



October 6, 2008

MEMORANDUM TO: The Board of Directors

FROM: Arthur J. Murton  
Director  
Division of Insurance and Research

SUBJECT: Restoration Plan, Notice of Proposed Rulemaking on Risk-Based Assessments, and the Designated Reserve Ratio for 2009

The Federal Deposit Insurance Reform Act of 2005 (the Reform Act) requires that the FDIC's Board of Directors adopt a restoration plan when the Deposit Insurance Fund reserve ratio falls below 1.15 percent or is expected to within 6 months. Staff is recommending such a restoration plan. As part of the plan, and in conjunction with it, staff is also recommending that the Board authorize publication of the attached notice of proposed rulemaking (NPR), which would make changes to the assessment system and raise assessment rates. Finally, staff is recommending that the Board set the designated reserve ratio for 2009 at 1.25 percent.

#### INTRODUCTION

Recent failures have significantly increased the Deposit Insurance Fund's (the DIF or the fund) loss provisions, resulting in a decline in the reserve ratio. As of June 30, 2008, the reserve ratio stood at 1.01 percent, 18 basis points below the reserve ratio as of March 31, 2008. This is the lowest reserve ratio for a combined bank and thrift insurance fund since March 31, 1995. Staff expects a higher rate of insured institution failures in the next few years compared to recent years; thus, the reserve ratio may continue to decline. Because the fund reserve ratio has fallen below 1.15 percent and is expected to remain below 1.15 percent, the FDIC is required to establish and implement a restoration plan to restore the reserve ratio to 1.15 percent. Absent extraordinary circumstances, the reserve ratio must be returned to at least 1.15 percent no later than five years after establishment of the plan.

In staff's view, to restore the reserve ratio to 1.15 percent within five years will require higher assessment rates. Since the current rates are already 3 basis points uniformly above the base rate schedule established in the 2006 assessments rule, a new rulemaking is required. Staff is proposing the other changes to the assessment system described below primarily to ensure that riskier institutions will bear a greater share of the proposed increase in assessments.

For reasons discussed in greater detail below, staff continues to view 1.25 percent as an appropriate long-term target for the fund reserve ratio and recommends maintaining the DRR at 1.25 percent for 2009.

Concur: \_\_\_\_\_  
Sara A. Kelsey  
General Counsel

## SUMMARY OF RECOMMENDATIONS

### **The Restoration Plan**

Staff recommends that the Board adopt and implement the attached Restoration Plan. In sum, the Restoration Plan provides that:

1. The FDIC will have the accompanying NPR published in the Federal Register as soon as possible. Based upon the projections contained in the NPR, the assessment rates proposed in the NPR will return the Deposit Insurance Fund reserve ratio to at least 1.15 percent no later than five years after establishment of the plan. The FDIC will rely on the December 31, 2013 reserve ratio, which is the first date after October 7, 2013 for which the reserve ratio will be known, to determine whether the reserve ratio has returned to the statutory range.
2. Before the FDIC adopts a final rule following the NPR, it will update its loss and income projections for the fund and, if needed to ensure that the fund reserve ratio reaches 1.15 percent within the five-year period, will adopt higher assessment rates than those proposed in the NPR. If consistent with the fund reserve ratio reaching 1.15 percent within the five-year period, the FDIC may also adopt lower assessment rates.
3. At least semiannually thereafter, the FDIC will update its loss and income projections for the fund and, if needed to ensure that the fund reserve ratio reaches 1.15 percent within the five-year period, will increase assessment rates, following notice-and-comment rulemaking if required. If consistent with the fund reserve ratio reaching 1.15 percent within the five-year period, the FDIC may also lower assessment rates, again following notice-and-comment rulemaking if required.
4. Institutions may continue to use assessment credits without additional restriction (other than those imposed by law) during the term of the Restoration Plan, since the few remaining credits should have only a minimal effect on fund revenue.

Recommended assessment rates and the analysis supporting them are described beginning on the next page.

### **The Notice of Proposed Rulemaking**

Staff's proposals to amend the assessment system and adopt new assessment rates are set out in detail in the Supplementary Information Section of the attached NPR. In summary, however, staff makes the recommendations that follow and recommends that the FDIC seek comment on every aspect of the proposed rulemaking.

## Assessment Rates

### *Assessment rates for the first quarter of 2009*

Staff proposes raising the current rates uniformly by seven basis points for the assessment for the quarter beginning January 1, 2009, which would be reflected in the fund balance as of March 31, 2009, and assessments due June 30, 2009. Rates for the first quarter of 2009 only would be as follows:

Table 1

Proposed Assessment Rates for the First Quarter of 2009

	Risk Category				
	I*		II	III	IV
	Minimum	Maximum			
<b>Annual Rates (in basis points)</b>	12	14	17	35	50

\* Rates for institutions that did not pay the minimum or maximum rate would vary between these rates.

The proposed rates for the first quarter of 2009 would raise almost as much assessment revenue as under the rates proposed described below for quarters beginning on or after April 1, 2009. Data and system requirements do not make it feasible to adopt the proposed changes to the risk-based assessment system discussed below until the second quarter of 2009.

### *Assessment rates beginning April 1, 2009*

Staff recommends that the Board adopt the initial base assessment rates set forth in Table 2 below effective April 1, 2009. These recommended rates reflect a proposed increase in the spread between minimum and maximum initial base assessment rates in Risk Category I from the current 2 basis points to an initial range of 4 basis points.

