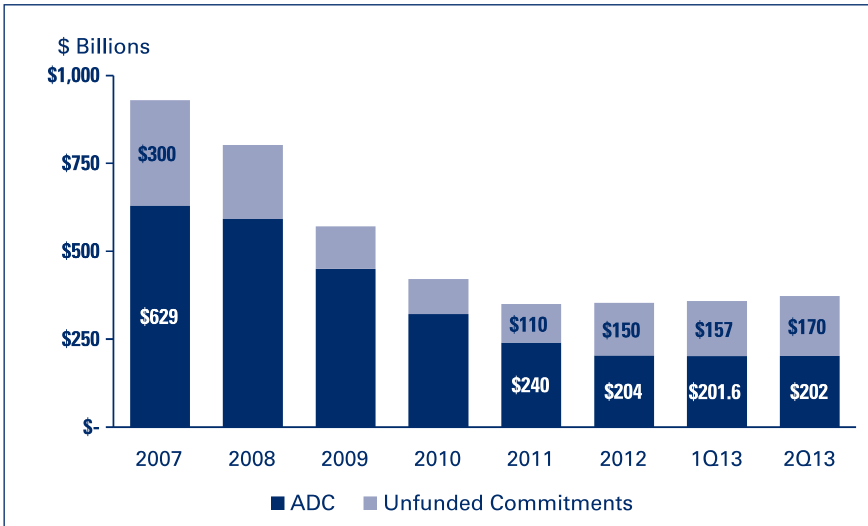
Aggregate loan balances have been rising, even though overall underwriting standards have been tightened. As previously discussed, the frequency of higher-risk practices, such as out-of-area lending, has been reduced. As shown in Chart 4, outstanding loans increased dramatically from 2006 to a peak in mid-2008, and began to decline during the financial crisis. From late 2008 through 2010, the collapse of the credit and housing markets significantly reduced residential mortgage originations and ADC lending. In particular, ADC loan balances have declined more than 65 percent from the peak in first quarter 2008 as lenders continue to write down and transfer loans to ORE. However, in second quarter 2013, ADC loans posted a slight increase in outstanding balances and, more dramatically, in unfunded commitments. Unfunded commitments for commercial real estate projects significantly exceed those for residential projects (see Chart 5 for a breakdown of on-book and off-balance sheet ADC lending).

Approximately 300 institutions with concentrated ADC and Other CRE loan portfolios are increasing these portfolios.[6] When owner-occupied properties are included, the number of institutions is almost 550. A majority of the concentrated loan growth is in the commercial real estate portfolio with over 170 banks growing

[5] FDIC Call Reports.

concentrated loan portfolios.[7] ADC-concentrated growth is on the rise with more than 100 banks growing concentrated portfolios. Map 1 (see page 22) shows where banks are growing concentrated portfolios; many are in states hit hardest during the recent crisis, including Illinois, Florida, California, and Georgia. New Jersey has the greatest percentage of Other CRE-concentrated banks increasing this loan type with 17 percent of that state's insured institutions;[8] Texas has the greatest percentage of ADC-concentrated banks increasing ADC loans at almost 7 percent of the state's insured institutions.

Chart 5: ADC Loan Portfolios Stabilizing with Rising Unfunded Commitments



Source: FDIC Call Reports

Coming after a long real estate downturn, a return to growth could be considered a healthy sign, especially since Survey results indicate these banks generally have not loosened underwriting standards. Nevertheless, growth in concentrated portfolios has been an important risk factor in banking crises, such as the farm crisis in the early 1980s, the oil and gas crisis in the mid-1980s, the New England real estate crisis in the early 1990s,[9] and the most recent crisis.[10] Concentrations of credit require greater levels of risk assessment, monitoring, and management. Moreover, appreciable loan growth should be supported by an appropriate infrastructure of skilled lenders operating under a framework of appropriate underwriting, credit administration, and risk management policies.

Overall Loan Growth and its Influences

Lending activity is on the rebound across the country, albeit at a modest pace.[11] Almost 60 percent of insured depository institutions have grown their loan portfolios between second quarter 2012 and second quarter 2013. As seen in Map 2 (see page 23), loan growth has spread in most states, with a growing percentage of banks within the states increasing

[6] ADC and CRE concentrations of credit are based on the December 12, 2006 Financial Institution Letter FIL 104-2006 – *Joint Guidance on Commercial Real Estate Lending:* 100 percent of total risk-based capital and 300 percent of total risk-based capital, respectively.

[7] Growth for purposes of this article had a de minimis level of 5 percent.

[8] For states with total number of banks greater than 10.

[9] George Hanc, et al., History of the 80s – Volume 1: An Examination of the Banking Crises of the 1980s and Early 1990s. FDIC, Washington, DC, pp. 3-86. http://www.fdic.gov/bank/historical/history/3_85.pdf.

[10] Office of the Inspector General – Report Number MLR 11-010, "Follow-Up Audit of FDIC Supervision Program Enhancements." https://www.fdicoig.gov/sites/default/files/reports/2022-08/11-010.pdf.

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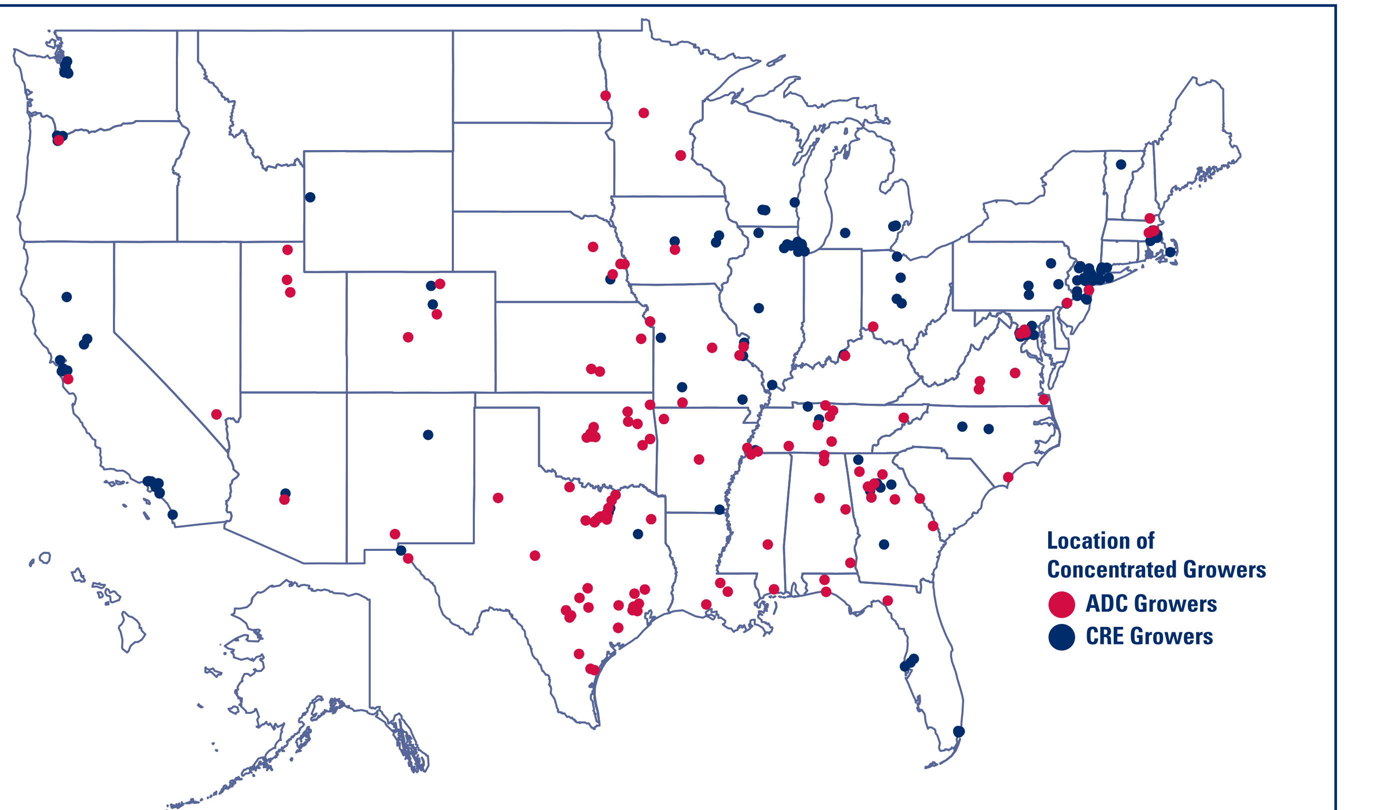
Map 1: Location of Concentrated ADC and Other CRE Loan Growers



