Proposed Assessment Rate Adjustment Guidelines for Large and Highly Complex Institutions

FDIC Proposes New Assessment Rate Adjustment Guidelines for Large and Highly Complex Institutions in connection with its Final Rule on Assessment and Large Bank Assessment Pricing

SUMMARY

On February 7, 2011, the Federal Deposit Insurance Corporation (the “FDIC”) issued a final rule adopting a new methodology for determining deposit insurance assessment rates for large and highly complex institutions (the “New Assessment System”). The New Assessment System introduced a scorecard method to calculate assessment rates and provided the FDIC with discretionary authority to adjust an institution’s total score. The final rule also required the FDIC to publish new guidelines before using this discretionary authority.

On April 12, 2011, the FDIC proposed for comment new guidelines relating to the deposit insurance assessment rate adjustment for large and highly complex institutions (the “Guidelines”). 76 Fed. Reg. 21,256 (April 15, 2011). The proposed Guidelines describe the process the FDIC would follow and the information it would consider to determine whether to make an adjustment and the size of the adjustment, and how the FDIC would provide notice to an institution of such adjustment. The FDIC would primarily consider two types of information in determining whether to make an adjustment and the size of the adjustment: (a) scorecard measure “outliers,” and (b) information not directly captured in the scorecard, including complementary risk measures and qualitative risk considerations. The proposed Guidelines when finalized would supersede the large bank pricing adjustment guidelines published by the FDIC on May 15, 2007, 72 Fed. Reg. 27,122 (the 2007 guidelines).
The FDIC seeks comment on all aspects of the proposed Guidelines, which must be received on or before May 31, 2011.

BACKGROUND

On February 7, 2011, the FDIC issued a final rule adopting the New Assessment System. 76 Fed. Reg. 10,672 (February 25, 2011). The New Assessment System, among other things, eliminates risk categories for large institutions and combines CAMELS ratings and forward-looking financial measures into one of two scorecards – one for highly complex institutions and another for all other large institutions. Each of the two scorecards produces two scores – a performance score and a loss severity score – that are combined into a total score, which cannot be greater than 90 or less than 30. The score is then converted to an initial base assessment rate, which, after application of other possible adjustments, results in a total assessment rate. The total assessment rate is multiplied by the institution’s assessment base to calculate the amount of its assessment obligation.

The New Assessment System allows the FDIC, after consultation with an institution’s primary federal regulator, to make adjustments to an institution’s total score by up to 15 points, either upward or downward, but the resulting score cannot be greater than 90 or less than 30. The final rule of the New Assessment System provides that no new adjustments would be made until new guidelines have been published for comment and approved by the FDIC’s Board of Directors. The Guidelines, once finalized, would satisfy this requirement of the New Assessment System. According to the FDIC, the total score produced by the scorecard under the New Assessment System would reflect an institution’s overall risk relative to other large institutions in most cases; however, the scorecard includes assumptions that may

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1 A “highly complex institution” is defined as: (1) an insured depository institution (excluding a credit card bank) that has had $50 billion or more in total assets for at least four consecutive quarters and that either is controlled by a U.S. parent holding company that has had $500 billion or more in total assets for four consecutive quarters, or is controlled by one or more intermediate U.S. parent holding companies that are controlled by a U.S. holding company that has had $500 billion or assets for four consecutive quarters, or (2) a processing bank or trust company, whose last three years’ non-lending interest income, fiduciary revenues, and investment banking fees, combined, exceed 50 percent of total revenues (and its last three years’ fiduciary revenues are non-zero), whose total fiduciary assets total $500 billion or more, and whose total assets for at least four consecutive quarters have been $10 billion or more. See 76 Fed. Reg. 21,256, 21,256 (April 15, 2011).

2 A large institution is defined as an insured depository institution that: (1) had assets of $10 billion or more as of December 31, 2006 (unless, by reporting assets of less than $10 billion for four consecutive quarters since then, it has become a small institution); or (2) had assets of less than $10 billion as of December 31, 2006, but has since had $10 billion or more in total assets for at least four consecutive quarters, whether or not the institution is new. See 76 Fed. Reg. at 21,256.

3 These adjustments are the unsecured debt adjustment, the depository institution debt adjustment, and the brokered deposit adjustment. 76 Fed. Reg. at 21,256.

4 The final rule adopting the New Assessment System establishes a new assessment base for an insured depository institution as the average consolidated total assets of the institution during the assessment period minus the average tangible equity of the institution during the assessment period. See 76 Fed. Reg. 10,672, 10,704 (February 25, 2011).
not be appropriate for all institutions. The FDIC believes that it must have the ability to consider idiosyncratic or other relevant risk factors that are not adequately captured in the scorecards and make appropriate adjustments to an institution’s total score.