Table 2

Proposed Initial Base Assessment Rates

	Risk Category				
	I*		II	III	IV
	Minimum	Maximum			
<b>Annual Rates (in basis points)</b>	10	14	20	30	45

\* Initial base rates that were not the minimum or maximum rate would vary between these rates.

As discussed in greater detail below, staff proposes several adjustments that could be made to an institution's base assessment rate. After applying all possible adjustments, minimum

and maximum total base assessment rates for each risk category would be as set out in Table 3 below.

Table 3  
Total Base Assessment Rates\*

	RISK CATEGORY I	RISK CATEGORY II	RISK CATEGORY III	RISK CATEGORY IV
Initial base assessment rate	10 - 14	20	30	45
Unsecured debt adjustment	-2 - 0	-2 - 0	-2 - 0	-2 - 0
Secured liability adjustment	0 - 7	0 - 10	0 - 15	0 - 22.5
Brokered deposit adjustment		0 - 10	0 - 10	0 - 10
Total base assessment rate	8 - 21.0	18 - 40.0	28 - 55.0	43 - 77.5

\* All amounts for all risk categories are in basis points annually. Rates for institutions that did not pay the minimum or maximum rate would vary between these rates. Adjustments would be applied in the order listed in the table. The large bank adjustment would be made before any other adjustment.

Based on the information currently available, staff proposes setting actual rates at the proposed total base assessment rate schedule. These proposed rates and other revisions to the assessment rules would take effect for the quarter beginning April 1, 2009, which would be reflected in the fund balance as of June 30, 2009 and in the invoices for the assessment due September 30, 2009.

The proposed rates are intended to improve the way the assessment system differentiates risk among insured institutions and make the risk-based assessment system fairer, by limiting the subsidization of riskier institutions by safer ones. They are also intended to increase assessment revenue while the Restoration Plan is in effect in order to raise the reserve ratio to the minimum threshold of 1.15 percent within 5 years of the Plan's implementation.

Table 4 shows projected minimum initial base assessment rates needed to raise the reserve ratio to 1.15 percent (the lower bound under the requirements for the Restoration Plan) in 2013 for alternative average annual insured deposit growth rates and total costs of bank failures from 2008 through 2013.

Table 4  
Minimum Initial Base Assessment Rates (in Basis Points)  
Needed to Raise the Reserve Ratio to 1.15 Percent in 2013

Insured Deposit Growth Rate	If institution failures from 2008 to 2013 cost in total:*					
	\$20 Billion	\$30 Billion	\$40 Billion	\$50 Billion	\$60 Billion	\$70 Billion
3%	5	5	8	11	13	16
4%	5	6	9	11	14	16
5%	5	7	9	11	14	16
6%	5	7	9	12	14	17
7%	5	8	10	12	15	17

\* Costs include \$12.8 billion for actual and projected failures in 2008.

Staff expects that housing price declines, financial market turmoil, and generally weaker economic conditions will continue to exert stress on banking industry earnings and credit quality in the near term, most notably in residential real estate and construction and development lending, all contributing to staff's expectation of higher losses for the insurance fund. Significant uncertainty remains about the outlook for a recovery in mortgage securitization markets and the return of confidence to financial markets overall. Economic activity in the industrial Midwest has especially suffered from higher energy and commodity prices. Housing market downturns in Arizona, California, Nevada, Florida, and other coastal areas are contributing to declines in construction and consumer spending and economic downturns in those areas. Regional disparities in housing market and economic conditions, as well as financial market difficulties, have led in turn to variation in prospects among banks. Institutions most at risk include: (1) those with large volumes of subprime and nontraditional mortgages, particularly those heavily reliant on securitization; and (2) those with heavy concentrations of residential real estate and construction and development loans in markets with the greatest housing price declines. Within each of these groups, those heavily reliant on non-core funding incur additional risks should the availability of these funds decline as conditions deteriorate.

The insurance fund balance and reserve ratio are likely to experience further declines before recovering as the current problems confronting the banking industry abate. Staff projects that the reserve ratio will continue to fall for the remainder of this year and early 2009 to a low of 0.65 to 0.70 percent, as the fund's loss reserves for anticipated failures increase. Higher assessment revenue should begin to increase the reserve ratio gradually in the latter part of 2009. Staff's best estimate is that institution failures could cost the insurance fund approximately \$40 billion from 2008 to 2013, of which almost \$13 billion represent actual and projected costs incurred this year (including almost \$9 billion for the failure in July of one institution with over \$30 billion in assets). Staff bases its loss projections on: analysis of specific troubled institutions and risk factors that may adversely affect other institutions; analysis of recent and expected loss rates given failure; stress analyses of the effects of housing price declines and an economic slowdown in specific geographic areas on loan losses and bank capital; and recent and historic supervisory rating downgrade and failure rates.

Staff also assumes that insured deposits would increase on average 5 percent per year from 2008 to 2013. This assumption is in line with the most recent 12-month growth rate and average annual growth rates over the past 5 and 10 years.