Source: FDIC Call Reports

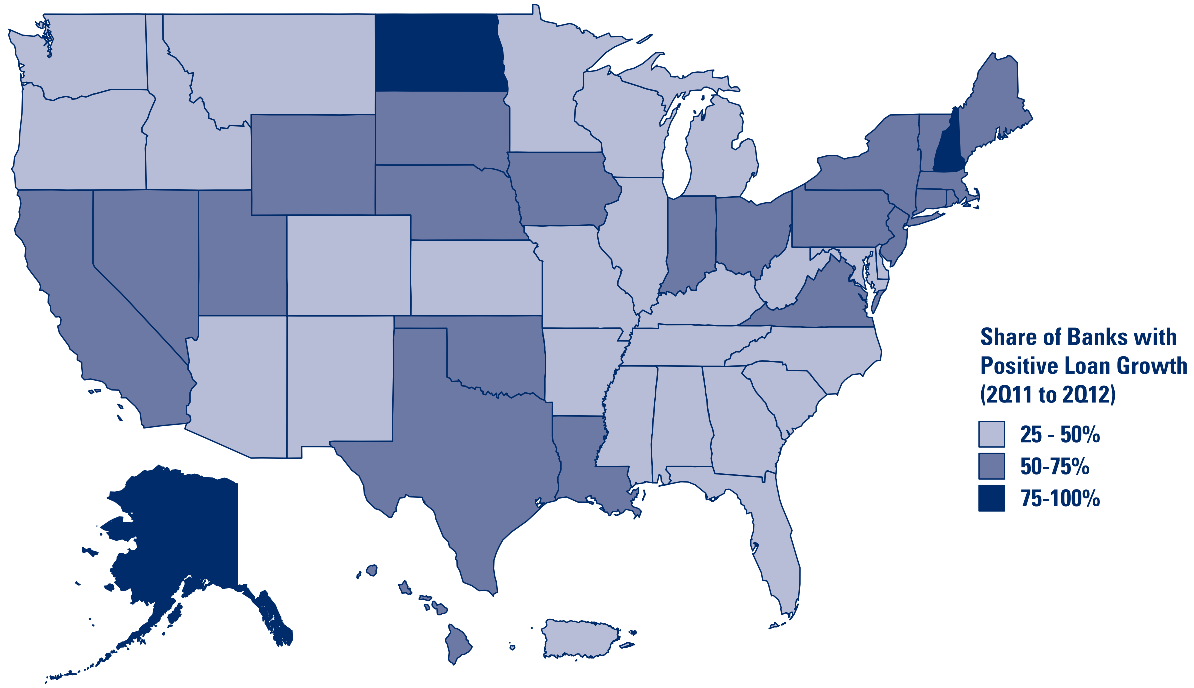
their outstanding loan portfolios. The percentage of banks with loan growth was highest in New England, with more than 75 percent of institutions reporting loan growth in the twelve months ending June 30, 2013. In the Northeast, Midwest, and West Coast, more than 50 percent of banks are reporting loan growth. Banks in the Southeast and Michigan (both hard-hit areas during the crisis) are showing signs of a recovery in lending with almost 50 percent of these institutions reporting loan growth. States with the greatest percentage of institutions reporting loan growth were Maine, Massachusetts, Hawaii, and New Hampshire. States with the lowest percentage were Idaho, South Carolina, District of Columbia, Georgia, and North Carolina.

As previously mentioned, Survey results indicate three primary factors influence loan underwriting: changes in economic conditions, changes in the financial condition of institutions, and responses to regulatory observations. During the financial crisis and the ongoing recovery, these factors collectively contributed to a tightening in underwriting standards and reduced loan growth; more recently, however, the influence of these factors appears to be moderating as reflected

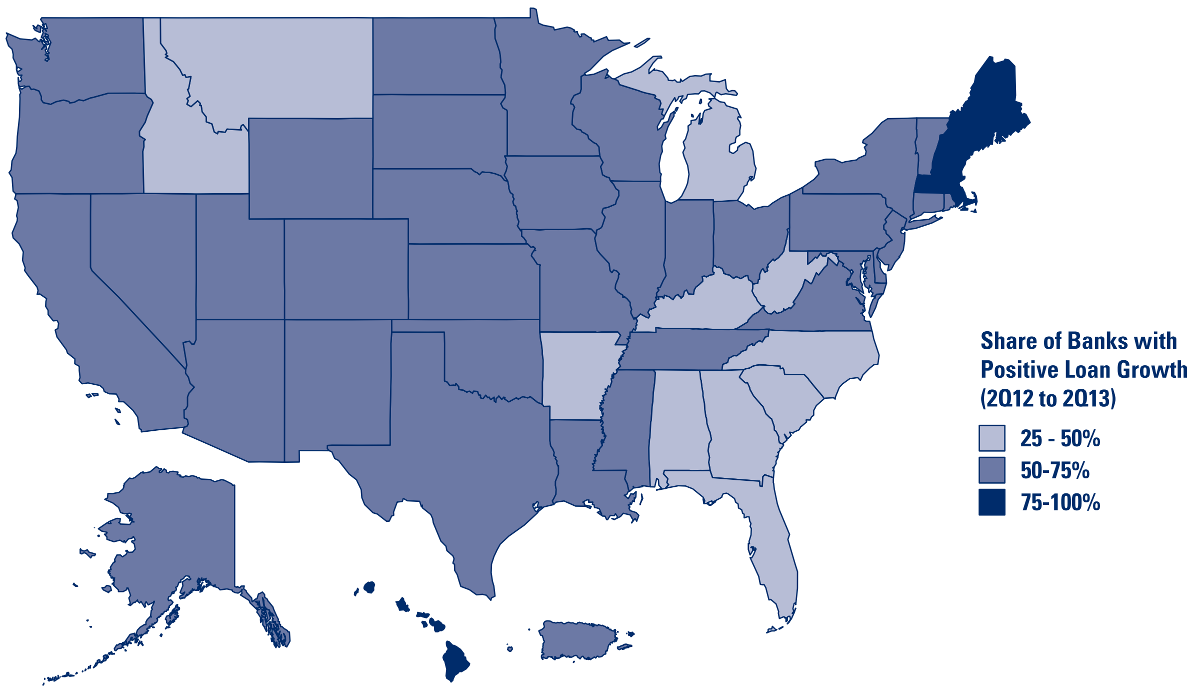
[11] FDIC Call Reports.

Map 2: Percentage of Banks with Loan Growth Has Risen in Majority of States

States with Loan Growth between 2Q11 and 2Q12



States with Loan Growth between 2Q12 and 2Q13



Source: FDIC Call Reports

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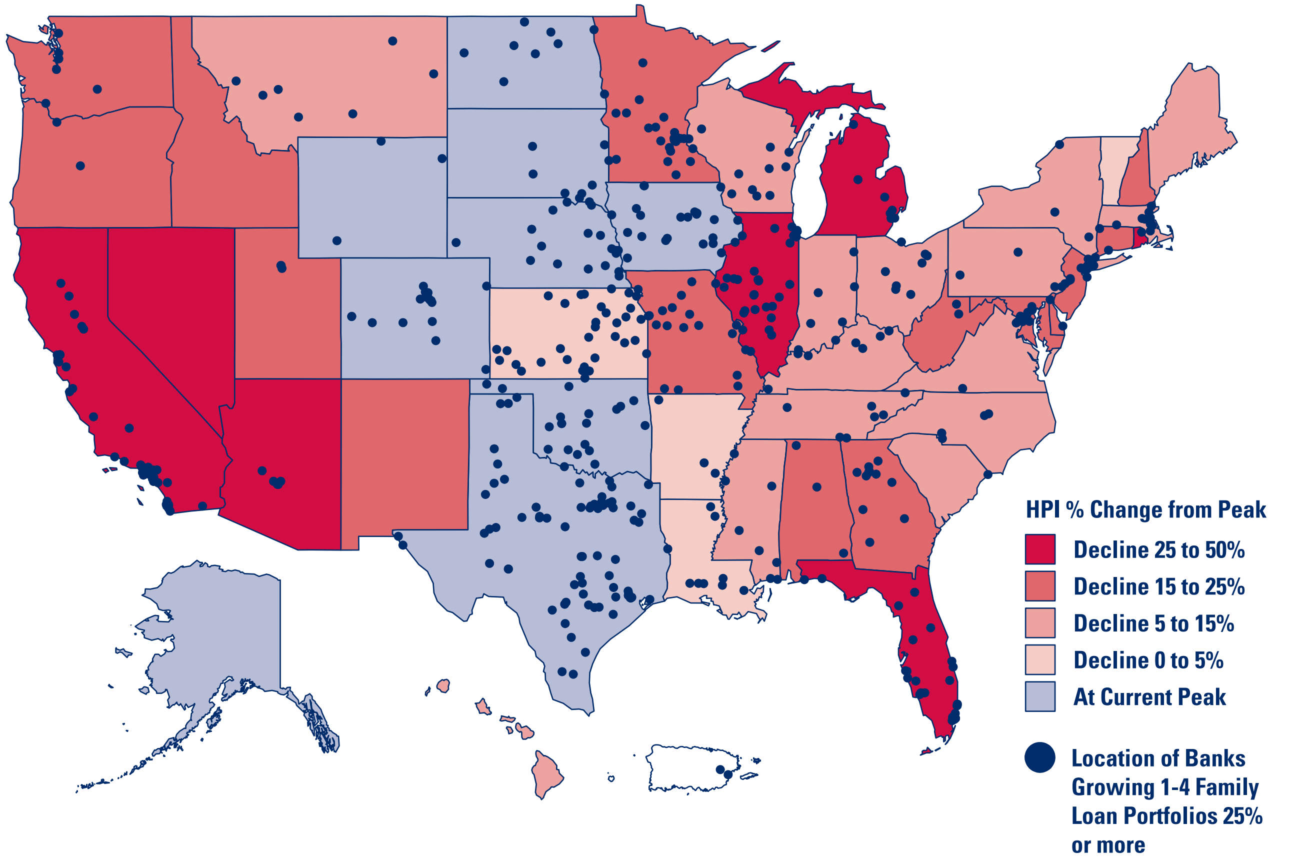
Map 3: Some Banks Increasing Residential Loans in Markets with a Housing Price Index Far From Peak



Source: CoreLogic June 2013 Home Price Index Report; FDIC Call Reports; De minimis = residential loans > 2% of assets.

in an overall increase in outstanding and unfunded loans.