THE ASSESSMENT RATE ADJUSTMENT PROCESS

A. IDENTIFYING THE NEED FOR AN ADJUSTMENT

Under the proposed Guidelines, the adjustment process can be initiated by the FDIC either on its own initiative or upon a written request by an institution. The FDIC would evaluate scorecard results each quarter to identify institutions with a score that is clearly too high or too low (i.e., a scorecard measure outlier). The FDIC also would consider other risks or risk-mitigating factors that are not directly captured in the scorecard, including considerations for purchased credit impaired (PCI) loans, accounting rule changes such as FAS 166/167, credit underwriting and credit administration practices, collateral and other risk mitigants such as the materiality of guarantees and franchise value. In addition, the FDIC would, where appropriate, assign an institution to a peer group to see how an institution compares to similar institutions; this would allow the FDIC to consider variations in risk measures that may exist among institutions with different business models.

Unlike the 2007 guidelines, the proposed Guidelines now explicitly allow institutions to make a request to the FDIC for an adjustment. According to the Guidelines, the FDIC would consider an institution-initiated request only if the request is supported by evidence of a material risk or risk-mitigating factor that is not adequately accounted for in the scorecard. The FDIC’s rejection or modification of an institution-initiated request would not preclude a subsequent request for review or appeal.

B. DETERMINING THE ADJUSTMENT AMOUNT

Once the FDIC determines that an adjustment may be warranted, it would determine the adjustment amount necessary to bring an institution’s total score into better alignment with those of other institutions that pose similar levels of risk, with particular emphasis on institutions in the same peer group. The FDIC believes that the adjustment process should be used to address material idiosyncratic issues in a

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6 The proposed peer groups are: (i) Processing Banks and Trust Companies, including large institutions whose last three years’ non-lending interest income, fiduciary revenues, and investment banking fees, combined, exceed 50% of total revenues (and its last three years’ fiduciary revenues are non-zero), and whose total fiduciary assets total $500 billion or more; (ii) Residential Mortgage Lenders, including large institutions not described in (i) whose mortgage loans plus mortgage backed securities exceed 50% of total assets; (iii) Non-diversified Regional Institutions, including large institutions not described in (i) or (ii) whose credit card plus securitized receivables exceed 50% of assets plus securitized receivables or whose sum of residential mortgage loans, credit card loans, and other loans to individuals exceed 50% of assets; (iv) Large Diversified Institutions, including large institutions not described in (i), (ii) or (iii) whose assets are over $150 billion; and (v) Diversified Regional Institutions, including large institutions not described in (i), (ii), (iii) or (iv) whose assets are less than $150 billion. 76 Fed. Reg. at 21,258-59.
small number of institutions rather than as a fine-tuning mechanism for a large number of institutions. Therefore, according to the proposed Guidelines, unless there would be a meaningful adjustment of an institution’s total score (generally, an adjustment of five points or more), the FDIC is unlikely to determine that an adjustment is necessary. If the FDIC determines that the size of the adjustment required to align an institution’s total score with institutions of similar risk is not material, it would not make any adjustment.

C. CONSULTATION WITH PRIMARY FEDERAL REGULATOR

The Guidelines provide that, before making an adjustment, the FDIC would consult with an institution’s primary federal regulator and state banking supervisor to obtain further information and comment. The Guidelines, however, do not elaborate on the process of such consultation.

D. COMMUNICATING WITH INSTITUTIONS

The process of communicating with affected institutions and implementing adjustments remain largely unchanged from the 2007 guidelines. If the FDIC determines to make an upward adjustment to an institution’s total score, the institution would be given advance notice. The notice would include the reasons for the upward adjustment, the size of the adjustment and when the adjustment would take effect. The notice would also provide institutions up to 60 days to respond. The timing of the advance notice would correspond approximately to the invoice date for the previous assessment period, and the notice of the FDIC’s decision to implement the adjustment would correspond approximately to the invoice date for the period in which the adjustment would become effective. To illustrate the above time frames, if an institution’s assessment rates covering the period of April 1 through June 30 were proposed for adjustment, the institution would receive the advance notice around June 15, which is the invoice date for the January 1 through March 31 assessment period. The institution then would have 60 days, i.e., until August 14, to respond. If, after evaluating the institution’s response and updated information for the period ending June 30, the FDIC decides to proceed with the upward adjustment, it would communicate this decision to the institution by approximately September 15, which is the invoice date for the period of April 1 through June 30. The adjusted rate would be reflected in the September 15 invoice. The FDIC would not give notice for any downward adjustment, which would be directly reflected in the invoices.