Table 4 shows that an initial minimum rate of 9 basis points is necessary for the reserve ratio to reach 1.15 percent by 2013 assuming that failures between 2008 and 2013 cost \$40 billion and that insured deposits increase on average by 5 percent annually. With an initial minimum rate of 9 basis points, staff projects that the reserve ratio would equal 1.18 percent by the end of 2013. Staff's proposed rates, with an initial minimum rate of 10 basis points, would raise the reserve ratio to 1.26 percent by 2013. Staff believes that it would be prudent to provide this margin for error in the event that losses exceed staff's best estimate or insured deposit growth is more rapid than expected.<sup>1</sup>

Staff recognizes that there is considerable uncertainty about its projections for losses and insured deposit growth, and that changes in assumptions about these and other factors could lead to different assessment revenue needs and rates. Consequently, at the time of the issuance of the final rule, the Board may need to set a higher base rate schedule based on information available at that time, including any intervening institution failures and updated failure and loss projections. A higher base rate schedule may also be necessary because of changes to the proposal in the final rule, if these changes have the overall effect of changing revenue for a given rate schedule. In order to fulfill the statutory requirement to return the fund reserve ratio to 1.15 percent, the base rate schedule in the final rule may have to be substantially higher than the proposed base assessment rate schedule (for example, if projected or actual losses at the time of the final rule greatly exceed staff's current estimates).

Under the terms of the proposed Restoration Plan, staff must update its projections for the insurance fund balance and reserve ratio at least semiannually while the Restoration Plan is in effect and adjust rates as necessary. The Supplementary Information Section of the attached NPR contains an analysis of the statutory factors that the Board must take into consideration when setting assessments. The proposed rule would continue to allow the Board to adopt actual rates that were higher or lower than total base assessment rates without the necessity of further notice and comment rulemaking, provided that: (1) the Board could not increase or decrease rates from one quarter to the next by more than three basis points without further notice-and-comment rulemaking; and (2) cumulative increases and decreases could not be more than three basis points higher or lower than the total base rates without further notice-and-comment rulemaking.

Staff is of the opinion that its recommendation is consistent with the statutory factors that the Board must consider when setting rates and with the statutory requirement that the Board adopt and implement a restoration plan that provides that the reserve ratio of the Fund will meet or exceed 1.15 percent within 5 years of the implementation of the plan.

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<sup>1</sup> By contrast, if the minimum initial rate were 8 basis points or less, the reserve ratio is projected to fall short of the 1.15 percent threshold.

Staff projects that adopting the proposed rate schedule would raise the overall average assessment rate to 13.5 basis points beginning in April 2009 and 12.6 basis points in 2010 and thereafter, from a 6.3 basis point average assessment rate (before accounting for credit use) as of June 30, 2008. For institutions in Risk Category I, the projected average rate would be 11.6 basis points beginning in April 2009 and 11.9 basis points in 2010 and thereafter, up from 5.5 basis points as of June 30, 2008.<sup>2</sup>

Table 5 shows the distribution of institutions and domestic deposits by risk category (divided into four parts for Risk Category I) under the proposed initial base rate schedule (effective April 1, 2009) based on data as of June 30, 2008; Table 6 shows the distribution of institutions and domestic deposits by bands of proposed total base assessment rates.<sup>3</sup> For purposes of assessment revenue projections beginning next April, staff relied on the proposed assessment rates based on data as of June 30, 2008, but also accounted for projected migration of institutions across risk categories as supervisory ratings change.

Table 5  
Distribution of Initial Base Assessment Rates and Domestic Deposits  
Data as of June 30, 2008

Risk Category	Initial Assessment Rate	Number of Institutions	Percent of Institutions	Domestic Deposits (in billions of \$)	Percent of Domestic Deposits
I	10	1,775	21%	823.0	12%
	10.01 - 12.00	2,976	35%	2,945.7	42%
	12.01 - 13.99	1,758	21%	1,714.4	24%
	14	1,219	14%	593.3	8%
II	20	588	7%	896.5	13%
III	30	121	1%	27.1	0%
IV	45	14	0%	29.1	0%

\* This table and the following two tables exclude insured branches of foreign banks.

<sup>2</sup> Changes in the projected average rates under the proposed schedule over time reflect projected changes in the migration of institutions within and across risk categories.

<sup>3</sup> The assessment base is almost equal to total domestic deposits.

Table 6  
Distribution of Total Base Assessment Rates and Domestic Deposits  
Data as of June 30, 2008

Risk Category	Total Base Assessment Rate	Number of Institutions	Percent of Institutions	Domestic Deposits (in billions of \$)	Percent of Domestic Deposits
I	8.00 - 10	1,834	22%	806.6	11%
	10.01 - 12	2,674	32%	3,047.6	43%
	12.01 - 14	2,588	31%	1,632.5	23%
	14.01 - 21	632	7%	589.7	8%
II	18.00 - 20	346	4%	204.7	3%
	20.01 - 40	242	3%	691.8	10%
III	28.00 - 30	72	1%	8.0	0%
	30.01 - 55	49	1%	19.1	0%
IV	43.00 - 45	9	0%	5.8	0%
	45.01 - 77.5	5	0%	23.3	0%

\* Because of data limitations, secured liability adjustments for TFR filers are calculated using imputed values based on simple averages of Call Report filers as of June 30, 2008 (discussed below). Unsecured debt adjustments are calculated using "Qualifying subordinated debt and redeemable preferred stock" included in Tier 2 capital.