Economic conditions tend to have the greatest impact on commercial- as well as consumer-related lending. Loan portfolios, particularly ADC portfolios, declined substantially at many banks from 2008 to 2010.[12] The second quarter of 2013 was the first quarter that ADC and unfunded commitments increased since first quarter 2008. This shift from contraction to expansion coincides with continued improvement in the Home Price Index (HPI) and commercial real estate sales as reported by CoreLogic.[13]

It is noteworthy that even in markets that were hardest hit by the crisis some banks are growing their loan portfolios. For example, in areas where the HPI remains well below peak, banks are increasing their residential loan portfolios. Map 3 (see page 24) shows where banks have grown resi-

[12] FDIC Call Reports.

dential real estate portfolios more than 25 percent during the twelve months ending June 30, 2013, in relation to the state's HPI peak.

The uptick in loan growth is also being driven in part by improvements in banks' financial condition. During the crisis, new loan originations often were placed on hold as lenders focused on problem loan workouts, or the bank's capital position could not support asset growth. However, as the number of problem institutions has declined from a high of 888 to a reported level of 553 as of June 30, 2013,[14] loan balances are increasing. As of June 30, 2013, earnings have improved with an aggregate annualized quarterly return on assets of 1.17 percent. Furthermore, aggregate past-due and nonaccrual rates have declined from a high of 7.37 percent in first quarter 2010 to 4.07 percent as of June 30, 2013. Annualized quarterly net loan growth was more than 4 percent as of June 30, 2013.[15]

The third critical factor influencing lending activity has been response to regulatory observations, such as examination findings, Uniform Financial Institutions Rating System ratings, and enforcement actions. As previously mentioned, the number of problem institutions continues to decline – a sign of overall improvement in the condition of insured depository institutions. Additionally, the number of banks operating under a formal enforcement action has declined from 599 as of June 30, 2011, to 428 as of June 30, 2013. Removal of these actions often removes asset growth limitations, a result of restrictive capital requirements, which enables banks to resume lending. Loan growth was reported by approximately 20 percent of banks operating under a formal enforcement action and by an estimated 63 percent of banks operating without a formal enforcement action.[16]

Conclusion

Recent Survey results indicate insured institutions are generally reducing credit risk profiles, especially in ADC, C&I, and Other CRE portfolios, as a greater number of institutions are tightening underwriting practices. In addition, a rebound in lending appears to have carried over from 2012 and into 2013. A majority of banks have experienced loan growth during

[13] CoreLogic collects and maintains a comprehensive property and financial services database that includes mortgage-backed securities, property tax data, MLS listings, and traditional and non-traditional credit information. The data are used to predict performance, identify opportunity, gauge trends, and detect risk.

[14] FDIC ***Quarterly Banking Profile***, Second Quarter 2013. https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2013-vol7-3/fdic-quarterly-vol7no3.pdf.

[15] Ibid.

[16] FDIC Call Reports.

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the twelve months ending June 2013, with more than 300 banks reporting growth in concentrated loan portfolios. Led by increased C&I lending, loan growth was generated in many markets across the country, including some institutions reporting growth in areas hardest hit by the financial crisis. The same factors - economic conditions, the financial health of institutions, and responses to regulatory observations - appear to have influenced changes in underwriting as well as overall lending activity at most institutions captured in the Survey.

Despite growing some traditionally higher-risk portfolios, such as ADC and associated unfunded commitments, bankers have reduced the use of higher-risk practices, such as funding projects on a speculative basis. Survey respondents report that bankers have grown concentrated portfolios without loosening underwriting or changing to a more liberal lending philosophy. However, as stated in the December 2006 Financial Institution Letter titled *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices,*[17] lenders are reminded to establish appropriate policies, procedures, and practices to manage the associated risk from concentrations in credit.

Through use of Survey results combined with other financial and economic data, the FDIC will continue to monitor the financial health of insured institutions as they shake off the recession's lingering effects and return to a more normalized environment.

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[17] Financial Institution Letter (FIL)-104-2006, "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices," December 12, 2006. http://www.fdic.gov/news/news/financial/2006/fil06104.html.

The New Basel III Definition of Capital: Understanding the Deductions for Investments in Unconsolidated Financial Institutions

On July 9, 2013, the FDIC Board of Directors approved the Basel III interim final rule (new capital rule or rule). The new capital rule, which takes effect for community banks in January 2015, is intended to strengthen the quality and increase the required level of regulatory capital in order to promote a more stable and resilient banking system.[1] This article is part of the FDIC's effort to provide technical assistance to community banks on the new capital rule. It focuses on a specific aspect of the rule that changes the treatment for certain capital investments that community banks may hold: the deductions from regulatory capital for investments in the capital instruments of unconsolidated financial institutions.

Background on Basel III

An important goal of the new capital rule is to strengthen the definition of regulatory capital to ensure it consists of elements that can absorb loss. Beginning with the Call Report dated March 31, 2015, community banks will report a new regulatory capital measure, common equity tier 1 (CET1), which is limited to capital elements of the highest quality. Some banks may have other capital elements such as noncumulative perpetual preferred stock; these, if any, may be recognized as "additional tier 1 capital," which when added to CET1 equals tier 1 capital. Finally, a bank's total regulatory capital may also include certain tier 2 elements (see Table 1).

Table 1 – Components of Regulatory Capital

Total capital	Tier 1 capital	Common Equity tier 1 capital (CET1)	Composed of common stock and surplus, retained earnings, accumulated other comprehensive income (unless an opt-out is chosen*) and qualifying minority interest
		Additional tier 1 capital	Noncumulative perpetual preferred stock and related surplus, and qualifying minority interest
		Tier 2 capital	Subordinated debt, qualifying minority interest, limited amounts of gains on available-for-sale equity securities, and the allowable portion of the allowance for loan and lease losses

*All banks, other than advanced approaches banks, are given a one-time irrevocable option to continue to treat certain accumulated other comprehensive income (AOCI) components as they are treated under the current general risk-based capital rules. The AOCI opt-out election must be made on the Call Report filed as of March 31, 2015.

[1] The rule, which is substantively identical to the rule issued by the Federal Reserve and the Office of the Comptroller of the Currency, is described in FIL-31-2013. Additional resources are available at http://www.fdic.gov/regulations/capital/index.html.

New Basel III Definition of Capital

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The new rule includes a series of adjustments and deductions to arrive at the final value of reported CET1 used to meet the regulatory capital requirements (see Table 2). Some adjustments and deductions are straightforward and longstanding, such as the deduction of goodwill. Others are conceptually straightforward but new. For example, certain types of deferred tax assets are automatically deducted, and all intangible assets are deducted except a limited amount of mortgage servicing assets. In addition, there are threshold deductions, which are new and not quite as straightforward. The remainder of this article will describe the threshold deductions and work through an extended example to demonstrate the deduction calculations.

The Call Report instructions will also be available to walk banks step by step through these calculations. It is expected that the once a bank has identified its investments that are subject to the threshold deductions (if any), the calculation of those deductions and applicable transitions will be performed within Call Report software. It should also be noted that the examples in this article involve relatively large capital deductions and a relatively large proportion of additional tier 1 capital within the example bank's tier 1 capital. The amounts in the examples are to help explain the calculations and are not viewed as representative of typical banks.

Table 2 – Regulatory Capital Deductions and Adjustments

Deduction or Adjustment	Common Items for Community Banks*
Regulatory Capital **Deductions** from CET1 capital	Goodwill
	Intangible assets (other than mortgage servicing assets (MSAs))
	Deferred Tax Assets (DTAs) that arise from Net Operating Losses and tax credit carryforwards
Regulatory **Adjustments** to CET1 capital	Unrealized Gains and Losses included in Accumulated Other Comprehensive Income (if the opt-out election is not chosen)
Threshold Deductions to CET1 capital	Non-significant investments in the capital of unconsolidated financial institutions exceeding 10% of the bank's CET1, after regulatory capital deductions and adjustments
	Items subject to the 10% and 15% CET1 capital deduction thresholds: DTAs arising from temporary differences that could not be realized through net operating loss carrybacks MSAs Significant investments in the capital of unconsolidated financial institutions in the form of common stock

* This chart does not include all the deductions or adjustments a community bank may be required to make and only includes a few of the more common deductions or adjustments for illustrative purposes. See 12 CFR § 324.22(a)-(d) for a complete list of items subject to deduction or adjustment.

Reasons for these threshold deductions

First and foremost, the purpose of the threshold deductions for investments in financial institutions is to limit the double counting of capital in the financial system. When banks invest in capital instruments of other financial institutions, problems at one institution can directly affect the financial health of other banks investing in its capital instruments. A good example is the losses some banks experienced on their investments in collateralized debt obligations (CDOs) of trust preferred securities of other banking organizations. This type of interdependence among banks can exacerbate a financial crisis.