E. DURATION OF THE ADJUSTMENT

The adjustment would remain in effect for subsequent assessment periods until the FDIC determines either that the adjustment is no longer warranted or that the magnitude of the adjustment needs to be adjusted (subject to the 15-point limitation and, in the case of an upward adjustment, the requirement for

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For the purposes of this memorandum, an upward adjustment includes an upward adjustment, removal of a previously implemented downward adjustment, and an increase in a previously implemented upward adjustment.
further advance notice). The FDIC would reevaluate the need for total score adjustment on a quarterly basis.

F. REQUEST FOR REVIEW AND APPEALS
An institution can request review of or appeal an upward adjustment and the size of the adjustment pursuant to 12 C.F.R. 327.4(c). An institution could also request review of or appeal the FDIC’s decision to deny its request for an adjustment.

INFORMATION TO BE CONSIDERED IN ADJUSTMENT
The FDIC would consider primarily two types of information in determining whether to make an adjustment and the size of the adjustment: (a) scorecard measure outliers, and (b) information not directly captured in the scorecard, including complementary risk measures and qualitative risk considerations. The FDIC would use these two types of information to consider whether potential discrepancies exist between the risk ranking of institutions based on their total scores and the relative risk ranking suggested by a combination of these two types of information. Specific risk measures would vary in importance for different types of institutions. In some cases, a single risk factor or indicator may support an adjustment if the factor suggests a significantly higher or lower risk than the total score reflects.

A. SCORECARD MEASURE OUTLIERS
To compare different ratios in a standardized way among institutions for risk ranking and assign statistically based weights, the New Assessment System converts each scorecard ratio into a score that ranges between 0 and 100. A score of 100 reflects the highest risk and a score of 0 reflects the lowest risk. In order to convert each ratio to such score, the New Assessment System uses minimum and maximum cutoff values (generally the 10th and 90th percentile values) for each ratio based on data for the period from 2000 to 2009. All values less than the low percentile cutoff or all values greater than the high percentile cutoff are assigned the same score. According to the FDIC, however, this method may

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8 In addition, as noted in the final rule of the New Assessment System, an institution’s assessment rate can increase without notice if the institution’s supervisory ratings or scorecard ratios deteriorate. 76 Fed. Reg. at 10,715.

9 An institution shall submit a written request to the FDIC’s Director of the Division of Insurance and Research within 90 days from the receipt of the quarterly certified statement invoice containing the adjustment. The written request should include documentation sufficient to support the change sought by the institution. The institution shall provide any additional information within 21 days from the receipt of such request from the FDIC. Upon completion of a review, the Director of the Division of Insurance and Research or the Director of the Division of Supervision and Consumer Protection (or designee) or any successor divisions shall promptly notify the institution in writing of the determination. If the institution disagrees with the determination, it may appeal to the FDIC’s Assessment Appeals Committee. Notice of the procedures applicable to such appeal to the FDIC’s Assessment Appeals Committee will be included in the written determination. See 12 C.F.R. 327.4(c).
mask significant differences in risk among institutions with the minimum and maximum score.\footnote{See 76 Fed. Reg. at 21,260.} As noted in the Guidelines, an institution with one or more scorecard ratios well in excess of the maximum cutoffs or well below the minimum cutoffs may pose significantly greater or lower risk to the deposit insurance fund than its score suggests.

An example from the Guidelines illustrates this point. Assume that a bank, Bank A, has a Tier 1 Leverage Ratio with a score of zero. The FDIC would review whether the ratio underlying this measure \textit{materially} differs from the “cutoff” value associated with a score of zero. The FDIC will determine materiality by analyzing and reviewing the amount that the underlying ratio differs from the relevant cutoff value as a percentage of the overall scoring range (the maximum cutoff minus the minimum cutoff). Assuming the cutoff values for Tier 1 Leverage Ratio are 6\% (minimum) and 13\% (maximum) and Bank A’s Tier 1 Leverage Ratio is 17\%, the difference between Bank A’s ratio and cutoff value (17\% minus 13\%) represents 57\% of the scoring range (13\% minus 6\%). Based on this additional information and assuming there are no other offsetting factors, the FDIC may determine that Bank A’s loss absorbing capacity is not fully recognized, particularly when compared to other institutions receiving the same overall score, and may therefore make an upward adjustment to Bank A’s total score. Furthermore, as noted earlier, the FDIC will make the adjustment by the amount that is necessary to bring Bank A’s total score consistent with those of banks of comparable overall risk, with particular emphasis on institutions of the same institution type. Typically, adjustments supported by only one extreme outlier value would be less than the FDIC’s potential adjustment authority of 15 points. In the case of multiple outlier values, inconsistent outlier values, or outlier values that are exceptionally beyond the scoring range, an overall analysis of each measure’s relative importance may call for higher or lower adjustment amounts. In this example, for Bank A, the Guidelines indicate that a 5-point adjustment may be most appropriate.