As noted earlier, the proposed changes to risk-based assessments are intended to better capture differences in risk and impose a greater share of the necessary increase in overall assessments on riskier institutions. Table 7 shows how institutions would have fared if staff had proposed leaving the current risk-based assessment system unchanged except for a uniform increase in rates that would have produced the same revenue as under the proposed schedule. To produce the same revenue, the FDIC would have to increase the current rates uniformly by 7.6 basis points, based upon data as of June 30, 2008. As the table shows, 85 percent of institutions, with 74 percent of domestic deposits, would pay a lower rate under the proposed assessment rate schedule than under a uniform increase of 7.6 basis points to the current rate schedule.



Table 7  
 Difference between Proposed Assessment Rates and  
 A Uniform Increase in Current Rates to Raise the Same Revenue  
 Data as of June 30, 2008

Compared to a uniform increase in current rates, proposed rates are:	Number of Institutions	Percent of Institutions	Domestic Deposits (in billions of \$)	Percentage of Total Domestic Deposits
Over 4 bp lower	339	4%	64	1%
2-4 bp lower	3,070	36%	1,551	22%
0-2 bp lower	3,819	45%	3,551	51%
0-2 bp higher	463	5%	785	11%
2-4 bp higher	541	6%	321	5%
4-6 bp higher	110	1%	121	2%
6-8 bp higher	49	1%	244	3%
8-10 bp higher	18	0%	245	3%
Over 10 bp higher	42	0%	146	2%

Appendix 3 to the NPR contains an analysis of the effect of proposed rates on the capital and earnings of insured institutions. Given the assumptions in the analysis, for the industry as a whole, projected total assessments in 2009 would result in capital that would be 0.3 percent lower than if the FDIC did not charge assessments and 0.1 percent lower than if current assessment rates remained in effect. The proposed assessments would cause 6 institutions whose equity-to-assets ratio would have exceeded 4 percent in the absence of assessments to fall below that percentage and 5 institutions to fall below 2 percent. The proposed *increase* in assessments would cause 3 institutions whose equity-to-assets ratio would have exceeded 4 percent under current assessments to fall below that threshold and 1 institution to fall below 2 percent.

For the industry as a whole, assessments in 2009 would result in pre-tax income that would be 11 percent lower than if the FDIC did not charge assessments and 5.6 percent lower than if current assessment rates remained in effect. Appendix 4 also provides an analysis of the range of effects on capital and earnings.

Staff recommends seeking comment on the proposal and, specifically, on the use of the base schedule and the Board's ability to modify rates without further notice-and-comment rulemaking.

### Assessment system changes

#### *Risk Category I—Financial Ratios Method*

Staff proposes to introduce a new financial ratio into the financial ratios method, which is used to determine base assessment rates for all small institutions and a few large ones. This new ratio would capture brokered deposits (in excess of 10 percent of domestic deposits) that are used to fund rapid asset growth, which is defined as cumulative growth of 20 percent or more in the

previous four years. In addition, staff proposes to update the uniform amount and the pricing multipliers used in the financial ratios method.

Staff is proposing this new risk measure for a couple of reasons. A number of costly institution failures, including some recent failures, have experienced rapid asset growth before failure and have funded this growth through brokered deposits. Moreover, statistical analysis reveals a significant correlation between rapid asset growth funded by brokered deposits and the probability of an institution's being downgraded from a CAMELS composite 1 or 2 rating to a CAMELS composite 3, 4 or 5 rating within a year. A significant correlation is the standard the FDIC used when it adopted the financial ratios method in the 2006 assessments rule.

Staff proposes to update the uniform amount and the pricing multipliers used in the financial ratios method, in part because the addition of a new financial ratio requires an update. To compute the values of the new uniform amount and pricing multipliers, staff chose cutoff values for the predicted probabilities of downgrade such that, using June 30, 2008 Call Report and TFR data: (1) 25 percent of small institutions in Risk Category I (other than institutions less than 5 years old) would have been charged the minimum initial assessment rate; and (2) 15 percent of smaller institutions in Risk Category I (other than institutions less than 5 years old) would have been charged the maximum initial assessment rate. These cutoff values would be used in future periods, which could lead to different percentages of institutions being charged the minimum and maximum rates.

In comparison, under the current system: (1) approximately 28 percent of small institutions in Risk Category I (other than institutions less than 5 years old) were charged the existing minimum assessment rate; and (2) approximately 19 percent of small institutions in Risk Category I (other than institutions less than 5 years old) were charged the existing maximum assessment rate based on June 30, 2008 data.

#### *Risk Category I—Large Bank Method*

Staff also proposes that the assessment rate for a large institution with a long-term debt issuer rating be determined using a combination of the institution's weighted average CAMELS component rating, its long-term debt issuer ratings (converted to numbers and averaged) and the financial ratios method assessment rate, each equally weighted. The new method would be known as the large bank method.