A. What is the starting point for the threshold deductions?

If a bank has investments in the capital instruments of a financial institution, then these investments may be subject to the threshold deductions. The threshold deductions are made to CET1 *after* regulatory capital **deductions** and regulatory **adjustments** (see the first two panels of Table 2).

B. What is the definition of a financial institution?

If certain investments in financial institutions are to be deducted, the first question must be, for what types of financial institutions? The answer is in the definition of financial institution in the Basel III regulation, which determines whether any of a bank's capital investments may be subject to the threshold deductions. In brief, "financial institutions" include banks (including bankers' banks), bank holding companies, savings and loan holding companies, and other institutions cited in the definition. For purposes of the threshold deductions, financial institutions do not include government-sponsored enterprises (for example, Federal Home Loan Banks), small business investment companies, community development financial institutions, mutual funds, and employee benefit plans.

The definition also includes a *predominantly engaged* test as a catch-all for types of financial institutions not expressly listed. Investments in the capital instruments of such companies would also be subject to the threshold deduction. If a community bank owns more than 10 percent of a potential unconsolidated financial institution's common stock, the bank would have to apply this test.

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C. What is the amount of my investment?

Once a bank determines it has an investment in the capital instrument of an unconsolidated financial institution, it must determine the amount of the investment. A bank may have such an investment through either a direct, indirect, or synthetic exposure (see Table 3).

D. Is my investment *significant* or *non-significant?*

The bank needs to determine whether its investment is significant or non-significant as this directly affects the calculation of the deduction:

- A significant investment in the capital of an unconsolidated financial institution refers to all investments in the capital instruments of an unconsolidated financial institution where the bank owns more than 10 percent of the common stock of the unconsolidated financial institution. Note that when a bank determines it has a significant investment in the capital instruments of an unconsolidated financial institution, the bank's other investments in the capital instruments of that financial institution are also considered significant. For example, any qualifying subordinated debt or noncumulative perpetual preferred stock owned by the bank also would be considered a significant investment.
- A non-significant investment in the capital of an unconsolidated financial institution refers to all investments in the capital instruments of an unconsolidated financial institution where the bank owns 10 percent or less of the common stock of the unconsolidated financial institution (including situations in which the bank owns no common stock). For example, if a bank only owns noncumulative perpetual preferred stock in an unconsolidated financial institution, its investment is non-significant regardless of the amount of preferred stock owned.

Banks must evaluate investments in the capital instruments of <u>each</u> unconsolidated financial institution to which they are exposed to determine whether the exposure is significant or non-significant. Once this analysis is completed, the resulting significant and non-significant investments are aggregated into two separate buckets for purposes of the threshold deductions (i.e., the separate threshold deductions for significant and non-significant investments are computed based upon the aggregate exposure, not an individual exposure). The calculation of the threshold deductions differs for significant and non-significant investments and is described in greater detail in the next two sections of the article.

Table 3 – Exposures to investments in the capital instruments of an unconsolidated financial institution

Direct exposure	An exposure held directly by the bank (not through a fund or securitization). The amount is normally the balance sheet carrying value.
Indirect Exposure	An exposure held indirectly by the bank, such as through a fund.
Synthetic exposure	A synthetic exposure results from a bank's investment in an instrument where the value of such instrument is linked to the capital instrument of a financial institution. For example, a bank that owns a total return swap on a capital instrument of another bank would have a synthetic exposure.

E. The threshold deduction requirements for non-significant investments in unconsolidated financial institutions

The threshold deduction requirements for non-significant investments in unconsolidated financial institutions are described in § 324.22(c)(4) of the new capital rule. First, the bank aggregates all of its non-significant investments in the capital of unconsolidated financial institutions. Second, the bank must determine its 10 percent threshold amount. The threshold is 10 percent of the bank's adjusted CETI capital (conceptually, the adjusted CET1 is computed by completing Table 1 and adjusting according to the first two panels of Table 2). Any aggregate amount of non-significant investments above this threshold is deducted according to the corresponding deduction approach (see Box 1). Amounts below the threshold are not deducted and are risk weighted in accordance with the new standardized approach (see Part 324 Subpart D of the new capital rule). For example:

- Bank A has adjusted CET1 of $1,050 and a total of $500 in noncumulative perpetual stock issued and outstanding.
- Bank A's threshold for non-significant investments in the capital of unconsolidated financial institutions is 10% of its adjusted CET1, or $105.
- Bank A has a total of $200 in non-significant investments in the capital of unconsolidated financial institutions consisting of $100 in common stock and $100 in noncumulative perpetual preferred stocks.

Box 1 – Corresponding Deduction Approach

Some deductions resulting from a bank's significant and non-significant investments must be made according to the corresponding deduction approach. Under this approach, the threshold deductions must be made from the tier of capital for which the instrument qualifies:

If a bank investment is in an instrument that qualifies as:	Any required deductions would be:
Tier 2 capital	Deducted from tier 2 capital
Additional tier 1 capital	Deducted from Additional tier 1 capital
CET1 capital	Deducted from CET1 capital

Furthermore, if a tier of capital is not sufficient to absorb the deduction, the shortfall is deducted from the next, more subordinated (higher quality) tier of capital. For example:

- Bank XYZ has $100 of issued and outstanding common stock (CET1) and $20 of issued and outstanding noncumulative perpetual preferred stock (additional tier 1 capital)
- Bank XYZ's aggregate non-significant investment in the capital of unconsolidated financial institutions exceeds its threshold by $25 and the investments consist solely of noncumulative perpetual preferred stock (an additional tier 1 capital component). Therefore, Bank XYZ must deduct 100% of its excess investment from its additional tier 1 capital. However, Bank XYZ's additional tier 1 capital only totals $20.
- Per the corresponding deduction approach, Bank XYZ deducts $20 from its additional tier 1 capital (completely deducting this tier of capital) and the remaining $5 from its CET1.

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- Therefore, Bank A must deduct $95 of its aggregate non-significant investment in the capital of unconsolidated financial institutions. This is reflected in line 4 of Table 4.
- Now the bank must follow the corresponding deduction approach to determine how to deduct its excess non-significant investment in unconsolidated financial institutions. Since Bank A's investments included $100 in common stock (a CET1 capital component) and $100 in noncumulative perpetual preferred stock (an additional tier 1 capital component), 50% of the excess non-significant investment in the capital of unconsolidated financial institutions is deducted from CET1 and 50% is deducted from additional tier 1 capital. This is reflected in lines 5 and 6 of Table 4.
- If Bank A did not have any qualifying additional tier 1 capital instruments on its books, it would have deducted the entire excess non-significant investment in the capital of unconsolidated financial institutions from its CET1 (refer to Box 1).

F. The threshold deduction requirements for significant investments in the form of common stock

The deduction for significant investments in common stock of an unconsolidated financial institution is governed by the 10 percent and 15 percent CET1 threshold deductions. These threshold deductions are applied individually and collectively to the following three categories:

- Significant investments in common stock of unconsolidated financial institutions;
- Mortgage servicing assets; and
- Deferred tax assets that arise from temporary timing differences not subject to carryback.

The 10% and 15% thresholds are applied to CET1 capital after making deductions for non-significant investments in the capital of an unconsolidated institution. These threshold deductions are calculated in two

Table 4 - Calculation to determine the deduction for non-significant investments in the capital of an unconsolidated financial institution

Adjusted CET1 (before threshold deductions)	$1050
10% Threshold for Non-significant Investments ($1050 * 10%)	$105
Total amount of non-significant investments in unconsolidated financial institutions	$200
Amount over threshold to be deducted ($200 – $105)	$95
Amount to be deducted from CET1 ($95 * 50%)	$47.50
Amount to be deducted from Additional tier 1 ($95 * 50%)	$47.50
New CET1 ($1050 - $47.50)	$1002.50
New Additional tier 1 ($500 – 47.50)	$452.50

phases. First, the 10 percent threshold deduction is applied on an individual category basis – any amount of the three categories greater than the 10 percent threshold is deducted from CET1 capital. Second, the remaining amount attributed to the three categories is limited, in aggregate, to 15 percent of CET1 capital. Any amount above this threshold is also deducted from CET1 capital. The amounts not deducted in these three categories are risk weighted at 250 percent. Note that due to the transition periods, the calculation of the deduction changes slightly before and after 2018. See Table 5 (page 34) for an example:

- Continuing from the previous example, Bank A has CET1 capital of $1002.50 after adjustments, deductions and the threshold deduction for non-significant investments in the capital of an unconsolidated financial institution.
- Bank A has the following amounts in items subject to the 10 percent and 15 percent CET1 threshold deductions:
  - $150 in significant investments in the common stock of unconsolidated financial institutions
  - $50 in mortgage servicing assets
  - $75 in deferred tax assets that arise from temporary timing differences not subject to carry-back

As noted previously, the 10 percent and 15 percent CET1 threshold deductions occur in two parts. The individual 10 percent threshold is applied first and the aggregate 15 percent threshold is applied second. The new capital rule includes a transition period for the threshold deductions to allow banks time to manage the impact to their regulatory capital position. To make the example more useful and demonstrate the impact of the transition periods, the threshold deductions are calculated below assuming two different time periods.