\textbf{B. COMPLEMENTARY RISK MEASURES}

Complementary risk measures are measures that are not included in the scorecard, but that can inform the appropriateness of a given scorecard measure for a particular institution. These complementary risk measures are readily available for all institutions and include quantitative metrics and market indicators that provide further insights into an institution’s ability to withstand financial adversity and the severity of losses in the event of failure.

The following example from the Guidelines illustrates the analytical process the FDIC would follow in determining whether to propose an upward adjustment based on complementary risk measures. Assume that a bank, Bank B, has a total score of 66. Some of Bank B’s risk measure scores may be significantly higher than the total score while others may be significantly lower. The FDIC would review complementary measures for all financial ratios contained in the scorecard and may find, for example, that the complementary measures for Tier 1 Leverage Ratio show that the Tier 1 Leverage Ratio score

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(42) may not correctly reflect the level and quality of capital protection. Two complementary capital measures – the total equity ratio (a score of 64) and the ratio of other comprehensive income to Tier 1 capital (a score of 83) – suggest higher risk than the Tier 1 Leverage Ratio score suggests. Additional review reveals that sizeable unrealized losses in the securities portfolio account for these differences and that Bank B’s loss absorbing capacity is potentially overstated by the Tier 1 Leverage Ratio. Therefore, an upward adjustment to Bank B’s total score may be appropriate, assuming that no significant risk mitigants are evident. In this example, the Guidelines indicate that an adjustment of 5 points would be likely since the underlying level of unrealized losses is very high (e.g., greater than 25% of Tier 1 capital).

C. QUALITATIVE RISK CONSIDERATIONS

According to the FDIC, qualitative risk information often provides significant insights into institution-specific or idiosyncratic risk factors that cannot be captured in the scorecard. Generally, qualitative factors would become more important in determining whether to apply an adjustment when an institution has high performance risk or if the institution has high asset, earnings, or funding concentrations. When qualitative risk considerations materially affect the FDIC’s view of an institution’s probability of failure or loss given failure, these considerations can be the primary factor supporting an adjustment. Qualitative risk considerations include, but are not limited to, underwriting practices related to material concentrations, risk management practices, strategic risk, the use and management of government support programs, information obtained through the supervisory process such as stress test results, and factors affecting loss severity.

The following example from the Guidelines illustrates the analytical process the FDIC would follow to determine whether to make an adjustment based on qualitative information. Assume that a bank, Bank C, has a high total score of 82 that is largely driven by a high score for the ability to withstand the asset-related stress component, which is, in turn, largely driven by the higher-risk asset concentration score and the underperforming asset score. The FDIC would review qualitative information pertaining to the higher-risk asset concentration measure and the underperforming asset measure for Bank C to determine whether there are one or more important risk mitigants that are not factored into the scorecard. Assume that the further review revealed that, although Bank C has concentrations in non-traditional mortgages, its mortgage portfolio has the following characteristics that suggest lower risk: (a) most of the loan portfolio is composed of bank-originated residential real estate loans on owner-occupied properties; (b) the portfolio has strong collateral protection (e.g., few or no loans with a high loan-to-value ratio) compared to the rest of the industry; (c) debt service coverage ratios are favorable (e.g., few or no loans with a high debt-to-income ratio) compared to the institution’s peers; and (d) the primary Federal regulator notes in its examination report that the institution has strong collection practices and reports no identified risk management deficiencies. Additionally, these qualitative factors surrounding the bank’s real estate portfolio suggest that loss rate assumptions applied to Bank C’s residential mortgage portfolio may be too severe, resulting in a loss severity score that is too high relative to its risk. Based on the information
above, the Guidelines indicate that the bank would be a strong candidate for a 10- to 15-point reduction in
total score, primarily because the asset-related stress score and loss severity score do not reflect a
number of significant qualitative risk mitigants that suggest lower risk.

OBSERVATIONS AND IMPLICATIONS

The proposed Guidelines provide some clarification of factors the FDIC will consider to determine whether
to make an adjustment and the size of the adjustment, and the process that the FDIC will follow.
Nonetheless, the scope of complementary risk measures and qualitative risk considerations is quite
broad, and it may prove difficult for institutions to predict when and which factors will trigger the
adjustment process. Institutions’ ability to identify, monitor and manage these factors may be limited.

COMMMENTS

The FDIC seeks comment on all aspects of the Guidelines. Comments must be received on or before
May 31, 2011. The Guidelines further provide that notice and comment are not required and need not be
employed to make future changes to the Guidelines.

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