In recent periods, assessment rates for some large institutions have not responded in a timely manner to rapid changes in these institutions' financial conditions. Based on June 30, 2008 data and ignoring the large bank adjustment, under the current system: (1) 45 percent of large institutions in Risk Category I (other than institutions less than 5 years old) would have been charged the existing minimum assessment rate, compared with 28 percent of small institutions; and (2) 11 percent of large institutions in Risk Category I (other than institutions less than 5 years old) would have been charged the existing maximum assessment rate, compared with 19 percent of small institutions. Staff proposes combining the financial ratios method with weighted average CAMELS component ratings and long-term debt issuer ratings so that, using June 30, 2008 data, the percentages of large institutions in Risk Category I (other than new

institutions) that would have been charged the minimum and maximum initial base assessment rates would be the same as the percentages of small institutions that would have been charged these rates (25 percent at the minimum rate and 15 percent at the maximum rate).<sup>4,5</sup>

Staff anticipates that incorporating the financial ratios method into the large bank method assessment rate would result in a more accurate distribution of initial assessment rates and in timelier assessment rate responses to changing risk profiles, while retaining the market and supervisory perspectives that debt and CAMELS ratings provide. A more accurate distribution of initial assessment rates should require fewer adjustments to rates based upon reviews of additional relevant information (the large bank adjustments).<sup>6</sup>

#### *Risk Category I—Initial Base Assessment Rates*

Staff proposes that the financial ratios method or the large bank method, whichever is applicable, would determine a Risk Category I institution's *initial* base assessment rate. Staff proposes to broaden the spread between minimum and maximum initial base assessment rates in Risk Category I from the current 2 basis points to an initial range of 4 basis points and to adjust the percentage of institutions subject to these initial minimum and maximum rates.

#### *Increase the Adjustment for Large Institutions and Insured Branches of Foreign Banks in Risk Category I*

At present, for any Risk Category I large institution or insured branch of a foreign bank, initial assessment rate determinations may be modified up to half a basis point upon review of additional relevant information (the large bank adjustment). Staff proposes to increase the maximum possible large bank adjustment from one-half basis point to one basis point. Any such adjustment up or down would be made before any other adjustment. The adjustment could not: (1) decrease any rate so that the resulting rate would be less than the minimum initial base assessment rate; or (2) increase any rate above the maximum initial base assessment rate.

Staff makes this proposal for two primary reasons. First, at present, the difference between the minimum and maximum base assessment rates in Risk Category I is two basis points. The maximum one-half basis point large bank adjustment represents 25 percent of the difference between the minimum and maximum rates. While an adjustment of this size is generally sufficient to preserve consistency in the orderings of risk indicated by assessment rates and to ensure fairness, there have been circumstances where more than a half a basis point

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<sup>4</sup> As with the financial ratios method for small institutions, these percentages could change in future periods.

<sup>5</sup> A "new" institution, as defined in 12 CFR 327.8(l) is generally one that is less than 5 years old, but there are several exceptions, including, for example, certain otherwise new institutions in certain holding company structures. 12 CFR 327.9(d)(7). The calculation of percentages of small institutions, however, was determined strictly by excluding institutions less than 5 years old, rather than by using the definition of a "new" institution and its regulatory exceptions, since determination of whether an institution meets an exception to the definition of "new" requires a case-by-case investigation.

<sup>6</sup> The FDIC has issued additional Guidelines for Large Institutions and Insured Foreign Branches in Risk Category I (the large bank guidelines) governing these large bank adjustments. 72 FR 27122 (May 14, 2007).

adjustment would have been warranted. A half basis point large bank adjustment would represent only 12.5 percent of the difference between the minimum and maximum rates and would not be sufficient to preserve consistency in the orderings of risk indicated by assessment rates or to ensure fairness. The proposed increase in the maximum possible large bank adjustment would continue to represent 25 percent of the difference between the minimum and maximum rates.

Staff expects that, under the proposed rule, large bank adjustments would be made infrequently for a limited number of institutions.<sup>7</sup> Staff is of the view that the use of supervisory ratings, financial ratios and agency ratings (when available) would sufficiently reflect the risk profile and rank orderings of risk in large Risk Category I institutions in most (but not all) cases.

Staff expects to revise its large bank guidelines. Until then, the guidelines would be applied taking into account the changes resulting from this rulemaking.

#### *Adjustment for Unsecured Debt for all Risk Categories*

Staff proposes that an institution's total base assessment rate could vary from the initial base rate as the result of other possible adjustments. Staff proposes to lower a large institution's initial base assessment rate (after making any large bank adjustment) based upon its ratio of long-term unsecured debt to domestic deposits (the unsecured debt adjustment).<sup>8</sup> Any decrease in base assessment rates from the unsecured debt adjustment would be limited to two basis points.

When an institution fails, holders of unsecured claims, including subordinated debt, receive distributions from the receivership estate only if all secured claims, administrative claims and deposit claims have been paid in full. Consequently, greater amounts of long-term unsecured claims provide a cushion that can reduce the FDIC's loss in the event of failure.

At present, institutions separately report neither long-term senior unsecured liabilities nor long-term subordinated debt in the report of condition. In a separate notice of proposed rulemaking, the Federal Financial Institution Examination Council has proposed revising the Call Report to report separately long-term senior unsecured liabilities and subordinated debt that meet this definition. The OTS has also published a notice of proposed rulemaking that would adopt similar reporting requirements. Until banks separately report these amounts in the Call Report, the FDIC will use subordinated debt included in Tier 2 capital and will not include any amount

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<sup>7</sup> In the six quarters since the 2006 assessment rule went into effect, the total number of adjustments in any one quarter has ranged from 2 to 13. For the second quarter of 2008, the FDIC continued or implemented assessment rate adjustments for 13 large Risk Category I institutions, 12 to increase an institution's assessment rate, and 1 to decrease an institution's assessment rate. Additionally, the FDIC sent four institutions advance notification of a potential upward adjustment in their assessment rate.