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Table 5 - 2016 Example (includes a 60% phase-in)

Step 1: Application of the individual 10% CET1 threshold deduction

10% CET1 threshold ($1002.50 * 10%)	$100.25
Amount over threshold to be deducted:	
Significant investments in the common stock of unconsolidated financial institutions ($150 - $100.25)	$49.75
Mortgage servicing assets ($50 - $100.25)	$0*
Deferred tax assets that arise from temporary timing differences not subject to carry-back ($75 - $100.25)	$0*
Application of the 60% phase-in	
Significant investments in the common stock of unconsolidated financial institutions ($49.75 * 60%)	$29.85
Mortgage servicing assets ($0 * 60%)	$0
Deferred tax assets that arise from temporary timing differences not subject to carry-back ($0 * 60%)	$0
Sum of deductions from CET1 capital due to the 10% threshold after phase-in ($29.85 + $0 + $0)	$29.85

* Enter 0 if the calculation results in a negative number.

Step 2: Application of the aggregate 15% CET1 threshold deduction

15% CET1 threshold ($1002.50 * 15%)	$150.38
Remaining items not deducted due to 10% CET1 threshold	
Significant investments in the common stock of unconsolidated financial institutions ($150 - $29.85)	$120.15
Mortgage servicing assets (no deduction due to 10% threshold so entire amount is subject to 15% CET1 threshold)	$50
Deferred tax assets that arise from temporary timing differences not subject to carry-back (no deduction due to 10% threshold so entire amount is subject to 15% CET1 threshold)	$75
Subtotal ($120.15 + $50 + $75)	$245.15
Amount over threshold to be deducted ($245.15 - $150.38)	$94.77
Deductions from CET1 capital due to the 15% threshold after phase-in ($94.77 * 60%)	$56.86
Total deductions due to 10% and 15% CET1 thresholds ($29.85 + $56.86)	$86.71
Common equity after threshold deductions ($1002.50 – $86.71)	**$915.79**

As demonstrated in the prior example, the transition period provided in the new capital rule mitigates the impact of the threshold deductions. See below for the impact to the threshold deductions once fully phased in (as of 2018):

Application of the 10 percent threshold: The calculation of the 10 percent threshold is consistent during and after the transition period. Once the threshold deductions are fully phased in, the amount to be deducted is no longer adjusted; therefore, in this example, the amount to be deducted due to the 10 percent threshold is $49.75.

Application of the 15 percent threshold: The calculation of the 15 percent threshold changes slightly once the deductions are fully phased in. The new capital rule requires that the aggregate sum of these items that are not deducted cannot exceed 15 percent of the CET1 capital of a bank. To effect this requirement, the 15 percent threshold is calculated as CET1 minus the sum of the three items before any deductions, with the result multiplied by 17.65 percent. Multiplying by 17.65 percent ensures that the ending amount of the items subject to deduction do not exceed 15 percent of ending CET1. See Table 6 below for an example:

Table 6 - 2018 Example (fully phased in thresholds)

Step 1: Application of the individual 10% CET1 threshold deduction			
CET1 deduction due to 10% threshold	The calculation of the 10% threshold is unchanged from 2016. As noted above, the full amount of the deduction is taken in 2018.	$49.75	
Step 2: Application of the aggregate 15% CET1 threshold deduction			
Calculation of 15% CET1 threshold	CET1 base	$1002.50	
	Sum of the items before any deductions:		
	Significant investments in the common stock of unconsolidated financial institutions		$150
	Mortgage servicing assets (no deduction due to 10% threshold so entire amount is subject to 15% CET1 threshold)		$50
	Deferred tax assets that arise from temporary timing differences not subject to carryback (no deduction due to 10% threshold so entire amount is subject to 15% CET1 threshold)		$75
	Subtotal ($150 + $50 + $75)	$275	
	Ratio of 15% / 85%	17.65%	
	15% threshold: ($1002.50 - $275) * 17.65%	$128.40	
CET1 deduction due to 15% threshold	Remaining items not deducted due to 10% CET1 threshold ($275 – $49.75)	$225.25	
	CET1 Deduction: ($225.25 - $128.40)	$96.85	
Ending CET1: ($1002.50 - $49.75 – 96.85)		$855.90[2]	

[2] In this example, the amount of the items not deducted as a result of the 10% and 15% thresholds is $128.40, calculated as ($150 + $50 + 75) – ($49.75 + $96.85). Using 17.65% to calculate the 15% threshold, ensures that the amounts not deducted do not comprise more than 15% of ending CET1. ($128.40 / $855.90 = 15%).

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See Table 7 for a comparison of the deductions under these two time periods:

Table 7 - Comparison of 10% and 15% CET1 threshold deduction before and after phase-in

	2016, 60% phase-in	2018, fully phased-in
10% CET1 threshold	$100.25	$100.25
Sum of deductions from CET1 capital due to the 10% threshold	$29.85	$49.75
15% CET1 threshold	$150.38	$128.40
Deductions from CET1 capital due to the 15% threshold	$56.86	$96.85
Ending CET1	$915.79	$855.90

G. Significant investments in the capital of unconsolidated financial institutions that are not in the form of common stock

As discussed previously, if a bank determines it has a significant investment in the capital instruments of an unconsolidated financial institution (i.e., the bank owns 10 percent or more of the financial institution's common stock), all other investments in the capital instruments of that unconsolidated financial institution are considered significant. These investments are fully deducted using the corresponding deduction approach; see Table 8, continuing from our previous example:

Table 8 - Bank A's capital structure in 2018

Ending CET1	$855.90
Additional tier 1 capital after the threshold deductions for non-significant investments in unconsolidated financial institutions	$452.50
Tier 2 capital	$80

Suppose that in addition to the $150 in significant investments in the common stock of unconsolidated financial institutions, Bank A also has exposure of $100 in qualifying subordinated debt (tier 2 capital) to these same unconsolidated financial institutions. The $100 in subordinated debt would also be considered a *significant investment* as these are the capital instruments of unconsolidated financial institutions in which Bank A owns 10 percent or more of the financial institution's common stock. Bank A would therefore deduct its entire exposure to the subordinated debt per the corresponding deduction approach:

- Bank A's tier 2 capital, after deduction: $0, calculated as $80 - $100
- Bank A's additional tier 1 capital, after deduction: $432.50, calculated as $452.50 - $20 (as Bank A's tier 2 capital has been completely deducted, the remaining $20 is deducted from additional tier 1 capital)

H. Summary of the impact of the threshold deductions on Bank A's capital structure

Table 9 shows the impact on Bank A's capital structure due to the threshold deductions (assuming the threshold deductions are made in the year 2018).

I. A bank will need to risk weight remaining amounts of capital instruments that are not deducted

The remaining amount of an item after making all required deductions is then risk weighted. Below is a summary of the risk weights to be applied to the items limited by the deductions described in this article (see Table 10):

Table 9 - Summary of the impact of the threshold deductions on Bank A's capital structure

Tier of Capital	Beginning Amount*	Deductions for Non-significant investments	Deductions for Significant investments	Ending Amount
CET1	$1050	47.50	($49.75 + $96.85)	$855.90
Additional tier 1 capital	$500	47.50	$20	$432.50
Tier 2 capital	$80	0	$80	$0

*After regulatory adjustments and deductions (see Table 2).

Table 10 – Summary of common risk weights for investments in the capital instruments of unconsolidated financial institutions limited by the threshold deductions

Risk weights that apply to the remaining amounts of significant investments in the capital instruments of unconsolidated financial institutions, MSAs and DTAs not deducted	100% (2015 to 2017) 250% (2018 onwards)
Risk weights that apply to remaining amounts of investments in financial institutions in the form of publicly traded equities	300%
Risk weights that apply to remaining amounts of investments in financial institutions in the form of non-publicly traded equities	400%
Trust Preferred Securities CDOs should be risk weighted using the securitization framework (sections 41 through 43 of the new capital rule), meaning	• Gross-up • Simple Supervisory Formula Approach (SSFA) • 1,250%

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Capital relief for a limited amount of non-significant equity exposures

The new capital rule applies significantly higher risk weights to equity exposures in general. To provide some relief from these higher risk weights, the new capital rule includes a 10 percent non-significant equity exposure threshold, *which is separate and distinct from the previously described thresholds*. This 10 percent threshold is calculated as 10 percent of the institution's total capital. Certain equities that fall within this threshold can be risk weighted at 100 percent; however, this 10 percent bucket must be filled in the following order:

- Equity exposures to unconsolidated small business investment companies described in Section 302 of the *Small Business Investment Act*
- Publicly traded equity exposures (including those held indirectly through investment funds)
- Non-publicly traded equity exposures (including those held indirectly through investment funds)

Once this 10 percent bucket is filled, the other risk weights shown above would apply.

J. Transition Rules

Although the new capital rule takes effect January 1, 2015, for community banks, various aspects of the rule, such as the deductions for capital instruments in unconsolidated financial institutions, have a phase-in period, as illustrated above. Banks should consult the Transitions section of the new capital rule (§ 324.300) for full details.