<sup>8</sup> Long-term unsecured debt includes senior unsecured and subordinated debt with a remaining maturity of at least one year. (For this purpose, long-term subordinated debt would include term-limited preferred stock with a remaining maturity of at least one year.)

of senior unsecured liabilities. These adjustments will also be made for TFR filers until thrifts separately report these amounts in the TFR.

For a small institution, staff proposes that the unsecured debt adjustment factor in a certain amount of Tier 1 capital (qualified Tier 1 capital) in addition to long-term unsecured debt. The amount of qualified Tier 1 capital would be the sum of one-half of the amount between 10 percent and 15 percent of adjusted average assets (between 2 and 3 times the minimum Tier 1 leverage ratio requirement to be a well-capitalized institution) and the full amount of the Tier 1 capital exceeding 15 percent of adjusted average assets (above 3 times the minimum Tier 1 leverage ratio requirement to be a well-capitalized institution).<sup>9</sup>

Cost concerns and lack of demand generally make it difficult for small institutions to issue unsecured debt in the market. For reasons of fairness, staff believes that small institutions that have large amounts of Tier 1 capital should receive an equivalent benefit for that capital. Furthermore, staff does not want to create an incentive for small institutions to convert existing Tier 1 capital into subordinated debt, for example, by having a shareholder in a closely held corporation redeem shares and receive subordinated debt.

#### *Adjustments for Secured Liabilities for all Risk Categories*

Staff proposes to raise an institution's base assessment rate based upon its ratio of secured liabilities to domestic deposits (the secured liability adjustment). An institution's ratio of secured liabilities to domestic deposits (if greater than 15 percent) would increase its assessment rate, but the resulting base assessment rate after any such increase could be no more than 50 percent greater than it was before the adjustment. The secured liability adjustment would be made after any large bank adjustment or unsecured debt adjustment.

At present, the only secured liabilities that thrifts report separately in the TFR are Federal Home Loan Bank advances. The Office of Thrift Supervision has agreed to revise the TFR so that thrifts will separately report these items. Until the TFR is revised, any of these secured amounts not reported separately from unsecured or other liabilities by a thrift in its TFR would be imputed based on simple averages as of June 30, 2008 for Call Report filers.

At present, an institution's secured liabilities do not directly affect its assessments. The exclusion of secured liabilities can lead to inequity. An institution with secured liabilities in place of another's deposits pays a smaller deposit insurance assessment, even if both pose the same risk of failure and would cause the same losses to the FDIC in the event of failure. In general, under the current rules, substituting secured liabilities for unsecured liabilities (including subordinated debt) raises the FDIC's loss in the event of failure without providing increased

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<sup>9</sup> Adjusted average assets would be used for Call Report filers; adjusted total assets would be used for TFR filers.

assessment revenue. Substituting secured liabilities for deposits can also lower an institution's franchise value in the event of failure, which increases the FDIC's losses, all else equal.<sup>10</sup>

#### *Adjustment for Brokered Deposits for Risk Categories II, III and IV*

Under the proposal, an institution in Risk Category II, III or IV would be subject to the unsecured debt adjustment and secured liability adjustment. In addition, staff proposes a final adjustment for brokered deposits (the brokered deposit adjustment) for institutions in Risk Categories II, III and IV. An institution's ratio of brokered deposits to domestic deposits (if greater than 10 percent) would increase its assessment rate, but any increase would be limited to no more than 10 basis points.

Significant reliance on brokered deposits tends to increase an institution's risk profile, particularly as the institution's financial condition weakens. Insured institutions—particularly weaker ones—typically pay higher rates of interest on brokered deposits. When an institution becomes noticeably weaker or its capital declines, the market or statutory restrictions may limit its ability to attract, renew or roll over these deposits, which can create significant liquidity challenges.<sup>11</sup>

Also, significant reliance on brokered deposits tends to decrease greatly the franchise value of a failed institution. In a typical failure, the FDIC seeks to find a buyer for a failed institution's branches among the institutions located in or around the service area of the failed institution. The more core deposits that the buyer can obtain through the acquisition of the failed institution, the greater the market share it can capture. Thus, the lower franchise value of the failed institution created by its reliance on brokered deposits leads to a lower price for the failed institution, which increases the FDIC's loss upon failure and the cost to the DIF.

Staff believes that these reasons warrant the additional charge for significant levels of brokered deposits.

#### *Insured branches of foreign banks*

Staff also proposes to make conforming changes to the pricing multipliers and uniform amount for insured branches of foreign banks in Risk Category I. Staff proposes that the insured branch of a foreign bank's initial base assessment rate be subject to any large bank adjustment, but not to the unsecured debt adjustment or secured liability adjustment. Total base assessment rates thus could not be less than the minimum initial base assessment rate applicable to Risk Category I institutions nor greater than the maximum initial base assessment rate applicable to

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<sup>10</sup> Overall, whether substituting secured liabilities for deposits increases, decreases, or leaves unchanged the FDIC's loss given failure also depends on how the substitution affects the proportion of insured and uninsured deposits, but FDIC's assessment revenue will always decline with a substitution.

<sup>11</sup> An adequately capitalized institution can accept, renew and rollover brokered deposits only by obtaining a waiver from the FDIC. Even then, interest rate restrictions apply. An undercapitalized institution may not accept, renew or rollover brokered deposits at all. Section 29 of the Federal Deposit Insurance Act (12 U.S.C. § 1831f).