K. Resources available to help guide the bank through these deduction requirements

Resources are available to guide banks through the deduction requirements, including the deductions related to investments in the capital instruments of unconsolidated financial institutions. For example, the preamble of the new capital rule includes a flow chart and the proposed call report instructions available on the Federal Financial Institutions Examination Council's (FFIEC) Web site helps banks navigate the deduction requirements and the calculation of each tier of capital, including the transition arrangements. The FDIC Regulatory Capital website (http://www.fdic.gov/regulations/capital/index.html) includes presentations describing key aspects of the new capital rule, the Interagency Community Bank Guide, the Expanded Community Bank Guide for FDIC-supervised banks and a listing of contacts who can help to answer questions. Through these resources and outreach efforts such as this article, the goal is that banks will be able to understand this admittedly complex aspect of the new capital rule.

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Overview of Selected Regulations and Supervisory Guidance

This section provides an overview of recently released regulations and supervisory guidance, arranged in reverse chronological order. Press Release (PR) and Financial Institution Letter (FIL) designations are included so the reader can obtain more information.

ACRONYMS and DEFINITIONS	
CFPB	Consumer Financial Protection Bureau
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FRB	Federal Reserve Board
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
Federal bank regulatory agencies	FDIC, FRB, and OCC
Federal financial institution regulatory agencies	CFPB, FDIC, FRB, NCUA, and OCC

Subject	Summary
FDIC Issues Final Guidance Regarding Deposit Advance Products (PR-105-2013, November 21, 2013)	The FDIC issued final supervisory guidance to FDIC-supervised financial institutions that offer, or may consider offering, deposit advance products. The guidance is intended to ensure banks are aware of the credit, reputational, operational, and compliance risks associated with deposit advance products and have taken steps to effectively mitigate these risks. This issuance supplements the FDIC's existing guidance on payday loans and subprime lending, as well as the FDIC's guidelines on small-dollar loans. See http://www.fdic.gov/news/news/press/2013/pr13105.html.
FDIC Releases Regulatory Capital Estimation Tool for Community Banks (FIL-54-2013, November 20, 2013; PR-102-2013, November 19, 2013)	The FDIC made available a regulatory capital estimation tool to help community banks evaluate the potential impact of the recently published interim final capital rule on their capital ratios. Banks can access the regulatory estimation tool. The tool provides a general estimate of a bank's leverage and risk-based capital ratios under the interim final capital rule, though it may not precisely reflect actual capital ratios under the framework. The tool is not a substitute for a bank's analysis of the impact of the rule on its financial operations for regulatory reporting and capital-planning purposes. See http://www.fdic.gov/news/inactive-financial-institution-letters/2013/fil13054.html.
Agencies Release Final Revisions to Interagency Questions and Answers Regarding Community Reinvestment (PR-101-2013, November 15, 2013; Federal Register, Vol. 78, No. 224, p. 69671, November 20, 2013)	The federal bank regulatory agencies published final revisions to *Interagency Questions and Answers Regarding Community Reinvestment.* The Questions and Answers document provides additional guidance to financial institutions and the public on the agencies' CRA regulations. The revisions focus primarily on community development. See http://www.fdic.gov/news/news/press/2013/pr13101.html.

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Subject	Summary
Interagency Supervisory Guidance on Troubled Debt Restructurings (FIL-50-2013, October 24, 2013)	The federal bank regulatory agencies and the NCUA jointly issued supervisory guidance clarifying certain issues related to the accounting treatment and regulatory classification of commercial and residential real estate loans that have undergone troubled debt restructurings (TDRs). The agencies' guidance reiterates key aspects of previously issued guidance and discusses the definition of a collateral-dependent loan and the classification and charge-off treatment for impaired loans, including TDRs. See http://www.fdic.gov/news/news/financial/2013/fil13050.html.
FDIC Signs Memorandum of Understanding With the People's Bank of China (PR-93-2013, October 24, 2013)	The FDIC announced the signing of a Memorandum of Understanding (MOU) between the agency and the People's Bank of China designed to extend their effective international working relationship in the areas of deposit insurance and resolution. The agreement updates an existing MOU signed on August 2, 2007. See http://www.fdic.gov/news/news/press/2013/pr13093.html.
Federal Financial Regulators Propose Joint Standards for Assessing Diversity Policies and Practices of Regulated Entities (PR-92-2013, October 23, 2013; Federal Register, Vol. 78, No. 207, p. 64052, October 25, 2013)	The federal financial institution regulatory agencies and the U.S. Securities and Exchange Commission (SEC) issued a notice of proposed interagency standards for assessing the diversity policies and practices of the entities they regulate. Each of the agencies houses an Office of Minority and Women Inclusion (OMWI). Under Section 342 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act), each OMWI is required to develop standards for assessing diversity policies and practices in the regulated entities. The proposed standards are intended to promote transparency and awareness of diversity policies and practices within the institutions. Comments are due by December 24, 2013. See http://www.fdic.gov/news/news/press/2013/pr13092.html.
Federal Regulators Provide Guidance on Qualified Mortgage Fair Lending Risks (PR-91-2013, October 22, 2013)	The federal financial institution regulatory agencies issued a statement to address industry questions about fair lending risks associated with offering only Qualified Mortgages. The CFPB's Ability-to-Repay Rule implements provisions of the Dodd-Frank Act that require creditors to make a reasonable, good faith determination that a consumer has the ability to repay a mortgage loan before extending credit to the consumer. Lenders are presumed to have complied with the rule if they issue Qualified Mortgages, which must satisfy requirements that prohibit or limit risky features that harmed consumers in the recent crisis. For the reasons described in the statement, the five agencies do not anticipate that a creditor's decision to offer only Qualified Mortgages would, absent other factors, elevate a supervised institution's fair lending risk. See http://www.fdic.gov/news/news/press/2013/pr13091.html.
Annual Stress-Test Reporting Template and Documentation for Covered Banks with Total Consolidated Assets of $10 Billion to $50 Billion (FIL-49-2013, October 21, 2013)	The FDIC issued a notice to describe the reports and information required to meet the reporting requirements under Section 165(i)(2) of the Dodd-Frank Act for covered banks with total consolidated assets between $10 billion and $50 billion. The data collected through these templates will be used to assess the reasonableness of the covered bank's stress-test results and provide forward-looking information to the FDIC regarding a covered bank's capital adequacy. See https://www.fdic.gov/news/inactive-financial-institution-letters/2013/fil13049.html.

Subject	Summary
FDIC Releases Economic Scenarios for 2014 Stress Testing (PR-100-2013, November 12, 2013)	The FDIC released the economic scenarios that will be used by certain financial institutions with total consolidated assets of more than $10 billion for stress tests required under the Dodd-Frank Act. The economic scenarios include baseline, adverse, and severely adverse scenarios with variables that reflect economic activity, unemployment, exchange rates, prices, income, interest rates, and other salient aspects of the economy and financial markets. The FDIC coordinated with the FRB and OCC in developing and distributing these scenarios. See http://www.fdic.gov/news/news/press/2013/pr13100.html.
FDIC Issues Proposed Rule to Restrict Sales of Assets of a Covered Financial Company by the FDIC (Federal Register, Vol. 78, No. 215, p. 66661, November 6, 2013)	The FDIC proposed a rule to implement Section 210(r) of the Dodd-Frank Act. Under this section, individuals or entities that have, or may have, contributed to the failure of a "covered financial company" cannot buy a covered financial company's assets from the FDIC. The proposed rule establishes a self-certification process that is a prerequisite to the purchase of such assets from the FDIC. See http://www.gpo.gov/fdsys/pkg/FR-2013-11-06/pdf/2013-26544.pdf.
FDIC, Bank of England, German Federal Financial Supervisory Authority and Swiss Financial Market Supervisory Authority Call for Uniform Derivatives Contracts Language (PR-99-2013, November 5, 2013)	The FDIC, together with the Bank of England, the German Federal Financial Supervisory Authority, and the Swiss Financial Market Supervisory Authority, authored a joint letter to encourage the International Swaps and Derivatives Association, Inc. to adopt language in derivatives contracts to delay the early termination of those instruments in the event of the resolution of a global systemically important financial institution. See http://www.fdic.gov/news/news/press/2013/pr13099.html.
FDIC Hosts Community Affairs Webinar: Lending in Native Communities: From Opportunity to Success (FIL-53-2013, November 1, 2013)	The FDIC hosted a webinar titled *Lending in Native Communities: From Opportunity to Success* on November 22, 2013. The webinar included examples of successful bank efforts to expand economic inclusion and lending in Native American, Alaska Native, and Hawaiian American communities. This was the fifth in a series of webinars highlighting strategies institutions can use to promote community development and expand access to the banking system. See http://www.fdic.gov/news/inactive-financial-institution-letters/2013/fil13053.html.
Agencies Request Comment on Proposed Liquidity Coverage Ratio (FIL-52-2013, October 30, 2013; PR-96-2013, October 30, 2013)	The federal bank regulatory agencies requested comment on a proposed rule that would implement a quantitative liquidity requirement consistent with the liquidity coverage ratio established by the Basel Committee on Banking Supervision. The requirement is designed to promote the short-term resilience of the liquidity risk profile of international banking organizations and encourage improvements in the measurement and management of liquidity risk. Comments are due by January 31, 2014. See http://www.fdic.gov/news/inactive-financial-institution-letters/2013/fil13052.html.
Uniform Agreement on the Classification and Appraisal of Securities Held by Financial Institutions (FIL-51-2013, October 29, 2013)	The federal bank regulatory agencies issued a joint statement to update and revise the 2004 Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts. The statement reiterates the importance of a robust investment analysis process and the agencies' longstanding asset classification definitions. It also addresses Section 939A of the Dodd-Frank Act, which directs the agencies to remove any reference to or requirement of reliance on credit ratings in the regulations and replace them with appropriate standards of creditworthiness. See http://www.fdic.gov/news/news/financial/2013/fil13051.html.