Risk Category I institutions. Insured branches of a foreign bank not in Risk Category I are charged the initial base assessment rate for the risk category in which they are assigned.

#### *New institutions*

Staff also proposes to make conforming changes in the treatment of new insured depository institutions.<sup>12</sup> For assessment periods beginning on or after January 1, 2010, any new institutions in Risk Category I would be assessed at the maximum initial base assessment rate applicable to Risk Category I institutions, as under the current rule.

Effective for assessment periods beginning before January 1, 2010, until a Risk Category I new institution received CAMELS component ratings, it would have an initial base assessment rate that was two basis points above the minimum initial base assessment rate applicable to Risk Category I institutions, rather than one basis point above the minimum rate, as under the current rule. All other new institutions in Risk Category I would be treated as are established institutions, except as provided in the next paragraph.

Either before or after January 1, 2010: no new institution, regardless of risk category, would be subject to the unsecured debt adjustment; any new institution, regardless of risk category, would be subject to the secured liability adjustment; and a new institution in Risk Categories II, III or IV would be subject to the brokered deposit adjustment. After January 1, 2010, no new institution in Risk Category I would be subject to the large bank adjustment.

#### *Technical and other changes*

Staff also proposes to make technical changes and one minor non-technical change to existing assessment rules. These changes are detailed in Supplementary Information Section of the attached NPR.

#### *Order of Adjustments*

Adjustments to the initial base assessment rate would be made in descending order as presented in Table 8 below, resulting in total base assessment rates for each risk category that would be within the ranges set forth in the table.

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<sup>12</sup> Subject to exceptions, a new insured depository institution is a bank or thrift that has not been chartered for at least five years as of the last day of any quarter for which it is being assessed. 12 CFR 327.8(l)

Table 8  
Total Base Assessment Rates after Adjustments\*

	RISK CATEGORY I	RISK CATEGORY II	RISK CATEGORY III	RISK CATEGORY IV
Initial base assessment rate	10 - 14	20	30	45
Unsecured debt adjustment	-2 - 0	-2 - 0	-2 - 0	-2 - 0
Secured liability adjustment	0 - 7	0 - 10	0 - 15	0 - 22.5
Brokered deposit adjustment		0 - 10	0 - 10	0 - 10
Total base assessment rate	8 - 21.0	18 - 40.0	28 - 55.0	43 - 77.5

\* All amounts for all risk categories are in basis points annually. Rates for institutions that did not pay the minimum or maximum rate would vary between these rates. Adjustments would be applied in the order listed in the table. The large bank adjustment would be made before any other adjustment.

### **The Designated Reserve Ratio**

#### **Summary and Recommendation**

The Reform Act eliminated the fixed designated reserve ratio (DRR) of 1.25 percent and directed the Board to set and publish annually a DRR for the DIF within a range of 1.15 percent to 1.50 percent of estimated insured deposits.<sup>13,14</sup> In November of 2006, and again in November 2007, the Board approved a DRR of 1.25 percent for 2007 and 2008 respectively. The staff recommends maintaining the DRR at 1.25 percent for 2009, and requests that the Board authorize the staff to publish the attached notice (to that effect) in the Federal Register.<sup>15</sup>

The statute does not specify a timeframe within which the reserve ratio should meet the DRR. It leaves determination of the timeframe to the Board. A reserve ratio above or below the DRR does not by itself require changes in assessment rates, nor does it affect the ability to use assessment credits or pay dividends from the DIF.

As discussed above, under the Restoration Plan recommended by staff, staff projects that the fund reserve ratio will reach 1.26 percent by 2013, the last year of the plan's 5-year horizon. Staff continues to view the DRR as a signal of the long-term target level that the DIF should achieve (although how the Board decides to use the DRR may change over time).

The FDIC must set the DRR in accordance with its analysis of statutorily prescribed factors: risk of losses to the DIF, economic conditions generally affecting insured institutions, preventing sharp swings in assessment rates, and other factors consistent with these three

<sup>13</sup> Section 2104 of the Reform Act, Pub. L. No. 109-171, 120 Stat. 9 (codified at 12 U.S.C. 1817(b)(3)).

<sup>14</sup> 12 U.S.C. 1817(b)(3)(A) (i), (B).

<sup>15</sup> A change to the DRR would require rulemaking with notice and opportunity for comment. 12 U.S.C. 1817(b)(3)(A) (ii).



factors.<sup>16</sup> Staff has identified four “other factors” that the Board may choose to consider, described below: (1) proposed new revisions to the assessment system; (2) the normal operating range for the reserve ratio; (3) historical experience; and (4) flexibility in managing the fund as conditions change. Staff’s view is that the best way to balance all of the statutory factors is to maintain the DRR at 1.25 percent.

## **Analysis of Statutory Factors**

### **1. Risk of Losses to the DIF**

Losses to the DIF in 2008 have been significantly higher than anticipated when the Board considered the DRR last November and assessment rates last March. Losses from one failure alone are expected to reach almost \$9 billion. As of June 30<sup>th</sup>, the reserve ratio stood at 1.01 percent. This is the lowest reserve ratio for a combined bank and thrift insurance fund since March 1995. More institutions have failed so far this year than in the previous 5 years combined.