Regulatory and Supervisory Roundup

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Subject	Summary
Joint Notice of Proposed Rulemaking on Loans in Areas Having Special Flood Hazards (FIL-48-2013, October 21, 2013; PR-90-2013, October 11, 2013; Federal Register, Vol. 78, No. 210, p. 65108, October 30, 2013)	The federal bank regulatory agencies, the NCUA, and the Farm Credit Administration issued a joint notice of proposed rulemaking to amend their respective regulations regarding loans in special flood hazard areas. The proposed rule would implement certain provisions of the *Biggert-Waters Flood Insurance Reform Act of 2012* regarding acceptance of private flood insurance, escrowing flood insurance payments, and force-placement of flood insurance. The proposal also would harmonize FDIC flood insurance regulations with the former Office of Thrift Supervision regulations for state savings associations. See https://www.fdic.gov/news/inactive-financial-institution-letters/2013/fil13048.html.
Director and Officer Liability Insurance Policies, Exclusions, and Indemnification for Civil Money Penalties (FIL-47-2013, October 10, 2013)	The FDIC issued an advisory statement on director and officer (D&O) liability insurance policies. In recent years, the agency has noted an increase in exclusionary terms or provisions in D&O policies that may limit insurance coverage, thereby increasing the potential personal exposure of board members and bank officers in civil lawsuits. This advisory statement discusses the importance of thoroughly reviewing and understanding the risks associated with such coverage exclusions and includes a reminder that insured depository institutions and holding companies may not purchase insurance policies that would indemnify institution-affiliated parties for civil money penalties. See http://www.fdic.gov/news/news/financial/2013/fil13047.html.
Managing Sensitivity to Market Risk in a Challenging Interest Rate Environment (FIL-46-2013, October 8, 2013)	The FDIC issued a financial institution letter re-emphasizing the importance of prudent interest rate risk oversight and risk management processes to ensure institutions are prepared for a period of rising interest rates. Interest rate risk management should be viewed as an ongoing process that requires effective measurement and monitoring, clear communication of modeling results, conformance with policy limits, and appropriate steps to mitigate risk. See http://www.fdic.gov/news/news/financial/2013/fil13046.html.
Agencies Release Public Sections of the Second Submission of Resolution Plans for Eleven Institutions (PR-86-2013, October 3, 2013)	The FDIC and FRB released the public sections of the second submission of resolution plans for eleven firms. The Dodd-Frank Act requires that bank holding companies with total consolidated assets of $50 billion or more and nonbank financial companies designated by the Financial Stability Oversight Council submit resolution plans to the FDIC and FRB. Firms that filed initial resolution plans in 2012 (generally those with U.S. nonbank assets greater than $250 billion) were required to submit revised resolution plans by October 1, 2013. Those firms include Bank of America Corporation, Bank of New York Mellon Corporation, Barclays PLC, Citigroup Inc., Credit Suisse Group AG, Deutsche Bank AG, Goldman Sachs Group, Inc., JPMorgan Chase & Co., Morgan Stanley, State Street Corporation, and UBS AG. See http://www.fdic.gov/news/news/press/2013/pr13086.html.
FDIC Supervisory Approach to Payment Processing Relationships With Merchant Customers That Engage in Higher-Risk Activities (FIL-43-2013, September 26, 2013)	The FDIC clarified its policy and supervisory approach related to facilitating payment processing services directly or indirectly for merchant customers engaged in higher-risk activities. Such financial institutions are expected to perform proper risk assessments, conduct due diligence to determine if merchant customers are operating in accordance with applicable law, and maintain systems to monitor relationships over time. Financial institutions that have appropriate systems and controls will not be criticized for providing payment processing services to businesses operating in compliance with applicable law. See http://www.fdic.gov/news/news/financial/2013/fil13043.html.

Subject	Summary
Proposed Regulatory Capital Reporting Changes (FIL-42-2013, September 26, 2013; FIL-41-2013, September 24, 2013)	The federal bank regulatory agencies requested comment on proposed revisions to the regulatory capital components and ratios portion of Schedule RC-R, Regulatory Capital, of the Consolidated Reports of Condition and Income (Call Report). The agencies also have proposed to revise the FFIEC 101, Risk-Based Capital Reporting for Institutions Subject to the Advanced Capital Adequacy Framework, which is completed by advanced approaches institutions. The proposed revisions are consistent with the revised regulatory capital rules approved by the banking agencies in July 2013. Comments were due by October 11, 2013. See https://www.fdic.gov/news/inactive-financial-institution-letters/2013/fil13042.html.
Federal Regulators Issue Guidance on Reporting Financial Abuse of Older Adults (PR-84-2013, September 24, 2013)	The federal financial institution regulatory agencies, Federal Trade Commission, and the SEC issued guidance to clarify that the privacy provisions of the *Gramm-Leach-Bliley Act* generally permit financial institutions to report suspected elder financial abuse to appropriate authorities. See http://www.fdic.gov/news/news/press/2013/pr13084.html.
FDIC Advisory Committee to Discuss Initiatives to Expand Access to Banking Services (Federal Register, Vol. 78, No. 185, p. 58537, September 24, 2013)	The FDIC Advisory Committee on Economic Inclusion met on October 9, 2013, to discuss the FDIC's economic inclusion priorities. The meeting featured a discussion on expanding access to Safe Accounts (checkless, card-based electronic accounts that allow only automated withdrawals), financial education strategies, steps to support household savings, mobile financial services, and the FDIC's economic inclusion research projects. See http://www.gpo.gov/fdsys/pkg/FR-2013-09-24/pdf/2013-23140.pdf.
FDIC Approves Final Rule on the Definition of "Insured Deposit" at Foreign Branches of U.S. Banks (FIL-40-2013, September 19, 2013; PR-81-2013, September 10, 2013; Federal Register, Vol. 78, No. 178, p. 56583, September 13, 2013)	The FDIC approved a Final Rule clarifying that deposits in foreign branches of U.S. banks are not eligible for deposit insurance, although they may qualify as deposits for the purpose of national depositor preference. See http://www.fdic.gov/news/news/financial/2013/fil13040.html.
Agencies Provide Model Template for Submission of Tailored Resolution Plans (PR-78-2013, September 3, 2013)	The FRB and FDIC released an optional model template for tailored resolution plans that certain firms will submit in December 2013. The Dodd-Frank Act requires bank holding companies with total consolidated assets of $50 billion or more and nonbank financial companies designated for enhanced prudential supervision by the Financial Stability Oversight Council to submit resolution plans. See http://www.fdic.gov/news/news/press/2013/pr13078.html.
Agencies Request Comment on Proposed Risk Retention Rule (PR-74-2013, August 28, 2013; Federal Register, Vol. 78, No. 183, p. 57928, September 20, 2013)	The federal bank regulatory agencies, Department of Housing and Urban Development, Federal Housing Finance Agency (FHFA), and the SEC issued a joint notice revising a proposed rule requiring sponsors of securitization transactions to retain risk in those transactions. The new proposal revises the proposed rule the agencies issued in 2011 to implement the risk retention requirement in the Dodd-Frank Act. The new proposal includes basing risk retention on fair value measurements without a premium recapture and defining "qualified residential mortgages" to have the same meaning as "qualified mortgages" as defined by the CFPB. Comments were due by October 30, 2013. See http://www.fdic.gov/news/news/press/2013/pr13074.html.

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Subject	Summary
FDIC Hosts Community Affairs Webinar: **How to Effectively Utilize and Implement Financial Education Programs (FIL-38-2013, August 15, 2013)**	The FDIC hosted a webinar titled *How To Effectively Utilize and Implement Financial Education Programs* on September 10, 2013. Staff discussed opportunities, best practices, and strategies for implementing consumer financial education programs. See https://www.fdic.gov/news/inactive-financial-institution-letters/2013/fil13038.html.
Proposed Interagency Guidance on Company-Run Stress Tests (FIL-37-2013, August 9, 2013; PR-67-2013, July 30, 2013; Federal Register, Vol. 78, No. 150, p. 47217, August 5, 2013)	The federal bank regulatory agencies issued proposed interagency stress-testing guidance outlining principles for implementation of stress tests as mandated by Section 165(i)(2) of the Dodd-Frank Act. The guidance is applicable to all FDIC-supervised banks and savings associations with at least $10 billion but less than $50 billion in total consolidated assets. See https://www.fdic.gov/news/inactive-financial-institution-letters/2013/fil13037.html.
FDIC Releases Technical Assistance Video on Interest Rate Risk (PR-70-2013, August 6, 2013)	The FDIC released the third installment in its series of technical assistance videos to provide useful information to bank directors, officers, and employees on areas of supervisory focus. This video addresses key elements of a bank's interest rate risk framework and includes a discussion of the types of interest rate risk, measurement systems, assumptions used in interest rate risk models, and risk limits and mitigation. See http://www.fdic.gov/news/news/press/2013/pr13070.html.
Teleconference for Community Banks on the Interim Final Capital Rule (FIL-36-2013, August 1, 2013)	The FDIC held a free teleconference on August 15, 2013, to discuss the recently issued interim final capital rule. Officers and employees of FDIC-supervised institutions were invited to participate. Topics addressed issues community bankers have raised about the rule. See https://www.fdic.gov/news/inactive-financial-institution-letters/2013/fil13036.html.
Agencies Encourage Financial Institutions to Work with Student Loan Borrowers Experiencing Financial Difficulties (FIL-35-2013, August 1, 2013; PR-65-2013, July 25, 2013)	The federal bank regulatory agencies issued a statement encouraging financial institutions to work constructively with private student loan borrowers experiencing financial difficulties. The *Uniform Retail Credit Classification and Account Management Policy,* which covers student loans, permits prudent loan workout and modification programs that assist student loan borrowers who are temporarily experiencing financial difficulties. Financial institutions should provide clear and practical information to student loan borrowers on loan modifications and other options available and how to contact the lender or servicer to discuss the programs that might best fit their specific needs. See http://www.fdic.gov/news/news/financial/2013/fil13035.html.
Agencies Issue Proposed Rule to Exempt Subset of Higher-Priced Mortgage Loans from Appraisal Requirements (PR-62-2013, July 10, 2013)	The federal financial institution regulatory agencies and the FHFA issued a proposed rule that would create exemptions from certain appraisal requirements for a subset of "higher-priced mortgage loans." These agencies previously had issued a final rule establishing new appraisal requirements for "higher-priced mortgage loans" in January 2013. Comments were due by September 9, 2013. See http://www.fdic.gov/news/news/press/2013/pr13062.html.