As discussed above, the pressures on banks from housing pricing declines, financial market turmoil, the downturn in construction and development lending, and other economic stresses are expected to increase losses to the insurance fund. Staff projects that the costs of institution failures from 2008 through 2013 may be approximately \$40 billion (although there is a considerable degree of uncertainty surrounding these projections). This figure includes almost \$13 billion for the costs of actual and projected failures in 2008.

### **2. Economic Conditions Affecting FDIC-Insured Institutions**

As discussed above in greater detail, staff expects that housing sector and financial market problems, as well as generally weaker economic conditions will continue to exert stress on banking industry earnings and credit quality in the near term, most notably in residential real estate and construction and development lending.

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<sup>16</sup> The Reform Act provides:

(C) FACTORS- In designating a reserve ratio for any year, the Board of Directors shall--

- (i) take into account the risk of losses to the Deposit Insurance Fund in such year and future years, including historic experience and potential and estimated losses from insured depository institutions;
- (ii) take into account economic conditions generally affecting insured depository institutions so as to allow the designated reserve ratio to increase during more favorable economic conditions and to decrease during less favorable economic conditions, notwithstanding the increased risks of loss that may exist during such less favorable conditions, as determined to be appropriate by the Board of Directors;
- (iii) seek to prevent sharp swings in the assessment rates for insured depository institutions; and
- (iv) take into account such other factors as the Board of Directors may determine to be appropriate, consistent with the requirements of this subparagraph.

12 U.S.C. 1817(b)(3)(C)).

### 3. Prevent Sharp Swings in Assessment Rates

The Reform Act directs the FDIC's Board to consider preventing sharp swings in assessment rates for insured depository institutions. Statutory provisions for a restoration plan, however, require that the plan provide for the reserve ratio to meet or exceed 1.15 percent within five years. Depending on the level of projected losses and insured deposit growth, this requirement may limit the Board's ability to prevent sharp swings in assessment rates.

### 4. Other Factors

Staff has identified certain "other factors" that the Board may choose to consider in setting the DRR. In staff's view, these factors favor maintaining the DRR at 1.25 percent.

#### *Proposed new revisions to the assessment system*

In 2006, the assessment system underwent several significant changes. These changes included: (a) adoption of new risk-based pricing methods and rates; (b) application of the one-time credits, which limit assessment revenue in the near term; and (c) the new flexibility to manage the reserve ratio within a range, rather than having to treat the reserve ratio as a hard target. In addition, staff is proposing numerous changes, described above, to the assessment system that would take effect in April 2009. Staff believes that it would be preferable to wait until these changes have had some time to take effect and be evaluated before considering potential future changes to the DRR.

#### *Midpoint of the normal operating range for the reserve ratio*

The Reform Act in effect establishes a normal operating range for the reserve ratio of 1.15 percent to 1.35 percent within which the Board has considerable discretion to manage the size of the insurance fund.<sup>17</sup> The current DRR of 1.25 percent is the midpoint of the normal operating range and staff believes that, considering all the recent changes to the assessment system, it would be reasonable to leave the DRR at the middle of this range.

#### *Historical experience*

Historical experience with a DRR of 1.25 percent indicates that it has worked well under varying economic conditions, including periods when the fund's reserve ratio was under stress, in ensuring an adequate insurance fund and maintaining a sound deposit insurance system.

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<sup>17</sup> The Reform Act authorizes the Board to set the DRR at no less than 1.15 percent and no greater than 1.50 percent. The FDIC must adopt a restoration plan when the reserve ratio falls below 1.15 percent, or is projected to fall below 1.15 percent within six months. When the reserve ratio exceeds 1.35 percent, the Reform Act generally requires the FDIC to begin to pay dividends. Because there is no requirement to achieve a specific reserve ratio within a given timeframe, these provisions in effect establish a normal operating range for the reserve ratio of 1.15 percent to 1.35 percent within which the Board has considerable discretion to manage the size of the insurance fund.

### *Flexibility in managing the DIF as conditions change*

In setting the DRR, the Reform Act requires the Board to consider, among other factors, raising the DRR under more favorable economic conditions and lowering it under less favorable ones. The legislation also provides the Board with flexibility to manage the fund within a range, so that the Board, if it chooses, may respond to the current weak economy and challenging industry conditions by leaving the DRR unchanged but allowing a longer time for the insurance fund to reach this target. Either alternative would be consistent with the Reform Act objective of strengthening the Board's ability to avoid sharp increases in assessments sharply at a time of significant stress (subject, however, to restoration plan requirements). Based on staff's proposed assessment rate schedule, the DIF is expected to reach 1.26 percent by the end of 2013.

### **Balancing the Statutory Factors**

In staff's view, the best way to balance all of the statutory factors (including the "other factors" identified above) is to maintain the DRR at 1.25 percent. Higher expected losses to the fund could argue for targeting a higher reserve ratio. On the other hand, current unfavorable economic conditions could support a temporarily lower DRR. Balancing these factors with other factors that the Board may consider – recent and proposed changes to the assessment system, maintaining a DRR at the midpoint of the reserve ratio's normal operating range, the historical experience with a DRR of 1.25 percent, as well as the flexibility to manage the reserve ratio in response to changing conditions – would support maintaining the current DRR of 1.25 percent. Furthermore, a decision to change the DRR would be best deferred until after the objectives of the restoration plan are met.

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Attachments