Subject	Summary
Federal Bank Regulatory Agencies Issue Proposed Rule on Supplementary Leverage Ratio (FIL-33-2013, July 9, 2013; PR-61-2013, July 9, 2013; Federal Register, Vol. 78, No. 161, p. 51101, August 20, 2013)	The federal bank regulatory agencies issued a joint notice of proposed rulemaking (NPR) to strengthen the leverage requirements applicable to the largest, most systemically important banking organizations and their subsidiary insured depository institutions. Insured banks covered by the NPR would need to satisfy a 6 percent supplementary leverage ratio threshold to be well capitalized for prompt corrective action (PCA). Bank holding companies would need to maintain supplementary leverage ratios of at least 5 percent to avoid restrictions on capital distributions. Comments were due by October 21, 2013. See https://www.fdic.gov/news/inactive-financial-institution-letters/2013/fil13033.html.
FDIC Issues Interim Final Capital Rule (FIL-31-2013, July 9, 2013; FIL-32-2013, July 9, 2013; PR-60-2013, July 9, 2013; Federal Register, Vol. 78, No. 175, p. 55340, September 10, 2013, subsequently corrected in Vol. 78, No. 204, p. 62417, October 22, 2013)	The FDIC issued an interim final rule that revises existing capital rules to incorporate certain revisions to the Basel capital framework, including Basel III and other elements. The interim final rule implements a revised definition of regulatory capital, a new common equity tier 1 minimum capital requirement, and a higher minimum tier 1 capital requirement, and incorporates these into the FDIC's PCA framework. The rule also revises the advanced approaches risk-based capital rule, including a minimum 3 percent supplementary leverage ratio, and applies the market risk capital rules to state savings associations. Comments were due by November 12, 2013. See https://www.fdic.gov/news/inactive-financial-institution-letters/2013/fil13031.html.
Agencies Release Public Sections of Resolution Plans (PR-58-2013, July 2, 2013)	The FDIC and FRB made available the public portions of resolution plans for four firms with U.S. nonbank assets between $100 billion and $250 billion. The Dodd-Frank Act requires that bank holding companies with total consolidated assets of $50 billion or more submit initial resolution plans on a staggered schedule. The firms whose resolution plans were due on July 1, 2013, were BNP Paribas SA, HSBC Holdings plc, Royal Bank of Scotland Group plc, and Wells Fargo & Company. See http://www.fdic.gov/news/news/press/2013/pr13058.html.
Consolidated Reports of Condition and Income (FIL-30-2013, July 2, 2013; FIL-29-2013, June 28, 2013)	The federal bank regulatory agencies reminded financial institutions of a limited number of Call Report changes that took effect June 30, 2013. Revisions include the scope of an existing item for certain capital transactions with stockholders; the data reported for deposit insurance assessment purposes by large institutions and highly complex institutions (generally, institutions with $10 billion or more in total assets) on certain higher-risk assets, real estate loans and commitments, and U.S. government-guaranteed assets; and a new table of consumer loans by loan type and probability of default. See https://www.fdic.gov/news/inactive-financial-institution-letters/2013/fil13030.html.
Banking Agencies Issue Host State Loan-to-Deposit Ratios (PR-57-2013, July 1, 2013)	The federal bank regulatory agencies issued the host state loan-to-deposit ratios the agencies will use to determine compliance with Section 109 of the *Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.* These ratios update data released on June 29, 2012. See http://www.fdic.gov/news/news/press/2013/pr13057.html.

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Subject	Summary
FDIC Releases Second Installment of Technical Assistance Videos (PR-56-2013, July 1, 2013)	The FDIC released the second installment in a series of technical assistance videos to provide useful information to bank directors, officers, and employees on areas of supervisory focus. This video is a virtual version of the FDIC's Directors' College Program and consists of modules on interest rate risk, third-party risk, corporate governance, the Community Reinvestment Act, information technology, and the Bank Secrecy Act. See http://www.fdic.gov/news/news/press/2013/pr13056.html.
U.S. Treasury Community Development Financial Institutions Fund: Bank Enterprise Award Program Funding Round and Application Deadline (FIL-28-2013, June 17, 2013)	The U.S. Treasury Community Development Financial Institutions Fund announced it will award $17 million in financial incentives during fiscal year 2013 through its Bank Enterprise Award Program (BEA Program) to eligible FDIC-insured depository institutions. The BEA Program was created in 1994 to support FDIC-insured financial institutions dedicated to financing and supporting community and economic development activities. The deadline for submitting an application was July 12, 2013. See https://www.fdic.gov/news/inactive-financial-institution-letters/2013/fil13028.html.
FDIC and CFPB Collaborate to Develop a Tool for Older Adults to Prevent Financial Exploitation (PR-52-2013, June 12, 2013)	The FDIC and CFPB launched a new financial tool, *Money Smart for Older Adults,* to help older adults and their caregivers prevent elder financial exploitation. See http://www.fdic.gov/news/news/press/2013/pr13052.html.
FDIC Announces Memorandum of Understanding With Canada Deposit Insurance Corporation (PR-51-2013, June 12, 2013)	The FDIC announced the signing of a Memorandum of Understanding with the Canada Deposit Insurance Corporation that formalizes and strengthens cross-border cooperation in the event of the failure of a large, complex financial institution operating in both countries. See http://www.fdic.gov/news/news/press/2013/pr13051.html.
FDIC Adopts Final Rule Defining "Predominantly Engaged in Activities That Are Financial in Nature or Incidental Thereto" (Federal Register, Vol. 78, No. 111, p. 34712, June 10, 2013)	The FDIC adopted a final rule that establishes criteria for determining if a company is predominantly engaged in "activities that are financial in nature or incidental thereto" for purposes of Title II of the Dodd-Frank Act. A company that is predominantly engaged in such activities is a "financial company" and may be subject to Title II's orderly liquidation authority. See http://www.gpo.gov/fdsys/pkg/FR-2013-06-10/pdf/2013-13595.pdf.
Advisory on Mandatory Clearing Requirements for Over-the-Counter Interest Rate and Credit Default Swap Contracts (FIL-25-2013, June 7, 2013)	New mandatory clearing requirements for certain interest rate and credit default swap contracts took effect on June 10, 2013, for all state nonmember institutions. These requirements apply to any covered transaction entered into on or after June 10, 2013, unless the end-user exception or inter-affiliate exemption under the Commodity Futures Trading Commission's rules applies. See http://www.fdic.gov/news/news/financial/2013/fil13025.html.
Banker Teleconference on Leveraged Lending Guidance (FIL-23-2013, June 6, 2013)	The federal bank regulatory agencies co-sponsored an "Ask-the-Regulator" teleconference on June 19, 2013, to discuss the recently issued interagency leveraged lending guidance. The discussion outlined supervisory expectations for sound risk management of leveraged lending activities, including examples of how to define a leveraged loan, guidance on evaluating ability to repay, prudent underwriting practices, and enterprise valuation methods. See https://www.fdic.gov/news/inactive-financial-institution-letters/2013/fil13023.html.

Subject	Summary
FDIC Hosts Community Affairs Webinar: Finding Community Development Opportunities (FIL-21-2013, May 30, 2013)	The FDIC hosted a webinar titled *Finding Community Development Opportunities* on June 27, 2013. The webinar discussed potential approaches to identifying community development opportunities, with an emphasis on investment and service activities. See http://www.fdic.gov/news/news/financial/2013/fil13021.html.
FDIC Advisory Committee to Discuss 2013 Economic Inclusion Priorities (PR-39-2013, May 13, 2013)	The FDIC Advisory Committee on Economic Inclusion met on May 16, 2013, to discuss the FDIC's economic inclusion priorities. The meeting featured a panel discussion on Safe Accounts and prepaid cards. See http://www.fdic.gov/news/news/press/2013/pr13039.html.

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